MOODY'S INVESTORS SERVICE

CREDIT OPINION
28 May 2020

Update

Rate this Research

RATINGS

First International Bank of Israel

Domicile	Israel
Long Term CRR	A1
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Type	Senior Unsecured - Fgn Curr
Outlook	Not Assigned
Long Term Deposit	A2
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

Source: Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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First International Bank of Israel

Update to credit analysis

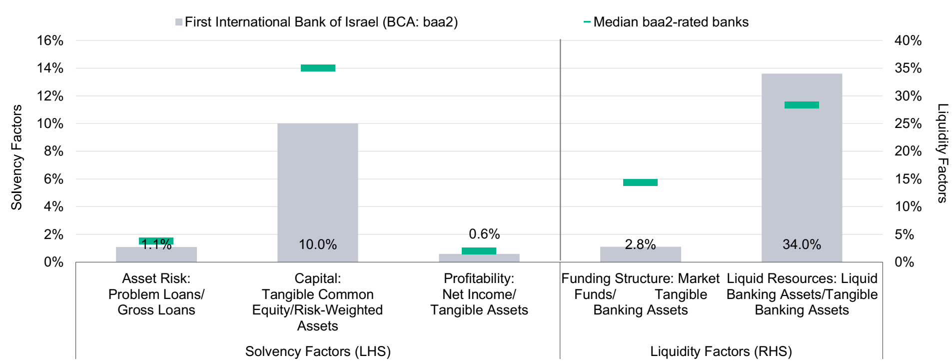
Summary

First International Bank of Israel (FIBI)'s A2 long-term deposit ratings reflect (1) the bank's baa2 Baseline Credit Assessment (BCA); and (2) three notches of rating uplift based on our assessment of a very high likelihood of support from the Government of Israel (A1 stable), in case of need.

FIBI's baa2 standalone BCA reflects the bank's (1) recently strong asset quality, with problem loans (defined as impaired loans and loans that are more than 90 days overdue) at 1.1% of gross loans as at the end of 2019; (2) a strong retail deposit base and comfortable liquidity; and (3) adequate capital buffers with a common equity tier 1 (CET1) ratio of 10.8% as at the end of 2019, which is nevertheless below similarly-rated international peers, mainly reflecting Bank of Israel's (BoI) more conservative risk weighting.

At the same time, the bank's BCA reflects downside risks from potential geopolitical tensions and a sharp correction in property prices. While the bank's profitability is modest, weighed down by relatively weak efficiency, management has successfully taken measures to both reduce costs and increase its revenue sources, resulting in improved efficiency and profitability. Despite continued focus on reducing costs, we expect the positive trend in profitability to halt in light of the coronavirus-induced economic disruption, which will exert pressure on the bank's asset quality and business volumes, and with the impact becoming more pronounced the longer the disruption lasts.

Exhibit 1
Rating Scorecard - Key financial ratios



These are our Banks Methodology scorecard ratios. Asset risk and profitability reflect the weaker of either the latest figure and the three-year and latest figure average. Capital is the latest reported figure. Funding structure and liquid resources reflect the latest fiscal year-end figures.
Source: Moody's Investors Service

Credit strengths

» Stable retail deposit base and strong liquidity

» Historically strong asset quality, and improved underwriting standards

» Strong presence in niche segments provides a stable customer base

» Very high likelihood of government support, in case of need, underpins the deposit ratings

Credit challenges

» Improving trend in profitability will halt in light of the coronavirus-induced economic fallout

» Modest risk-weighted capitalisation and leverage

» Asset quality will deteriorate; geopolitical tensions and high property prices remain a downside risk

Outlook

The stable outlook on the bank's long-term deposit ratings reflects our expectation that the bank's capitalisation will remain broadly unchanged against the expected deterioration in asset quality and profitability in the context of the current macroeconomic challenges.

Factors that could lead to an upgrade

» FIBI's ratings could be upgraded following (1) a sustained improvement in the bank's efficiency and profitability; and (2) materially stronger capitalisation and leverage.

