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Banking Industry Country Risk Assessment: Israel

October 18, 2022

Banking Industry Country Risk Assessment Group	3		
3 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	Low Risk	System wide funding	Low Risk

Government Support:

Supportive

BICRA Highlights

Key strengths	Key risks
Wealthy and diversified economy that has contained private sector debt burden.	Highly concentrated exposure to real estate-related lending.
Well-capitalized and profitable banking system.	Competitive environment including nonbank players.
Good asset quality with low cost of risk.	

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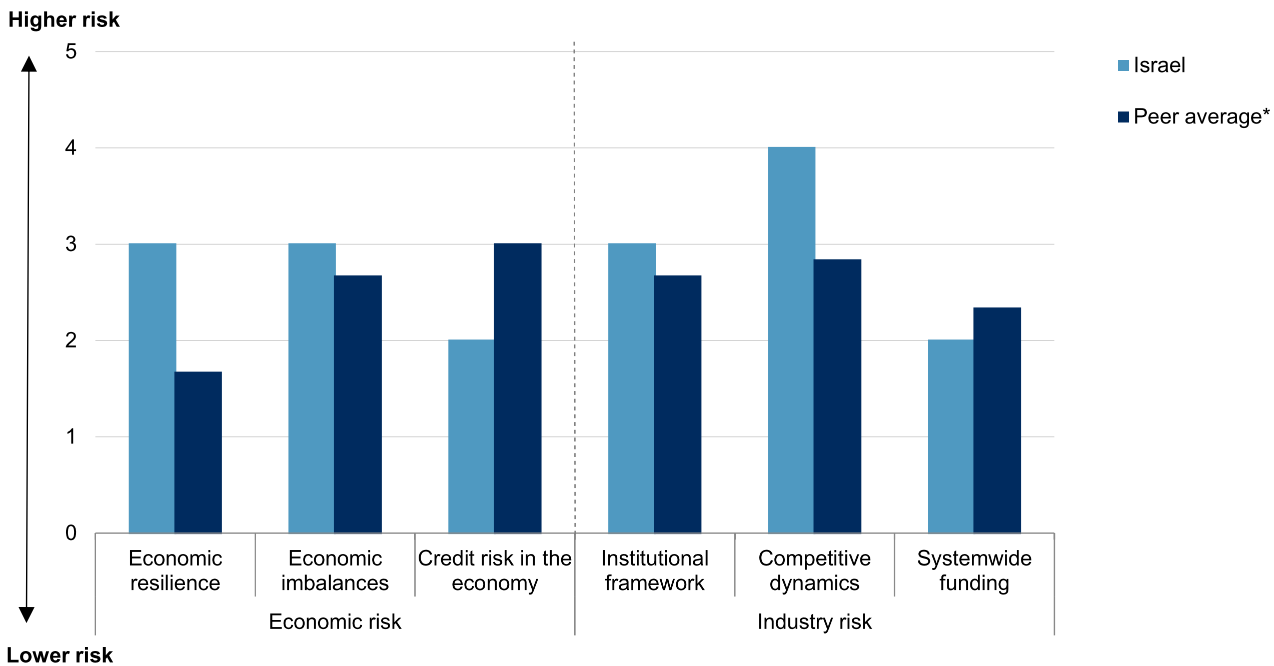
Chart 1



*Peers are Australia, the U.S., Czech Republic, the U.K., Denmark, and Netherlands. Source: S&P Global Ratings.

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Israeli banks benefit from the domestic economy being wealthy, diversified, and resilient, but display some concentration in their lending books. High income levels, contained private sector debt levels, and solid domestic economic performance support Israeli banks' asset quality metrics. Following strong performance in 2021, we expect the Israeli economy to remain broadly resilient, posting an average GDP growth of 3.2% in real terms over the next three years. Over the past few years, the Israeli financial system has experienced strong lending expansion, particularly in construction and real estate. Real estate prices have increased sharply, fueled by the economic rebound and very accommodative monetary policy. S&P Global Ratings now expects credit and price growth to decelerate because of rising interest rates and higher inflation. In addition, regulatory measures will weigh on the sector. We consider that vulnerabilities in this segment are manageable, but are mindful that the banks' significant exposure to the real estate sector poses some risks. We expect credit losses to gradually normalize to pre-pandemic levels of about 25 basis points (bps) by 2024.

