Banking Industry Country Risk Assessment: Israel

November 26, 2018

Banking Industry Country Risk Assessment Group	4		
4 Economic Risk		**4 Industry Risk**	
Economic resilience	Intermediate Risk	Institutional framework	Intermediate Risk
Economic imbalances	Intermediate Risk	Competitive dynamics	High Risk
Credit risk in the economy	Intermediate Risk	System wide funding	Low Risk

Government Support:

Supportive

Major Factors

Strengths:	Weaknesses:
- Limited number of banks with a stable customer franchise.	- Sensitive to risks emanating from geopolitics and wealth inequality.
- Stable funding from a sound core customer deposit base.	- Industry efficiency levels, although improving, still lag global peers'.
- Adequate banking regulation and supervision.	- Elevated exposure to local real estate sector.

Rationale

S&P Global Ratings classifies the banking sector of Israel (AA-/Stable/A-1+) in group '4' under its Banking Industry Country Risk Assessment (BICRA). Other countries in group '4' are Spain, Mexico, New Zealand, Malaysia, Iceland, Saudi Arabia, and Estonia (see chart 1).

We use our BICRA economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for banks operating only in Israel is 'bbb'.

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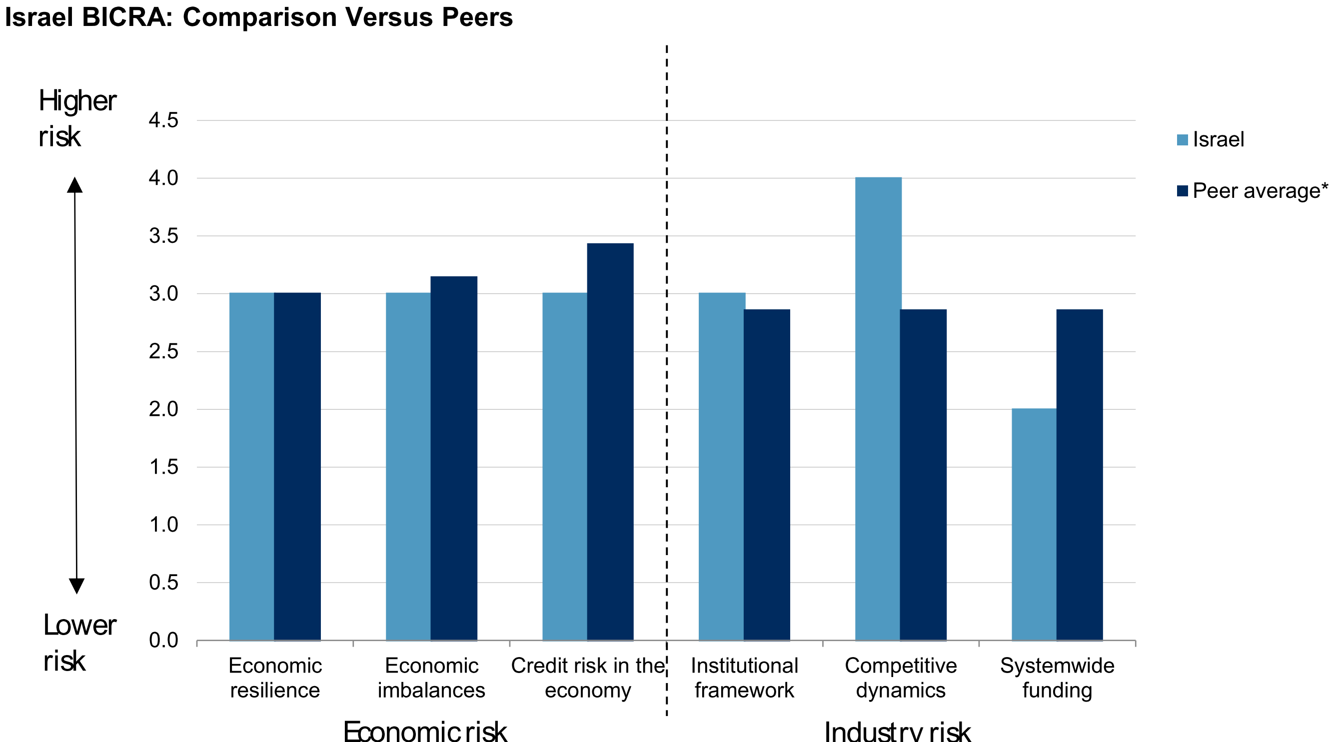
Chart 1



*Peers are Estonia, Malaysia, Mexico, New Zealand, Saudi Arabia, Spain and Iceland. Assessments as of Oct. 11, 2018. Source: S&P Global Ratings, Financial Institutions.

Over the past decade, Israel's sustained economic growth and strong currency have boosted GDP per capita to over $40,000. The debt burden is relatively stable and evenly balanced between the various economic sectors, following years of corporate and government deleveraging coupled with a rise in household debt from a low base. Israel's external fundamentals remain strong with a positive current account and an improving net creditor position. As a small, open economy in the Middle East, Israel remains vulnerable to geopolitical shocks and a rise in global protectionist sentiment.

Large property-related exposures pose a key risk for banks. Lending to construction, commercial real estate, and for mortgages now accounts for about 47% of total bank loans, having risen from 32% in 2006 thanks to booming property prices. Israeli banks' historically high single-name corporate borrower concentration has declined markedly. Holding company structures are gradually being dismantled and large corporations have deleveraged and now increasingly tap nonbank funding sources. Israeli households' financial strength, in aggregate, masks wide disparities in wealth, income, and skills.

The banking system is highly concentrated and barriers to entry are high. The system is well regulated and conservatively funded by core domestic deposits. This has helped Israeli banks deliver consistent and stable profits since 2009, notwithstanding fierce ongoing competition from the bond market and institutional investors for market share in corporate lending. We classify the Israeli government as supportive, reflecting our view that it would likely be willing and able to provide extraordinary support to the banking system in times of crisis.

Economic And Industry Risk Trends

We view the economic risk trend in Israel as positive. It reflects Israel's consistent economic growth, sustained low unemployment, and high and increasing levels of GDP per capita, while also taking into account decreasing levels of corporate leverage. Our view of Israel's economic risk is somewhat mitigated by uncertainties in the housing market. A combination of macro-prudential measures and government-driven supply-side initiatives in the housing market has led to a deceleration of both house price inflation and property-directed lending over the past year, but also to a shortage in housing building starts, which could result in negative consequences since demand remains strong. If this continues we could see housing prices rising again because demand is unlikely to decrease.

