Ratings Affirmed On Three Israeli Banks On Solid Domestic Economic Performance

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- Economic conditions for Israeli banks remain generally supportive, despite the global economic slowdown.
- We expect real estate price growth to continue, albeit at a slower pace compared with the past 12 months.
- We affirmed our ratings on Bank Hapoalim B.M. (BNHP), Bank Leumi le-Israel B.M. (Leumi), and Mizrahi Tefahot Bank Ltd. (Mizrahi).
- The outlook on BNHP and Leumi remains stable, and the outlook on Mizrahi remains positive.

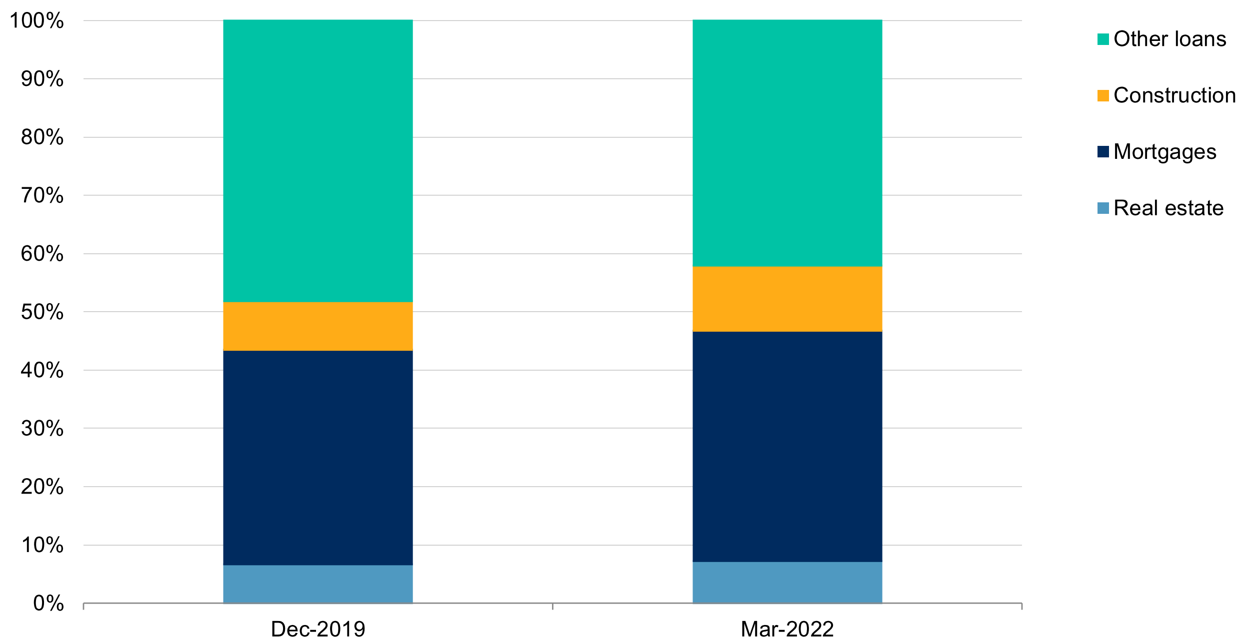
MILAN (S&P Global Ratings) July 20, 2022--S&P Global Ratings said today that it affirmed its 'A/A-1' long- and short-term issuer credit ratings on BNHP and Leumi and its 'A-/A-2' long- and short-term issuer credit ratings on Mizrahi. The outlook on BNHP and Leumi remains stable, and the outlook on Mizrahi remains positive.

Economic conditions remain supportive. Following strong performance in 2021, we expect the Israeli economy to remain broadly resilient, posting solid GDP growth of 5.5% in real terms, despite rising domestic inflation and the monetary policy tightening cycle of the Bank of Israel. However, the rebound after the peak of the COVID-19 pandemic and the very accommodative monetary policy have fueled real estate price growth, which has increased in real terms by about 10% over the past 12 months.

The banks' large exposure to the real estate sector poses some risks, but we expect them to remain contained. On the back of growing demand, Israeli banks expanded their lending books by about 14% last year. Most of the expansion occurred in real-estate-related lending, particularly mortgages and construction loans, where the sector has shown significant concentration. We continue to consider the commercial real estate sector as the most vulnerable. Offices and shopping malls have been resilient during the pandemic, but we still see a risk of oversupply in the office sector, particularly if the IT sector's demand were to slow significantly.

Chart 1

Israeli Real Estate Lending Has Increased In Recent Years



Fundamental demand driven by population growth and the limited supply side will continue pushing up prices and lending. However, we now expect the market to slow down as rising interest rates, higher inflation, and regulatory measures will weigh on lending expansion and price dynamics in 2022 and 2023. That said, we expect price dynamics to remain slightly above the pre-pandemic average of about 3%-4%, and we therefore foresee growing imbalances in the economy.