Low funding risk and active regulator support the industry. The Israeli banking sector benefits from a strong funding profile, a large core customer deposit base, and a net external creditor position. Banking regulations are broadly in line with international standards and the prudent regulatory oversight mitigates the risks stemming from the sector's structurally high exposure to real estate. Israeli banks engage in simple and traditional banking and their profitability has been

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boosted by strong business momentum, rising interest rates, the high amount of assets linked to the consumer price index, and continuous cost-cutting initiatives. That said, competition among both banks and nonbank financial institutions somewhat constrains margins and fees. Many banks are adapting their business models to changing customer preferences and new competitors. Less-dynamic, smaller banks and nonbank lenders could be more-vulnerable to the changing competitive landscape.

Economic And Industry Risk Trends

The trend for economic risk is stable. This reflects our expectation that the Israeli banks will benefit from resilient economic conditions. We anticipate that risks to banks' asset quality from exposure to real estate-related lending will remain manageable. Economic risks could increase if real estate prices rise materially above our expectations, or if banks' exposure to the construction sector continues to grow.

We view the industry risk trend as stable. Banks are expected to preserve their sound profitability, which supports their growth and capitalization. We also expect them to remain deposit-funded, with moderate risk appetites. Branch closures and workforce reductions have helped banks to limit increases in their operating expenses amid rising inflation, and they continue to invest in digitalization.

3 Economic Risk

Economic resilience: Continued economic growth despite domestic political and regional security risks

In our view, Israel's economy can be characterized as wealthy, diversified, and competitive. We forecast that real GDP growth will reach a strong 5.5% in 2022, and will then average 3.2% a year over the medium term (see chart 2). The economy saw a strong recovery in 2021, after a comparatively mild pandemic-driven recession in 2020, the first in almost two decades. Israel's strong growth performance is partly explained by the structure of its economy, which is centered around high value-added IT-related services exports including cyber security, fintech, digital health, defense, and broader technology.

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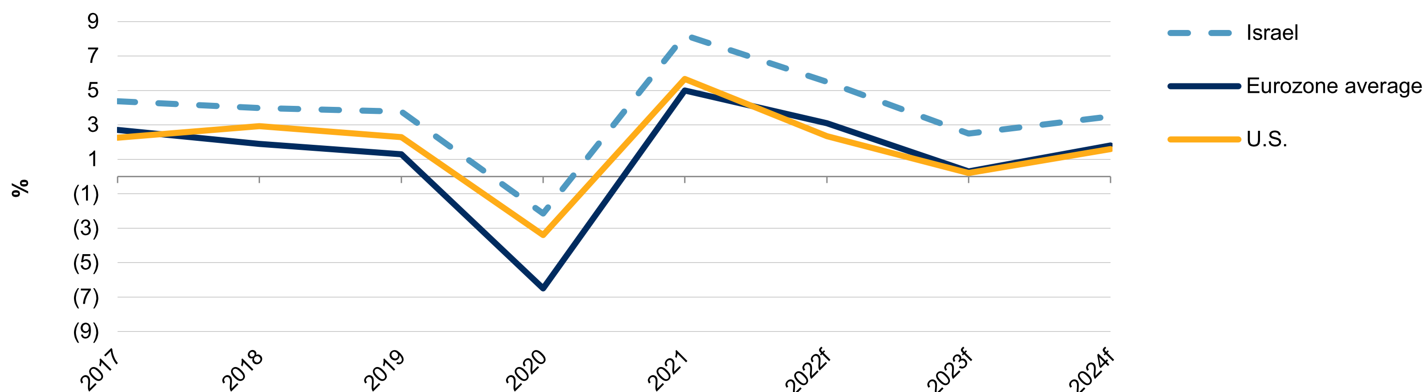
Chart 2

Israeli Economy Forecast To Continue Outperforming Its Peers
Real GDP growth rate (%)



f--Forecast. Source: S&P Global Ratings.

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We consider inequality in Israel to be relatively high. Although GDP per capita was high at about $51,502 in 2021, wide income disparities exist between different socioeconomic groups. Israel offers a relatively low level of social support and redistribution through transfers is one of the lowest among the advanced economies.

Israel's monetary policy flexibility remains a key credit strength. In our view, the Bank of Israel (BoI) is a highly credible and independent institution that commands a range of market-based monetary instruments and benefits from the deep local currency financial and capital markets. Inflation in Israel has picked up in recent months, reaching 4.6% in August 2022, but remains significantly below peer countries. Nevertheless, in response, BoI has started a tightening cycle; it has raised the key interest rate by 265 basis points, to 2.75%, since April 2022. One factor that has helped to slow domestic inflation is Israel's increased reliance on domestically produced gas, which partially offsets the effect of the global increase in energy prices.