We view the Israeli banking industry risk trend as stable. Attempts are being made to spur competition in the retail and small and midsize enterprise (SME) segments, where a handful of large banks maintain a dominant position. The two largest banks are in the process of divesting their credit card operations, but it is still too early to predict how the competitive landscape will evolve. Nevertheless, in our view, institutional checks and balances should ensure relative stability, provided populist legislative initiatives do not deprive the Bank of Israel (BoI) of its holistic oversight of the banking system. Banks are addressing historically poor efficiency levels by embracing digitization, closing branches, and reducing headcount as they move to adjust to a permanently low-interest-rate environment, financial-technology (fin-tech) disruption, and widening nonbank competition.

4 Economic Risk

The key factors that support our assessment of economic risk in Israel's banking sector are the country's high income level, sustained economic growth, and overall moderate leverage levels. These factors are mitigated by domestic vulnerabilities attributed to an erratic housing market and a wide disparity of wealth and skills, coupled with geopolitical risks.

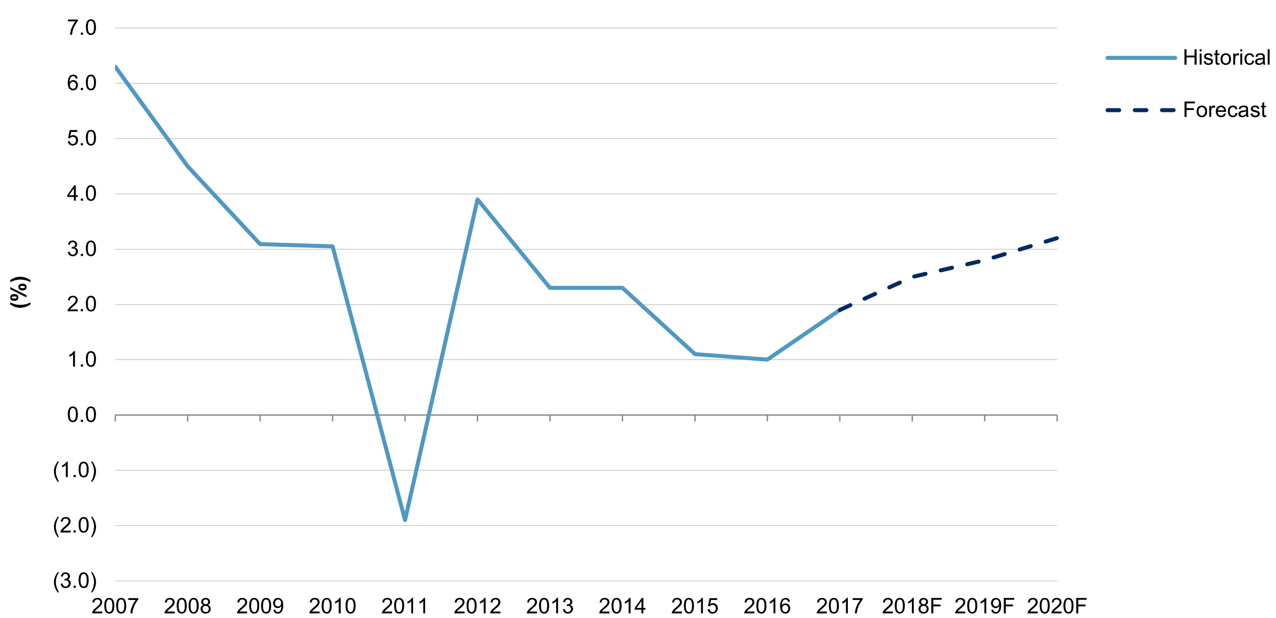
Economic resilience: High income country with sustained economic growth grappling with elevated property prices and inequality

Economic structure and stability. Israel's economy continues to thrive and benefit from diversification, with high-value-added manufacturing and services sectors, especially in the information technology industry. The information and communication sector contributes almost 10% of the total gross value added and scientific and technical activities contribute about 3%. Growth is underpinned by sizable expenditures for research and development, exceeding 4.5% of GDP on average, which is the highest among member countries of the Organization for Economic Co-operation and Development.

We assume Israel's economy will expand by about 3.3% on average over 2018-2021. Growth will stem from private consumption on the back of a strong labor market, continued corporate investment activity (not least in the hi-tech sector), and robust performance of services exports, supported by a global economic upswing. In U.S. dollar per capita terms, this equates to somewhat slower growth of 1.4% per year, reflecting continued population growth. We note that the projected growth comes on top of Israel's already vigorous economic performance since the 2008 global financial crisis. For example, GDP in U.S. dollar terms has increased by over 50% compared with 2010, and the unemployment rate is at historical lows. With the Leviathan natural gas project coming fully online in the next few years, growth might benefit from an additional boost, although this isnot yet reflected in our projections.

Chart 2

Israel -- Annual Real GDP Growth Rate



Macroeconomic policy flexibility. Exceptionally favorable macroeconomic conditions have supported Israel's public finance in recent years. The general government's fiscal deficit shrank to about 2.2% of GDP on average in 2015-2017 from an average of 3.3% over 2010-2014, while central government deficits averaged 2.1% and 3.3% for the same periods respectively. Fiscal results were again strong in 2017, with the deficit at an estimated 2.0% of GDP against the government's target of 2.9%.

Solid economic growth should enable the government to compensate for recent pro-cyclical tax cuts, including on personal and corporate income taxes, and to accommodate expenditure pressures from health care and education. We also believe that any new material spending proposals, for example, those related to the recently announced goal of enhancing public infrastructure (i.e. long-term national infrastructure strategy), will unlikely compromise fiscal stability. This is mainly thanks to the state's demonstrated commitment to, and the existing political consensus on containing public debt.

Strong export performance, especially booming high-value-added services exports, and the ongoing development of Israel's offshore natural gas fields, with its significant export capacity, support the country's strong external profile. This will enhance Israel's position as a net creditor versus the rest of the world, with liquid external assets exceeding gross external debt by over 50% of current account payments over our two year forecast horizon. These dynamics also contain the country's gross external financing needs (payments to nonresidents), indicating low dependence on external financing.

In addition, we consider Israel's monetary policy flexibility a credit strength. BoI has been intervening in foreign exchange markets, over and above its commitment to purchase foreign currency to offset the impact of domestic natural gas production on the balance of payments. We view the exchange rate regime as a managed float, which somewhat hampers monetary policy flexibility, in our view.

Political risk. Israel is exposed to persistent geopolitical risks. We note continued divergence between the U.S. and other stakeholders (notably the EU) with regards to the peace process with Palestinian authorities, especially after the U.S. moved its embassy to Jerusalem. This might lead to outbreaks of violence in Gaza and surrounding areas, triggering a backlash from the international community. At the same time, we note that geopolitical security risks, although still high, have somewhat moderated. The conflict in Syria, Israel's neighbor on the northern border, has so far had no spillover effect. This could be tied to the weakening of Hezbollah due to its active involvement in the Syrian civil war, which will likely undermine its willingness to challenge Israel in the next few years. Further moderating risks is the U.S administration's apparent commitment to supporting Israel if security risks escalate. Nevertheless, any significant armed conflict could adversely affect the ratings on Israel, since it would likely deter investment, weaken economic growth potential, or result in budgetary pressures.