Factors that could lead to a downgrade

» Downward pressure could be exerted on FIBI's ratings if a deterioration in operating conditions leads to a material weakening of asset quality and profitability, and therefore a reduction in the bank's capital.

» There could also be negative rating pressure if we consider that the government's willingness or capacity to provide support has materially declined.

Key indicators

Exhibit 2
First International Bank of Israel (Consolidated Financials) [1]

	12-19[2]	12-18[2]	12-17[2]	12-16[2]	12-15[2]	CAGR/Avg.[3]
Total Assets (ILS Million)	141,110.0	134,120.0	135,717.0	127,907.0	125,476.0	3.0[4]
Total Assets (USD Million)	40,854.1	35,892.2	39,092.9	33,234.3	32,247.3	6.1[4]
Tangible Common Equity (ILS Million)	8,252.0	7,863.0	7,467.0	7,079.0	6,821.0	4.9[4]
Tangible Common Equity (USD Million)	2,389.1	2,104.2	2,150.9	1,839.3	1,753.0	8.0[4]
Problem Loans / Gross Loans (%)	1.1	0.8	0.9	1.0	1.3	1.0[5]
Tangible Common Equity / Risk Weighted Assets (%)	10.0	9.8	9.5	9.1	8.9	9.5[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	10.4	8.1	9.3	10.2	13.1	10.2[5]
Net Interest Margin (%)	1.9	1.9	1.8	1.7	1.6	1.8[5]
PPI / Average RWA (%)	1.9	1.8	1.5	1.3	1.1	1.5[6]
Net Income / Tangible Assets (%)	0.7	0.6	0.5	0.4	0.4	0.5[5]
Cost / Income Ratio (%)	62.7	65.1	69.0	72.2	76.4	69.1[5]
Market Funds / Tangible Banking Assets (%)	2.8	2.8	2.9	2.8	3.8	3.0[5]
Liquid Banking Assets / Tangible Banking Assets (%)	34.0	33.2	36.9	35.2	37.6	35.4[5]
Gross Loans / Due to Customers (%)	74.6	76.2	71.5	74.1	71.4	73.6[5]

[1]All figures and ratios are adjusted using Moody's standard adjustments. [2]Basel III - fully loaded or transitional phase-in; LOCAL GAAP. [3]May include rounding differences because of the scale of reported amounts. [4]Compound annual growth rate (%) based on the periods for the latest accounting regime. [5]Simple average of periods for the latest accounting regime. [6]Simple average of Basel III periods.
Sources: Moody's Investors Service and company filings

Profile

FIBI is the fifth-largest banking group in Israel by assets with an 8.5% market share and total consolidated assets of NIS141 billion ($41 billion) as at the end of 2019. FIBI Holdings Ltd. owns a 48.3% stake in FIBI, with the Bino-Liberman Group in turn, owning 51.9% of the shares in FIBI Holdings Ltd. As a universal bank, FIBI provides banking services to individuals, small businesses, corporations and high net-worth clients. The bank also provides capital market, foreign currency, global trade and corporate finance services.

FIBI maintains a strong presence in specific niche retail segments, including the armed forces, teachers and the ultra-orthodox, as well as, in the capital market.

Recent developments

We have lowered our 2020-21 real GDP growth forecasts as the economic costs of the coronavirus crisis are accumulating rapidly. Even with a gradual recovery, we expect 2021 real GDP in most advanced economies to be below pre-coronavirus levels. Our forecasts assume that policy measures across advanced economies will continue to grow and be fine-tuned.

Nevertheless, we have maintained our stable outlook on Israel's banking system, for now. We expect an economic contraction in 2020, which will lead to an increase in problem loans and weigh on the banks' profitability. However, the deterioration in asset quality will be from strong levels, and will be mitigated by the relatively low private-sector debt and the comprehensive policy response from the authorities aiming to limit long-term damage to the economy. The economy's underlying strengths position it to recover strongly from the crisis, and we expect Israel's medium term growth potential will remain robust.