We think stringent regulation and the banking system's adequate lending and underwriting standards are mitigating risks stemming from the structural high exposure to the real estate sector. As such, we expect credit losses will gradually normalize to pre-pandemic levels of about 25 basis points (bps) by 2024 and we expect unsecured retail small and micro business lending to account for most of the credit losses.

Strong business momentum and higher interest rates will sustain Israeli banks' profitability and capitalization. Revenue will benefit from the strong lending growth observed over recent quarters, increasing interest rates, and a high amount of consumer price index-linked assets benefiting from rising inflation. That said, strong competition will dent margins. Branch closures and workforce reduction will continue helping banks to limit operating expenses increases, while banks continue investing in digitalization. Resilient profitability and financial flexibility to raise capital or cut dividends will help capitalization to stabilize over the next 12-24 months, in our view. This is despite the erosion of the capital buffer by strong lending growth, the resumption of dividend payments, and, to a lesser extent, asset repricing, following the peak of the pandemic.

Bank Hapoalim B.M.

The rating affirmation reflects our view of the bank's strong capitalization and the resilient economy where it operates. We expect the strong lending expansion experienced over the past 12-18 months--with the loan book expanding by about 19% since the end of 2020--to slow down in line with the sector and the loans to progress by about 6% per year on average by end-2024. We expect lending expansion and growing interest rates to support revenue. The bank reported that a parallel 100 bps interest rate increase would lift its net interest income (NII) by about 15% compared to 2021. Rising inflation will also contribute since a portion of the balance is linked to the consumer price index (CPI). Higher revenue will help absorb increasing costs and a gradual normalization of the cost of risk toward an average of 20 bps-25 bps per year in the next two years from about 102 bps cumulative release in 2021 and Q1 2022. As such, we expect our risk-adjusted capital (RAC) ratio to stay at about 10.3%-10.8% at end-2024 from 10.4% at end-2021. In our forecast, we factor in an approximate 35%-40% payout ratio over the next three years.

Although there are risks associated with the domestic large construction and real estate exposures, accounting for 20.9% of total domestic loans as of end-March 2022, we think the bank-controlled loan to value (LTV) and strong demand for residential housing, where about 51.7% of the corporate portfolio is concentrated, is containing the risks.

Outlook

The stable outlook on BNHP reflects our view that the bank's business, financial, and risk profiles will remain broadly stable over the next two years. We expect the bank's RAC ratio to remain above 10% in the medium term, with the nonperforming loan ratio remaining broadly in line with the system average, at about 1.5%-2.0% by 2024.

Downside scenario: Rating pressure could emerge if the Israeli economy, particularly the real estate sector, markedly deteriorated. Such weakening could stem from an abrupt readjustment of the local real estate market, economic stress amid the deteriorating global economic outlook, or a pronounced escalation in local geopolitical turbulence. Rating pressure could also emerge if higher-than-anticipated growth put pressure on capital or if we anticipated it could bring asset quality deterioration.

Upside scenario: Although unlikely during our two-year outlook period, we could upgrade BNHP if economic and operating conditions in Israel improved, in turn improving the bank's risk profile. This could happen if we observed lower concentration toward real estate sector and banks show better profitability than peers', for example.

Bank Leumi le-Israel B.M.

The rating affirmation reflects the resilient economy where the bank operates and its adequate financial flexibility. The bank recently completed an Israeli new shekel 2.7 billion capital increase, which supports our view of its strong capitalization. We also note that the bank's improving revenue generation will help it to improve its RAC ratio to about 10.4%-10.9% by end-2024 from 9.4% at end-2021. At the same time, we acknowledge that Leumi's capitalization is more volatile than peers', with a large portfolio of long-term securities valued at mark to market and large pension liabilities that do not perfectly offset each other when interest rates changes. We expect growing business, rising inflation, and growing interest rates to support revenue. Net interest income will benefit from about 8% of assets linked to CPI and a potential benefit (as estimated by the bank) of about 10.6% on its NII from a parallel 100 bps interest rate increase. Higher revenue will help absorb increasing costs, with the cost of risk gradually normalizing toward an average of 18 bps-23 bps per year until end-2024. We anticipate the bank will distribute about 40% of its net income over the next three years.

We expect the lending expansion to slow down after having expanded by about 18% since end-2020 on a gross basis, similar to peers. Most of the expansion was concentrated in the domestic construction and real estate segments, which have increased by about 45% since the end of 2020 and accounted for about 25.1% of total domestic loans as of end-March 2022. We note that there is risk associated with the real-estate-related exposures, but we acknowledge that a contained LTV is mitigating this risk.

Outlook

The stable outlook on Leumi reflects our view that the bank will be able to maintain strong capitalization, keeping its RAC ratio sustainably above 10% over the next two years, with asset quality metrics remaining broadly in line with the system average.