Table 1

BICRA Israel--Economic Resilience

	--Year ending Dec. 31--				
	2014	2015	2016	2017	2018 F
Nominal GDP (bil. $)	310.0	300.5	319.4	353.3	378.6
Per capita GDP ($)	37,734.5	35,855.3	37,371.6	40,530.1	42,627.7
Real GDP growth (%)	3.9	2.6	4.0	3.5	3.6
Inflation (CPI) rate (%)	0.5	(0.6)	(0.5)	0.2	1.0
Monetary policy steering rate (%)	0.3	0.1	0.1	0.1	0.1
Net general government debt as % of GDP	63.4	61.0	59.1	57.4	57.0

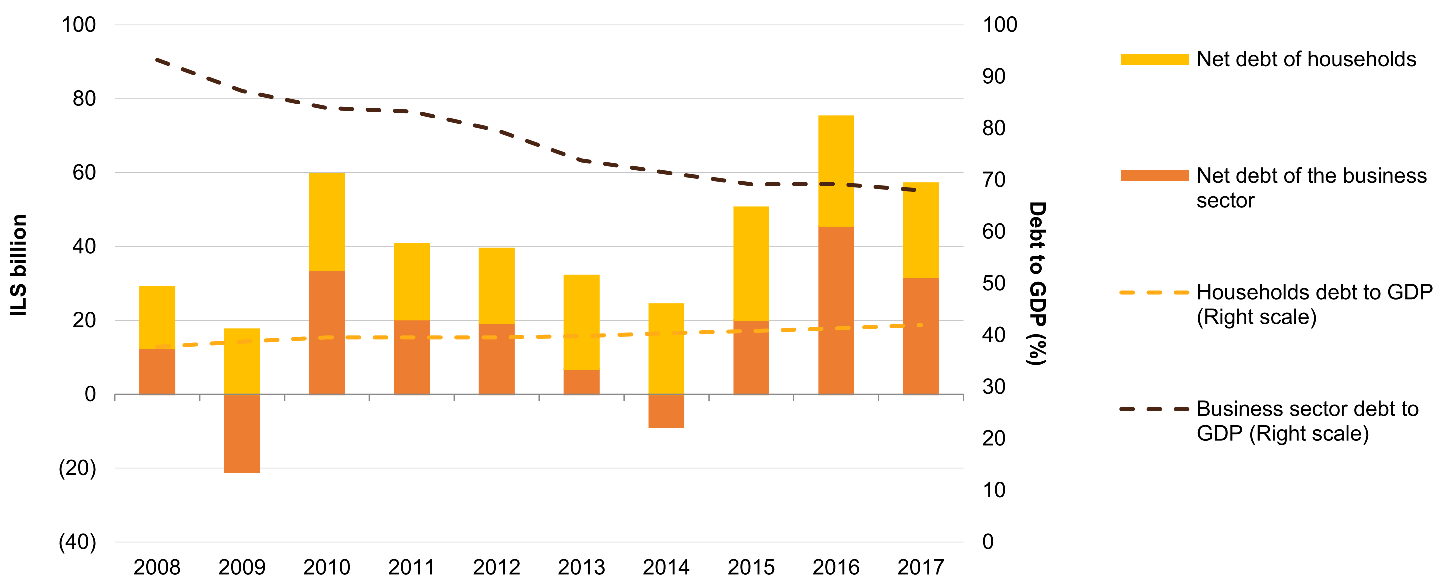
Economic imbalances:Housing market is cooling but underlying pressure remains high

Expansionary phase. The Israeli economy remains in an expansionary phase. We expect the economy will achieve real GDP growth of 3.3% on average over 2018-2021. Housing prices have increased by an annual average of 4.9% in the past four years (2013-2017) in real terms. There has been a slowdown in housing price increases in the last 12 months, and prices even declined between the third quarter of 2017 and the second quarter of 2018. However, an increase in housing prices has resumed and we believe it will continue in the future on the back of strong fundamental demand.

Private sector credit growth. Private sector credit is expected to increase by 5.0%-5.5% annually in the next few year, in line with GDP growth. In recent years, household credit has increased by high-single digits, while corporates have deleveraged. We now expect credit growth will be more evenly distributed between the corporate, household, and SME sectors, although we expect household credit growth will still outpace that of the business sector.

Chart 3

Estimated Annual Change in Nonfinancial Private Sector Debt, 2008–2017



Source: Bank of Israel. ILS--Israeli New Shekel.

Beginning in 2011, the BoI began phasing in several macro-prudential measures aimed at reducing systemic risks in banks' mortgage books. These include increasing banks' regulatory capital requirements, and limiting mortgage loans' loan-to-value (LTV) and payment-to-income ratios, as well as the floating rate portion of new loans. This has already improved the underwriting quality of new mortgages and has led to an increase in credit spreads on new mortgages over the past two years. Higher mortgage rates, coupled with government supply side reforms that have reduced prices for first time buyers, have slowed new mortgage production.

We expect corporates will begin to show some renewed appetite for re-leveraging, since corporates' debt to GDP has declined to less than 70%, from cyclical highs of almost 100% in 2007. We have also seen a strong pick up in new listings on the Tel Aviv stock exchange, and we expect some of these new companies will use debt to expand their activities. While competition from the nonbank lenders and the bond market is intense, we expect banks will find selective opportunities to write new corporate loans.