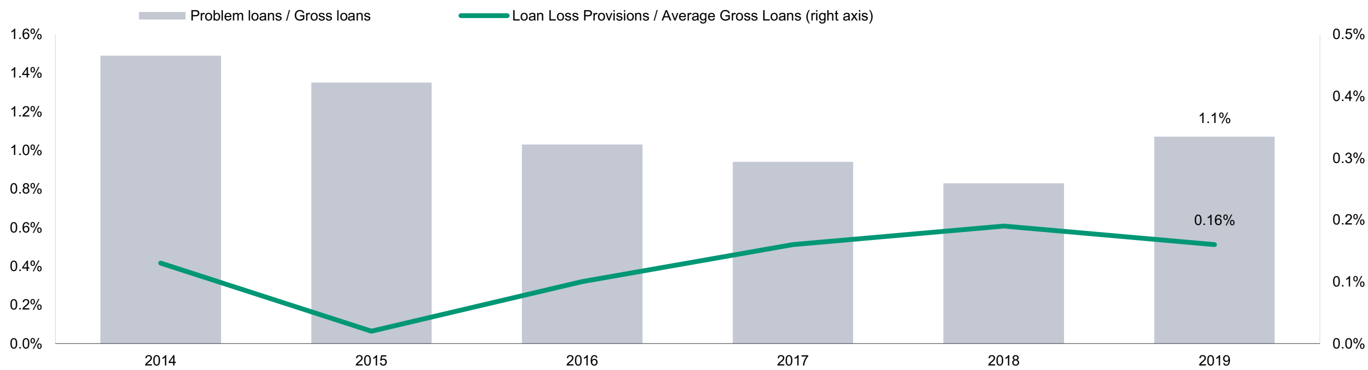
Detailed credit considerations

Asset quality will deteriorate from strong levels; geopolitical tensions and high property prices remain a downside risk

We expect problem loans and credit costs to increase in the coming quarters due to the coronavirus-induced economic disruption, but these will be from currently low levels and past through-the-cycle performance had been relatively strong, while underwriting standards have gradually improved. The full extent of the asset quality deterioration will, however, depend on how large the economic fallout will be, and whether higher unemployment persists into 2021. We also see elevated asset risks from potential geopolitical tensions and exposure to the real estate market along with high property prices.

Problem loans had stabilised at low levels in recent years, reflecting Israel's supportive macro-economic environment. As at the end of 2019, the bank reported problem loans of 1.1% of gross loans (see Exhibit 3). Provisioning reserves as a percentage of gross loans stood at 1.0%, implying a problem loan coverage ratio of 97%. In 2019, the bank reported provisioning charges equivalent to 0.16% of gross loans. This compares with an average of 0.39% during the period 2006-2009 and an average of 0.14% for 2010-2018. FIBI demonstrated a stronger asset quality performance through a complete cycle than most of its peers, with lower average credit costs.

Exhibit 3
FIBI's asset quality has been strong, but will deteriorate due to the economic fallout



Sources: Bank's financial statements, Moody's Investors Service

However, the weakening credit conditions and increase in unemployment from historically low levels will lead to a deterioration in the bank's asset quality. The immediate impact will be mitigated by government support measures and payment holidays, while we also note that in recent years, FIBI had tightened its underwriting standards for sectors sensitive to economic change and reduced credit concentrations. Exposures to the top 20 borrower groups were down to less than 10% of total loans and no exposure exceeded 15% of the bank's capital as at the end of 2019.

Mortgages accounted for 29% of total loans, while medium and large businesses for 28% as of the end of 2019. Small businesses could be hardest hit by the economic disruption, and the bank's exposure made up 18% of total credit. Other retail and consumer loans were 25% of total, but a significant portion of the unsecured retail portfolio is salary-assigned.