Downside scenario: Rating pressure could emerge if the Israeli economy, particularly the real estate sector, markedly deteriorated. Such weakening could stem from an abrupt readjustment of the local real estate market, an economic stress amid the deteriorating global economic outlook, or a pronounced escalation in local geopolitical turbulence. Furthermore, we could take a negative action if Leumi failed to sustain its capitalization. This could happen if the bank's growth, particularly in real estate-related lending, exceeded our expectation and put pressure on capital or risk profile.

Upside scenario: Although unlikely during our two-year outlook period, we could upgrade Leumi if economic and operating conditions in Israel improved, in turn improving the bank's risk profile. This could happen if we observed lower concentration toward real estate sector and banks show better profitability than peers', for example.

Mizrahi Tefahot Bank Ltd.

The rating affirmation reflects our view that the bank will continue to benefit from its leading position in mortgage lending and operate in a resilient economy. Ongoing integration of the recently acquired Union Bank, high lending growth, and a hike in interest rates and inflation are factors that will support the bank's 2025 profitability target of 14% return on equity and below 50% cost to income. The bank reported that a parallel 100bps interest rate increase would lift its NII by about 16.8% compared to 2021. Rising inflation will also contribute since about 18.6% of total assets are linked to CPI, providing additional upside. That said, following several quarters of pandemic-related provisions release, we expect cost of risk to increase above historical levels due to Mizrahi's ongoing and expected growth in the small and midsize enterprise and construction segments. In line with peers, the bank opportunistically grew its lending portfolio, particularly loans to the construction sector (by 20.8% in 2021 and 11.1% in Q1 2022). We anticipate that the bank's growth will lead to increased cost of risk. We therefore expect cost of risk to stand at about 20 bps in 2023, moderately below that of domestic peers as three-quarters of Mizrahi's lending book is retail. As such, we expect the RAC ratio to stay at about 10.5%-11.0% at end-2024 from

10.4% at end-2021. We anticipate the bank will distribute about 40% of its income.

Outlook

The positive outlook on Mizrahi reflects our expectation that the bank's creditworthiness will benefit from the ongoing integration of Union Bank, and that its business and financial profiles are set to improve with limited asset quality problems, with a strong capital buffer.

We could raise the ratings on the bank over the next 12-24 months if we concluded that Mizrahi could maintain its solid risk profile and strong capitalization while implementing its new strategic plan and successfully integrating Union Bank. An upgrade would hinge on the bank's accelerated growth in new segments and construction not bringing additional risks and remaining supportive of its overall capitalization.

We will monitor the evolution of asset quality, efficiency, and profitability metrics in comparison with higher-rated peers as Mizrahi starts realizing targeted cost synergies.

Downside scenario: We could revise the outlook to stable if the bank failed to maintain its solid risk profile, such that its asset-quality metrics weakened materially. This could happen if the anticipated fast growth led to higher credit losses than we currently expect, for example. An outlook revision could also stem from the bank failing to withstand competitive pressure in Israel and losing market share and revenue, to the detriment of its profitability.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Sector And Industry Variables For Banking Industry Country Risk Assessment Published For June 2022, June 28, 2022
- Research Update: Israel Ratings Affirmed At 'AA-/A-1+'; Outlook Stable, May 13, 2022
- Banking Industry Country Risk Assessment: Israel, Sept. 10, 2021

BICRA Score Snapshot*

Israel

	To	From
BICRA group	3	3
Economic risk	3	3
Economic resilience	Intermediate risk	Intermediate risk
Economic imbalances	Intermediate risk	Low risk
Credit risk in the economy	Low risk	Intermediate risk
Trend	Stable	Stable
Industry risk	4	4
Institutional framework	Intermediate risk	Intermediate risk
Competitive dynamics	High risk	High risk
Systemwide funding	Low risk	Low risk
Trend	Stable	Stable

Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores are on a scale from 1 (lowest risk) to 10 (highest risk). For more details on our BICRA scores on banking industries across the globe, please see "Banking Industry Country Risk Assessment Update," published monthly on RatingsDirect.

Ratings List

*** * * * * * * * * * * * * * Bank Hapoalim B.M. * * * * * * * * * * * * * ***	
Ratings Affirmed	
Bank Hapoalim B.M.	
Bank Hapoalim B.M. (New York branch)	
Issuer Credit Rating	A/Stable/A-1
Bank Hapoalim B.M.	
Junior Subordinated	BBB
*** * * * * * * * * * * * Bank Leumi le-Israel B.M. * * * * * * * * * * * ***	
Ratings Affirmed	
Bank Leumi le-Israel B.M.	
Issuer Credit Rating	A/Stable/A-1
Bank Leumi le-Israel B.M.	
Senior Unsecured	A
Junior Subordinated	BBB

* * * * * * * * * * * * Mizrahi Tefahot Bank Ltd. * * * * * * * * * * * *	
Ratings Affirmed	
Mizrahi Tefahot Bank Ltd.	
Issuer Credit Rating	A-/Positive/A-2
Mizrahi Tefahot Bank Ltd.	
Junior Subordinated	BBB-