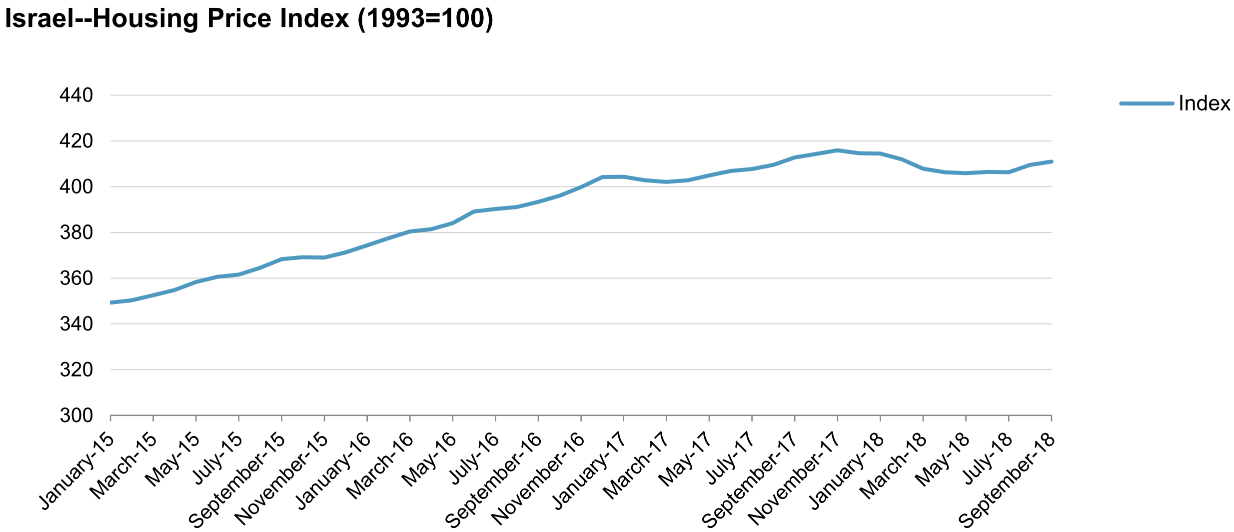
Real estate prices. Housing prices have become erratic and in the past two years, which makes it difficult to predict their future direction. After years of strong growth, with prices doubling since 2008, the increase of prices has slowed, with prices declining for three consecutive quarters between the third quarter of 2017 and the second quarter of 2018. Since then, prices have recovered and we expect annual appreciation of 2%-5% from 2019, given expected pressure from housing supply shortages. Low albeit increasing interest rates and economic and population growth continue to create underlying demand for housing and will support moderate prices increases in the near future, in our view.

The government has implemented a comprehensive set of measures to address supply-side issues, including freeing up more land for development, changing the tendering criteria to give first-time buyers a discounted market price (the Buyers' Price program), and speeding up the administrative process for construction permissions. These measures are not expected to address the supply shortage in the near term, given capacity constraints in the construction industry and increased demand stemming from population growth.

However, by removing most of the first-time buyers from the general property market, the program appears to have moderated house price inflation and led to a sharp slowdown in new home sales for non-Buyers' Price projects. Given Buyers' Price projects' long lead time, we have seen a sharp decline in housing starts and completions, which are now below previous levels. Construction starts remained at 50,000 new units per year, the estimated level required to maintain market equilibrium, but the housing start slowdown could accelerate if investors' appetite remains moderate. This shortfall risks re-igniting house price inflation. Our base-case scenario excludes the possibility that the government has overestimated the latent demand for housing and that we could head toward a stronger correction in the housing market.

There is very limited official data on national trends in commercial real estate prices. However, according to data disclosed by publicly listed property owners, this sector appears relatively healthy. Concerns about office building oversupply have dissipated thanks to a very strong uptake of leases, especially by global technology firms using Israel as an research and development hub. However, shopping malls seems to be feeling more pressure because retailers are suffering from the impact of internet retailing, and some cities seem oversupplied with retail space.

Chart 4



Source: Central Bureau of Statistics.

Equity prices. Banks have very little direct equity exposure. The Tel Aviv Stock Exchange 35 Index benchmark index is heavily weighted to the generic pharmaceuticals industry, which has been suffering from adverse business conditions. Over the last months, the index has slightly rebounded and is expected to perform well in 2018.

Current account and external debt position. Israel's external fundamentals remain strong, as it continues to expand its net creditor position versus the rest of the world. The current account was positive at 3% of GDP in 2017, and is projected to remain quite stable over 2017-2019.

BICRA Israel--Economic Imbalances

Table 2

	--Year ending Dec. 31--				
	2014	**2015**	**2016**	**2017**	**2018f**
Annual change in claims of resident depository institutions in the resident nongovernment sector in % points of GDP	(0.1)	(2.1)	(1.5)	0.3	(0.1)
Annual change in key index for national residential house prices (real) (%)	3.8	8.5	6.2	1.2	0.0
Annual change in inflation-adjusted equity prices (%)	9.7	5.0	(3.2)	2.4	8.3
Current account balance/GDP	3.8	5.1	3.7	2.9	2.9
Net external debt / GDP (%)	(38.4)	(41.8)	(42.8)	(47.1)	(50.4)

f--forecast.

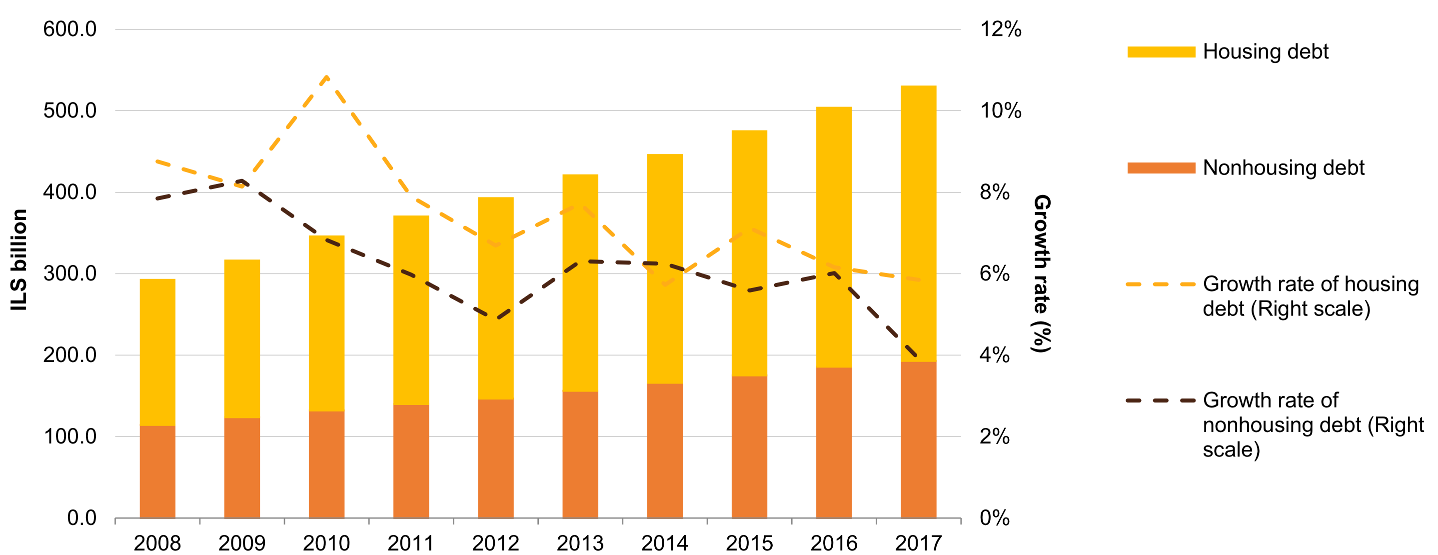
Credit risk in the economy: Moderate level of corporate and household leverage

Private-sector debt capacity and leverage. Israeli corporates have undergone a decade of deleveraging, with corporate debt to GDP declining to 68% from a high of almost 100% in 2007. The decline in leverage has been accompanied by a gradual unwinding of holding company structures and a number of debt restructurings involving bondholders and banks writing off debt or exchanging debt for equity. We believe that this deleveraging has largely run its course. While corporate debt to GDP is still elevated relative to household and government debt levels, we note some structural features that support debt capacity at these current leverage levels. Firstly, Israeli real estate companies make up a large portion of the corporate borrowers, and commercial real estate is typically more heavily debt financed than average for the corporate sector. Secondly, many Israeli corporates, including real estate companies, have very large exposures to markets outside of Israel. Corporates are therefore less reliant on the local asset base and economy in order to service debt.