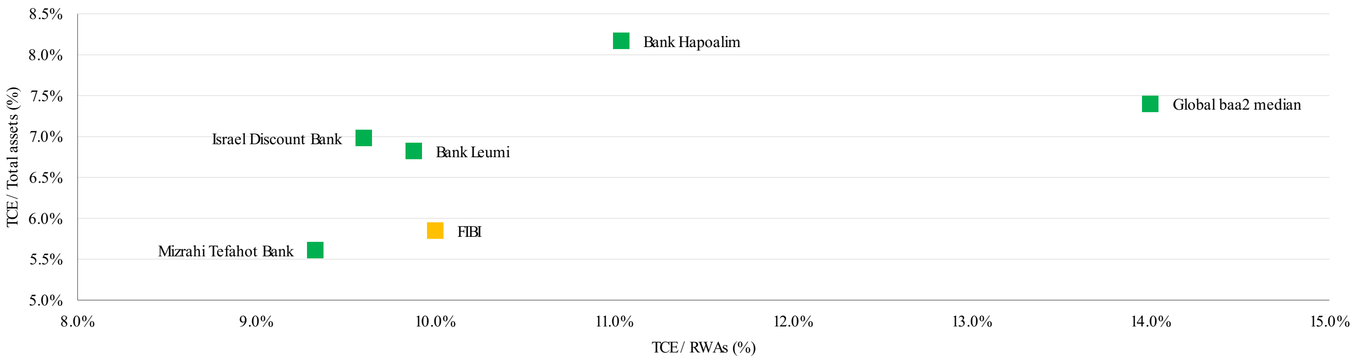
FIBI's asset quality, similarly to other Israeli banks, remains vulnerable to persistent geopolitical tensions that could compromise business confidence and economic activity. In addition, FIBI is exposed to the Israeli real estate market through its lending activities. In addition to the housing mortgage exposure mentioned above, construction and real estate made up a further 12% of total lending as of the end of 2019, High house prices combined with reduced consumer affordability expose banks to a potential house price correction, along with unexpectedly higher interest rates and a rise in unemployment. Risks are nonetheless mitigated by a number of macro-prudential measures and higher capital buffers against mortgages.[1] Although we expect the current crisis to cool the housing market, a structurally limited supply of new housing units can provide some price support. Nevertheless, we see risks in the office space market and commercial real estate retail, such as shopping malls and retail, from the fallout of coronavirus pandemic.

Modest risk-weighted capitalisation and leverage

We view FIBI's risk-weighted capitalisation and leverage as modest. However, FIBI's loss-absorption buffers are supported by relatively conservative regulatory risk-weights, especially on mortgage lending. Also, we expect the bank's capital buffers to remain broadly stable despite the negative impact of the pandemic on the bank's profitability, supported by the temporary suspension of dividend payments.

FIBI reported a CET1 ratio of 10.8% as at the end of 2019, exceeding the minimum regulatory requirement of 9.3% by 150 basis points. The bank's Basel III leverage ratio was 5.8%, at the same level as its tangible common equity (TCE)-to-total assets ratio. Our own TCE/risk-weighted assets (RWAs) ratio was 10.0% at the end of 2019, below that of similarly-rated international peers (see Exhibit 4). However, we recognise that BoI maintains a more conservative regulatory framework, which results in much higher RWAs. For example, the average risk weighting on mortgage lending is over 50% in Israel, against much lower risk weights applied by banks using the internal ratings-based approach and even the 35% used in the standardised approach.

Exhibit 4
FIBI's capitalisation against domestic and global peers



Note: Israeli banks are as the end of 2019
Source: Banks' financial statements; Moody's Investors Service

In light of the prospect of a significant weakening in economic activity, the BoI decided to lower banks' capital requirements by 1 percentage point for a period of six months (with the possibility of an extension by an additional six months) in order to support the provision of credit to the real economy. Following this period, banks will be required to replenish capital, in case it is reduced, over a period of two years. At the same time, in line with the BoI's recommendation, FIBI announced that it will not distribute dividends for 2019 profits. As a result, we expect the bank's capital levels to remain broadly stable.

Improving trend in profitability will halt

FIBI exhibits modest profitability, primarily affected by the high tax rate (of 34%), the low interest rate environment and high, although declining, cost base. Cost-to-income was 63% in 2019 and operating expenses accounted for 1.8% of assets.

Management's ongoing initiatives to improve cost efficiency by reducing headcount, optimising the branch network and reducing real estate space have been successful, consistently improving the bank's cost-to-income ratio from a recent peak of 76% in 2015. Over the period 2014-2019, the bank reduced personnel numbers by 20% to 4,150, with a corresponding reduction in 2019 of 5% following the completion of an early retirement plan, and the number of branches by 16% to 151. FIBI's digital initiatives and the merger within FIBI of its subsidiaries UBank, PAGI and more recently Otsar-Hahayal are further examples of its streamlining efforts.

FIBI's strong presence in niche markets, which include capital markets activity and teachers, armed forces and religious segments, coupled with high customer satisfaction, have resulted in consistent credit and revenue growth in recent years. As a result of the above efficiency measures and the bank's consistent loan growth (compound annual growth rate of 5% over 2014-19), particularly in the retail sector, the bank's profitability improved, with net income accounting for 0.7% of tangible assets in 2019 (2015: 0.4%).

However, these profitability improvements will halt in light of the deterioration in the operating environment, which will lead to a rise in credit costs and stalled new business. The sustained low interest rate environment (with rates recently reduced to 0.1%) coupled with lower loan growth and low CPI will also pressure the bank's margins. The extent to which the bank continues to successfully bring down operating costs will provide a mitigant against these pressures.

Stable retail deposit funding base and strong liquidity

FIBI exhibits a sound funding profile, supported by a large and stable customer deposit base in light of Israel's strong savings culture, which comfortably funds its loan portfolio. FIBI's gross loans-to-deposits ratio stood at 75% as at the end of 2019. The bank is a net lender in the interbank market and has a low reliance on potentially more confidence-sensitive market funding. FIBI's deposit base has proven to be stable during past shocks in Israel. We note however, that our assessment also considers that 21% of total deposits as of the end of 2019 were sourced from institutional and capital markets investors that would be more vulnerable to a loss in depositor confidence.

Overall, the bank also maintains a strong level of liquidity, with a liquid assets ratio of 34%, underpinned by prudent liquidity management. The bank's liquid assets portfolio is also conservatively structured, with 27% of total assets invested in cash and deposits with banks, and 8% invested in `securities' of which around 58% is to A1-rated Israeli government securities. FIBI reported a Liquidity Coverage Ratio of 128% as at the end of 2019.

Source of facts and figures cited in this report

Unless noted otherwise, we have sourced data relating to system-wide trends and market shares from the central bank. Bank specific figures originate from banks' reports and adjusted for analytical purposes. Please refer to the document Financial Statement Adjustments in the Analysis of Financial Institutions published on 9 August 2018.

ESG considerations

In line with our general view for the banking sector, FIBI has a low exposure to Environmental risks, see our Environmental risks heat map for further information. Although Israel is exposed to environmental risk through rising temperatures, drought episodes and water scarcity given its geographical location in a semiarid climate zone, the authorities have taken a number of steps to address these risks, including through seawater desalination and wastewater recycling.

Overall, we believe banks, including FIBI, face moderate Social risks, see our Social risks heat map. The most relevant social risks for banks arise from the way they interact with their customers. Social risks are particularly high in the area of data security and customer privacy which is partly mitigated by sizeable technology investments and banks' long track record of handling sensitive client data. Fines and reputational damage due to product misselling or other types of misconduct is a further social risk. Societal trends are also relevant in a number of areas, such as shifting customer preferences towards digital banking services, increasing information technology cost, aging population concerns in several countries, impacting demand for financial services or socially driven policy agendas that may translate into regulation that affects banks' revenue base. In Israel, authorities are taking measures to promote competition in the banking system, which will weigh on the banks' profitability. We also regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety.