Despite the run-up in household debt since 2009, leverage remains relatively low. Household debt to GDP stood at 42% at the end of 2017, decidedly modest compared with that of many advanced economies. Nevertheless, wide disparities in wealth and relatively modest levels of government social transfers leads us to suspect that the debt capacity of Israeli households (particularly mid-to-low income borrowers) is more constrained than for countries with a broader social welfare infrastructure.

Chart 5

Outstanding Household Debt, Housing And Nonhousing, And Its Yearly Growth Rate



Source: Bank of Israel. ILS-Israeli New Shekel.

Lending and underwriting standards. In our view, lending and underwriting standards in Israel still weigh on our assessment of credit risk. This assessment is underpinned by large sectoral exposures to the cyclical property sector and to mortgages, which together accounted for about 45% of bank lending at the end of 2017. Positively, we note that since the gradual demise of holding company structures, single-borrower concentration has reduced and is now more in line with that of peers. At the loan level, credit standards and lending practices appear more conservative than most global peers, demonstrated by a sustained and declining trend of the peak provisioning level, associated with episodes of economic and credit stress in the economy.

The outstanding amount of mortgage loans has increased significantly in recent years. However, in our view the macro-prudential measures adopted by the BoI have ensured that the quality of the mortgage loan book is high. The BoI monitors and publishes monthly data on the mortgage market. The value of housing loans with an LTV ratio of over 75% is negligible. The amount of new mortgages granted with a LTV ratio of 60%-75% has fluctuated between 27%-34%, with the balance being made up of with LTV ratios below 60%. We also note that to enable first-buyers to acquire real estate and in light of high housing prices, the government is reportedly considering raising mortgages worth up to 90% of the value of the house first-buyers are purchasing.

With tight lending standards in force with respect to mortgages, it is not surprising that credit risk in the household sector has migrated to unsecured personal loans and car loans. Most banks have reported a modest uptick in provisions on unsecured personal loans. Additionally, the new insolvency law could hinder the collection process and increase the level of write-offs. The BoI has become sufficiently concerned about the growth in motor-vehicle financing to release prudential guidelines addressing best practice risk management and underwriting standards.

Given its higher leverage, the corporate sector's financial profile is weaker, which has occasionally led to large write-offs in the past. However, corporate deleveraging and a reduction in large single-borrower exposures are positive developments and align Israel more with peers with advanced economies. The gradual elimination of holding company structures has driven leveraged lending down to Israeli new shekel (ILS) 15 billion, or approximately 1.7% of total bank credit. Despite the improving trends, however, the constraints of Israel's small economy mean a degree of higher concentration within the corporate sector is inevitable compared with banks operating in larger, more diverse economies.

Payment culture and rule of law. We view the payment culture and rule of law in Israel as at least moderately strong. We base our opinion on the World Bank's 2016 governance indicators for Israel, averaging an 81 percentile ranking for the "rule of law" and "control of corruption", although we do note the increase in the number of high-profile corruption investigations in recent years. We consider the legal infrastructure as supportive for banks in terms of predictability and timeliness of recovery of collateral in the event of bankruptcy or foreclosure. Social issues could arise in the event of a significant residential real estate crisis, and change our estimate. However, such a crisis is not part of our base case.

BICRA Israel--Credit Risk in the Economy

Table 3

	--Year ending Dec. 31--				
	2014	2015	2016	2017	2018f
Claims of resident depository institutions in the resident nongovernment sector as a % of GDP	77.0	74.9	73.4	73.7	73.6
Household debt as % of GDP	40.1	40.6	41.1	41.8	42.6

BICRA Israel--Credit Risk in the Economy (cont.)

Household net debt as % of GDP	(245.7)	(243.2)	(239.5)	(242.4)	(234.5)
Corporate debt as % of GDP	71.7	69.8	68.9	67.5	70.6
Real estate construction and development loans as a % of total loans	14.1	13.8	13.4	14.2	14.4
Foreign currency lending as a % of total domestic loans	15.0	12.6	12.4	11.2	11.0
Domestic nonperforming assets as a % of systemwide domestic loans (year-end)	2.4	2.0	1.8	1.5	1.6

f--Forecast.

Base-Case Credit Losses

Net loan loss provisions have trended down consistently over the past few years, assisted by a supportive economic environment and driven largely by recoveries on corporate loans that had been written down during previous spikes in the provisioning cycle, most notably in 2008, 2009, and 2011. In 2016 and 2017, credit losses started to rebound, and our base case assumes that net provisions continue to increase from a very low level, but remain very modest at just above 0.3% of loans in the next two years. Higher projected provisions are stemming from an increase in consumer credit provisions following a number of years of accelerated borrowing by households, and more modest levels of corporate recoveries following the conclusion of a number of high profile corporate workouts.

Table 4

BICRA Israel: Actual And Projected Loan Loss Provisions

	--Year ending Dec. 31--							
(%)	**2013**	**2014**	**2015**	**2016**	**2017**	**2018f**	**2019f**	**2020f**
Corporate, commercial, and SME loans	0.3	0.1	0.1	0.2	0.3	0.3	0.3	0.4
Residential mortgages	0.16*	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other nonsecured retail loans	0.3	0.60*	0.4	0.5	0.6	0.8	0.7	0.7
Total	0.3	0.2	0.1	0.2	0.3	0.3	0.3	0.3

f--S&P Global Ratings' forecast. *Includes a nonrecurring general provision dictated by the Bank of Israel. SME--Small or midsize enterprise.

4 Industry Risk

The key factors that support our assessment for industry risk in Israel are the adequate level of its institutional framework, a move to spur more competition in retail and small business lending, and a strong funding profile.

Institutional framework:Regulation, supervision, and transparency in line with international standards

Banking regulation and supervision. We view Israel as intermediate in terms of banking regulation and supervision and in line with international standards. Bank regulatory coverage is broad and many types of financial risks are closely and frequently monitored in a hands-on manner. Nevertheless, the BoI is not responsible for oversight of institutional investors. Insurance companies, pension and provident funds, and non-bank providers of credit fall under the newly established Capital Market, Insurance and Savings Authority. Certain activities of investment houses, such as mutual funds and portfolio management, are subject to supervision by the Israel Securities Authority. While there is ongoing cooperation between the various regulatory bodies, on occasion sharp differences in approach are apparent, creating the potential for the emergence of financial risks that are not fully supervised, or impeding efficient risk transfer between banks and institutional investors.

The BoI is working on introducing a Credit Bureau that would collect credit data and provide it to credit providers. The Bureau is expected to begin activity in mid-2019 and will enable a better pricing of lending. Additionally, in 2018 a new insolvency law was adopted by the Knesset, Israel's parliament, intending to ease the process and reduce the length of time required to receive the discharge.

Israeli banks now operate under the Basel III regime. Local banks are required to have a 9% common equity Tier 1 ratio (10% for the two largest banks) under the standardized approach. Basel III liquidity measurements are also operable, and banks have had to comply with minimum leverage ratios since Jan. 1, 2018.

Progress on introducing a resolution regime for failing banks is moving very slowly, in our view, and is unlikely to be implemented over the next 18-24 months. In particular, issues such as deposit insurance or bank bailouts are highly politically sensitive. Depending on the final form of any resolution process, the Justice Ministry may be required to extensively amend Israel's legal framework.

Regulatory track record. We assess the regulator's track record as intermediate. The Israeli banking system has successfully weathered all major global and domestic crises over the last 20 years, although with the onset of the second intifada and the bursting of the dot-com bubble during 2001-2003, we did witness the failure or near-failure of a couple of very small banks of negligible significance to the banking system.

The BoI has tightened limitations on leveraged finance and on single-name and group concentrations following a number of high-profile bankruptcies related to overleveraged holding companies. The central bank has been more proactive in introducing macro-prudential measures to cope with the surge in housing prices. In particular, we note limitations on mortgage lending, targeting leverage, repayment ability, and the interest rate mix. In addition, banks must hold an additional capital buffer as a proportion of their mortgage portfolio.

Governance and transparency. We view governance and transparency in Israel as supportive of the banking sector. In our opinion, reporting standards are high. At the insistence of the BoI, Israeli banks' financial reporting standards are an unusual mix of Israeli and U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards. This mix attempts to implement the most relevant and conservative accounting treatments. Comparability across banks is high, as the BoI looks to achieve a high degree of standardization of reporting.

As more Israeli banks move away from a controlling shareholder structure, the government has introduced a corporate governance structure tailored for banks with widely dispersed ownership. A special supervisory committee has been set up, headed by a retired Supreme Court judge, which submits a list of candidates for the board. Shareholders may elect from those candidates by voting. In addition, each individual shareholder that holds a stake of more than 2.5% in a bank is entitled to nominate a single director. In practice, this prevents any one investor from gaining control or exercising undue influence over the board.

Compensation practices for senior management are published and approved by shareholders. Compensation schemes focus on long-term profitability goals, including the bank's return on equity (ROE), performance versus specific bank goals and versus other banks, and performance evolvement through time. Some compensation schemes include bonus claw-back provisions in case performance does not meet expectations.

Competitive dynamics: Efforts to stimulate competition in the banking system realized

Risk appetite. Our assessment for risk appetite is mainly based on the Israeli banking industry displaying moderate profitability relative to other sectors of the economy, with a long-term average ROE in the high single digits. The banking system has recorded positive ROE each year since 2006, including during the 2007-2009 financial crises. We believe Israeli banks' lower profitability is a result of a number of factors. Income generation is constrained by a low interest rate environment, competition in certain plain-vanilla products and segments, and continued regulatory pressure on fees. Banks have also had to cope with high operational and staff costs in a highly unionized environment. We also believe that Israeli banks generally engage in simple and traditional banking, leading to lower returns than their global peers that tend to take more risks, thus generating higher returns.

Banks have been making sustained efforts to reduce costs and we have observed a decline in cost-to-income ratios, as most banks aim to converge on a cost-to-income ratio of 50%-60%, with an average of 65.5% at year-end 2017, versus the historical ratios in the mid-60% to high-70% range.

We are witnessing some efforts by banks to shift risks off their balance sheet. Currently this is mostly carried out by whole-loan sales or syndication, rather than using securitization. We do believe, however, that there is potential for a securitization market to develop.

Presence of high-risk products in Israel is limited. There is no subprime mortgage lending. While not part of our base-case scenario, we note that the growing share of unsecured personal loans in recent years may increase the sensitivity of bank earnings to deterioration in the household sector's creditworthiness.

Growth of total assets in the local banking system has lagged GDP growth since 2011, such that the amount of total assets of the banking system expressed as a percentage of GDP has been steadily declining and is now slightly over 115%. This is indicative of a moderate risk appetite, in our view.

Overall, we believe that the sector's compensation practices do not encourage excessive risk-taking in order to boost short-term profitability. Compensation schemes encourage long-term profitability and multiyear performance examination, and remuneration of senior management is capped according to law. In 2016, the Knesset passed a law to cap salaries of financial services executives at ILS2.5 million a year, or no more than 35x the salary of the lowest paid worker in the company. In theory, such a law should sharply reduce the appetite for risk-taking among banks' management.

Industry stability. In our opinion, the local banking sector is stable, and although it is set to face increasing competitive pressure from nonbank financial institutions over the coming years, this is unlikely to significantly weaken industry stability over the next 24 months. With the recommendations from the Strum Committee (a joint committee that set out policy recommendations for increasing competition in Israel's financial system) having being adopted into law, the two largest banks are currently divesting their credit card companies. Bank Leumi has already sold Leumi Card Ltd. to private equity firm Warburg Pincus for ISL2.5 billion ($684 million), an amount that could be distributed in extraordinary dividends, or be invested. Hapoalim, however, is still considering its options, including a possible IPO of Isracard. We estimate that these companies have a market share of about 7% of consumer credits (excluding mortgages) after neutralizing the monthly revolving balances of bank-issued credit cards. The credit card companies will have to address the issue of funding sources and cost of funding, because until now they have been indirectly reliant on the commercial banks' retail deposit bases. We note however, that large banks are currently requested to provide back-to-back funding to these players.