Governance is highly relevant for FIBI, as it is to all players in the banking industry. Corporate governance weaknesses can lead to a deterioration in a company's credit quality, while governance strengths can benefit its credit profile. Governance risks are largely internal rather than externally driven, and for FIBI we do not currently have specific governance concerns. Nonetheless corporate governance remains a key credit consideration and requires ongoing monitoring.

Support and structural considerations

Government support considerations

We believe there is a very high likelihood of government support for FIBI's rated deposits, reflecting the Israeli government's past practice of injecting capital into systemically-important banks in case of need. This will also likely be the case for FIBI given its 9.2% market share of deposits and hence material systemic consequences of an unsupported failure. We thus incorporate three notches of government support uplift into our deposit ratings, rating them at A2.

While a revised resolution framework is also under way in Israel, we expect it will exclude bail-in features for banks' depositors and other senior creditors. Instead, the revised framework will likely focus on early intervention adding to the tools the Bank of Israel has available to restore ailing banks.

Counteparty Risk Ratings

Counterparty Risk Ratings (CRRs) are opinions of the ability of entities to honour the uncollateralised portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honoured. CRRs are distinct from ratings assigned to senior unsecured debt instruments and from issuer ratings because they reflect that, in a resolution, CRR liabilities might benefit from preferential treatment compared with senior unsecured debt. Examples of CRR liabilities include the uncollateralised portion of payables arising from derivatives transactions and the uncollateralised portion of liabilities under sale and repurchase agreements.

FIBI's CRR is placed at A1/Prime-1

We consider Israel a jurisdiction with a non-operational resolution (non-ORR) regime. For non-ORR countries, the starting point for the CRR is one notch above the bank's Adjusted BCA (of baa2), to which we then typically add the same (three) notches of government support uplift as applied to deposit ratings.

FIBI's Counterparty Risk (CR) Assessment is positioned at A1(cr)/Prime-1(cr), as the approach to reaching this assessment is identical to that for the CRR.

Methodology and scorecard

About Moody's bank scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity

Rating methodology and scorecard factors

Exhibit 5

First International Bank of Israel

Macro Factors							
Weighted Macro Profile	**Strong**	**100%**					
Factor	**Historic Ratio**	**Initial Score**	**Expected Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**	
Solvency							
Asset Risk							
Problem Loans / Gross Loans	1.1%	a1	↓	baa1	Sector concentration	Expected trend	
Capital							
Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in)	10.0%	baa3	←→	ba1	Nominal leverage		
Profitability							
Net Income / Tangible Assets	0.6%	baa3	↓	ba1	Expected trend		
Combined Solvency Score		baa1		baa3			
Liquidity							
Funding Structure							
Market Funds / Tangible Banking Assets	2.8%	aa2	←→	a2	Deposit quality		
Liquid Resources							
Liquid Banking Assets / Tangible Banking Assets	34.0%	a3	←→	a3	Stock of liquid assets		
Combined Liquidity Score		a1		a2			
Financial Profile				baa2			
Qualitative Adjustments				Adjustment			
Business Diversification				0			
Opacity and Complexity				0			
Corporate Behavior				0			
Total Qualitative Adjustments				0			
Sovereign or Affiliate constraint				A1			
BCA Scorecard-indicated Outcome - Range				baa1 - baa3			
Assigned BCA				baa2			
Affiliate Support notching				0			
Adjusted BCA				baa2			

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency Rating**	**Foreign Currency Rating**
Counterparty Risk Rating	1	0	baa1	3	A1	A1
Counterparty Risk Assessment	1	0	baa1 (cr)	3	A1(cr)	
Deposits	0	0	baa2	3	A2	A2

[1]Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

Source: Moody's Investors Service

Ratings

Exhibit 6

Category	Moody's Rating
FIRST INTERNATIONAL BANK OF ISRAEL	
Outlook	Stable
Counterparty Risk Rating	A1/P-1
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Counterparty Risk Assessment	A1(cr)/P-1(cr)

Source: Moody's Investors Service

Endnotes

1 The measures include loan-to-value limits, a monthly repayment cap at 40% of a borrower's month salary and limit on the variable-rate of interest part of the mortgage.

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