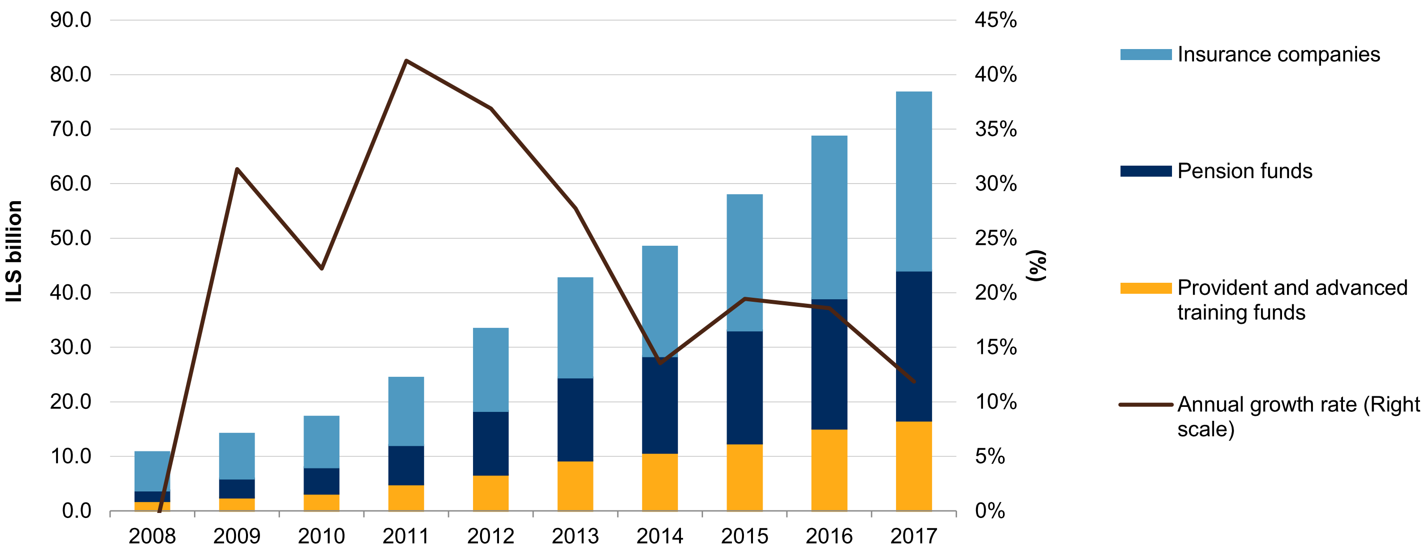
The largest three banks have also launched or bought their own payment apps in order to be well placed against potential competition that could emerge from the credit card companies or fin-tech startups. Online credit intermediaries need to comply with a very specific set of rules under the oversight of the Capital Market, Insurance and Savings Authority, although requirements are less stringent than for banks in order to reduce entry costs such as reporting obligations. Additionally, and in line with recent efforts to boost competition, a new legislation prohibits banks from setting up their own person-to-person platforms for three years following the law going into effect. This excludes credit cards companies being divested by banks.

Overall, five commercial banking groups hold about 92% of the market share by assets, and barriers to entry for new banks remain high. In our view the BoI is keenly aware of the importance of a stable banking industry and we expect that it will apply institutional checks and balances to ensure relative stability in the face of new competitive pressures from nonbank lenders, provided populist legislative initiatives do not deprive the BoI of its holistic oversight of the banking system. Within this context, we note that the credit card companies will continue to remain under the regulatory oversight of the BoI.

Market distortions. There are no material market distortions due to government or government-related financial institutions. In the corporate lending segment, however, distortion stems from nonbank players, mainly insurance companies, pension funds, and investment houses that are active in the short- and long-term savings markets. The corporate bond market is well developed, allowing retail participation in the corporate lending market, directly or indirectly, via corporate bond mutual funds and exchange-traded funds. This competition, which has proven to be less sensitive in pricing credit risk, has capped banks' market share at just below 50% and has kept pressure on interest margins in the corporate segment.

Chart 6

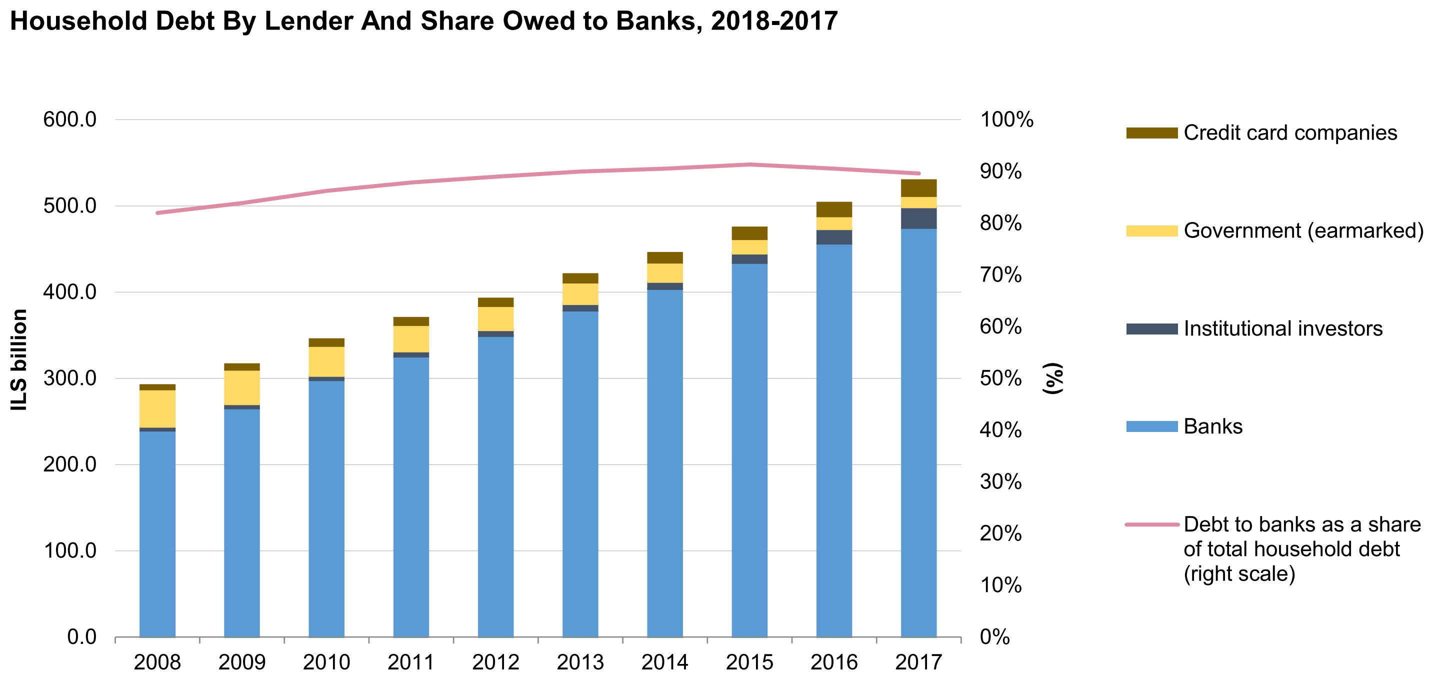
Outstanding Direct Loans From Institutional Investors To The Nonfinancial Business Sector, 2018-2017



Source: Bank of Israel. ILS--Israeli New Shekel.

Currently the banking system still has tight control on lending to the retail segment and small businesses (above 90% market share according to our estimates). Over the medium term, further distortions may emerge from the spin-off or sale of the credit card companies and from the growth of nonbank check discounters.

Chart 7



Source: Bank of Israel. ILS--Israeli Shekel.

BICRA Israel--Competitive Dynamics

Table 5

	--Year ending Dec. 31--				
	2014	**2015**	**2016**	**2017**	**2018f**
Return on equity (ROE) of domestic banks	11.8	14.4	13.9	13.8	13.0
Systemwide return on average assets (%)	0.8	1.0	1.0	1.0	1.0
Net operating income before loan loss provisions to systemwide loans (%)	3.2	3.2	1.9	1.9	1.8
Market share of largest three banks (%)	72.6	72.8	77.2	76.4	75.0
Annual growth rate of domestic assets of resident financial institutions (%)	6.6	1.8	1.2	1.4	2.4

Systemwide funding:Strong core customer deposit base, low reliance on external funding, and active domestic capital market

Core customer deposits. The Israeli banking system benefits from a solid core customer deposit base, because it is a relatively closed banking system. Domestic core customer deposits comprise more than 95% of domestic loans, a level we assume is relatively stable and sustainable. Despite low interest rates, core customer deposits increased by about 3.8% in 2017, and are expected to continue increasing at a similar level in the next two years. We believe local depositors have high confidence in the stability of the banking system. Their strong home bias and inherent conservative risk appetite with respect to asset allocation will likely support the banks' deposit base in the foreseeable future.

External funding. The Israeli banking sector has very low reliance on external funding, in keeping with Israel's profile as a net external creditor. External debt as a percentage of systemwide domestic loans decreased further in 2017 to slightly over 5%, and is projected to remain about the same in the near future. Absence of reliance on external funding is mainly due to the sector's strong domestic customer deposit base and the declining exposure of Israeli banks to foreign operations, given that some overseas subsidiaries have been sold or closed. Following recent legal settlements with the U.S. Department of Justice, banks' appetite for foreign markets has shrunk further and we expect this trend will continue.

Domestic debt-capital markets. Israel has an active market for issues by investment-grade entities, mainly banks, and for speculative-grade corporate entities. Private sector debt issued in the domestic market stood at about 29% of GDP as of 2017, and is expected to remain is this level in the near future. Although the bond market is not as active and deep as in countries such as the U.S., U.K., Germany, and Canada, there is healthy demand in the primary market, and bonds are usually oversubscribed and enjoy decent trading volume in the secondary market.

Government role. Over the past decades, the Israeli banking system has not faced a significant systemic crisis that required government support. During the 2008-2009 financial crises, the government did have a scheme to backstop banks' funding, liquidity, and capital needs, but the domestic banks successfully navigated that crisis without resorting to such back-stop facilities. Local banks are generally liquid and are net depositors of funds in the central bank, materially above their required minimum. However, in our opinion, should the need ever arise, the central bank facilities have adequate capacity to support the industry's funding needs.

In the absence of systemic bank-specific crises, the government's track record of providing guarantees and liquidity is limited by definition. Nevertheless, we believe both the government and the central bank acknowledge the importance of a stable banking sector.

BICRA Israel--Systemwide Funding

Table 6

	--Year ending Dec. 31--				
	2014	**2015**	**2016**	**2017**	**2018f**
Systemwide domestic core customer deposits by formula as a % of systemwide domestic loans	87.3	90.2	96.4	96.3	95.2
Net banking sector external debt as a % of systemwide domestic loans	(4.7)	(5.4)	(7.0)	(8.7)	(6.9)
Systemwide domestic loans as a % of systemwide domestic assets	58.1	60.2	59.8	61.4	62.8
Outstanding of bonds and CP issued domestically by the resident private sector as a % of GDP	28.3	28.0	27.9	28.9	28.6
Total consolidated assets of FIs as a % of GDP	125.6	124.3	124.7	123.1	118.9
Total domestic assets of FIs as a % of GDP	125.6	121.4	117.0	114.4	111.4

Peer BICRA Scores

Table 7

Israel Peer Group BICRA Scores

Factor	Israel	Mexico	Spain	Malaysia	New Zealand	Saudi Arabia	Estonia	Iceland
BICRA group	4	4	4	4	4	4	4	4
Economic risk	4	5	5	5	5	5	4	4
Economic resilience	Intermediate	High	Intermediate	High	Very low	High	Intermediate	Low
Economic imbalances	Intermediate	Low	Intermediate	Low	Very high	Intermediate	Low	High
Credit Risk in the economy	Intermediate	High	High	High	Intermediate	Intermediate	High	Intermediate
Industry risk	4	3	4	3	4	3	5	5
Institutional framework	Intermediate	Intermediate	Intermediate	Intermediate	Intermediate	Low	High	Intermediate
Competitive Dynamics	High	Intermediate	Intermediate	Intermediate	Low	Intermediate	Intermediate	Intermediate
Systemwide Funding	Low	Low	Intermediate	Low	High	Low	Intermediate	High
Government support assessment	Supportive	Supportive	Uncertain	Highly supportive	Uncertain	Highly supportive	Uncertain	Uncertain

All assessments as of Oct. 11, 2018. Source: S&P Global Ratings.

Government Support

We classify the Israeli government as supportive toward its banking system, reflecting our expectation that it is willing and able to support the system if needed. We think Israel's isolated geopolitical position and concentrated banking system makes it vulnerable to the risk of contagion and this acts as powerful incentive for government and regulators to step in in the event of a crisis. However, we are unaware of any explicit policy of the government to provide support for the banking system. Our view is that the authorities would prefer market-led solutions to banking failures as a first resort. We would reconsider our assessment of government support if regulatory authorities introduced an updated bank resolution framework, although we do not expect this in the near future.

Table 8

Five Largest Financial Institutions In Israel By Assets

	Assets* (bil. ILS)	Likelihood of government support	Market shares
Bank Hapoalim B.M.	454.4	Moderately high	29%

Table 8

Five Largest Financial Institutions In Israel By Assets (cont.)

	Assets* (bil. ILS)	Likelihood of government support	Market shares
Bank Leumi le-Israel B.M.	450.8	Moderately high	29%
Israel Discount Bank Ltd.	221.2	Moderately high	14%
Mizrahi Tefahot Bank ltd.	239.6	Moderately high	15%
First International Bank of Israel	135.7	Moderate	9%
Total assets of the top five banks	1501.7		
Total assets of the banking system	1,565.9		

*Data as of Dec. 31, 2017. ILS --Israeli new shekel.

Related Criteria And Research

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 30, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011

Related Research

- Research Update: Israel Upgraded To 'AA-/A-1+' On Economic Strength And Fiscal Improvements; Outlook Stable, Aug. 3, 2018
- S&P To Publish Economic And Industry Risk Trends For Banks, March 12, 2013
- Analytical Linkages Between Sovereign And Bank Ratings, Dec. 6, 2011

This report does not constitute a rating action.

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