The political and geopolitical landscape remains complex. The disparate governing coalition formed in June 2021 has lost its parliamentary majority and yet another out-of-cycle election will take place in November 2022. Domestic political uncertainty has been persistently high over the past few years. Positively, this has not yet substantially affected the economy but, in our view, it distracts the government from focusing on longer-term priorities and reforms. In addition, domestic security and regional geopolitical risks remain elevated, with frequent clashes and escalations in hostilities between Palestinians and the Israeli police, as well as between Israel and Hamas.

Table 1

Israel--Economic Resilience

(Mil. ILS)	2024f	2023f	2022f	2021	2020	2019
Nominal GDP (bil. $)	584.0	536.7	522.4	482.4	407.1	397.9
GDP per capita ($)	58,721.7	55,044.6	54,646.8	51,502.1	44,181.2	43,969.2

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Table 1

Israel--Economic Resilience (cont.)

(Mil. ILS)	2024f	2023f	2022f	2021	2020	2019
Real GDP growth (%)	3.5	2.5	5.5	8.2	(2.2)	3.8
Inflation (CPI) rate (%)	2.0	2.5	4.0	1.5	(0.6)	0.8
Monetary policy steering rate (%)	N/A	N/A	N/A	0.1	0.1	0.3

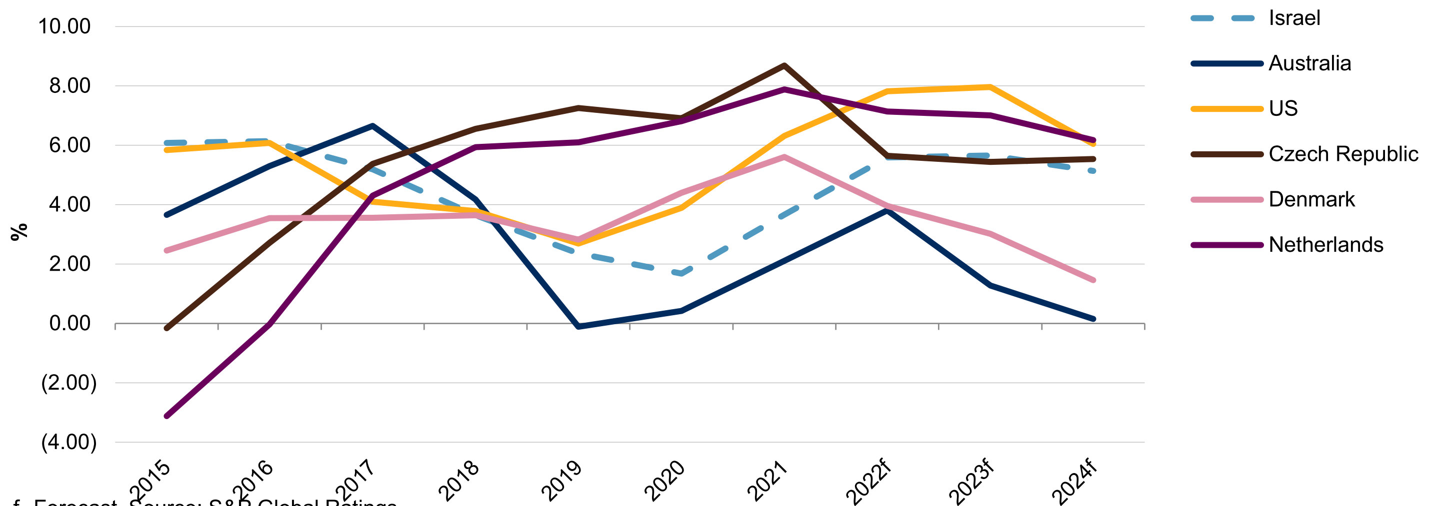
CPI--Consumer price index. f--Forecast. N/A--Not applicable. ILS--Israeli shekel. Source: S&P Global Ratings.

Economic imbalances: Rising real estate prices fuel imbalances

Banks in Israel remain exposed to the risk of an increase in credit losses. Housing prices started to increase again in 2019, after a few years of cooling. Growth over the past 12 months has accelerated to about 13% in real terms, amid the economic rebound that followed the ending of pandemic-related restrictions, combined with the very accommodative monetary policy. Fundamental demand, driven by the gap between limited supply and inelastic demand, together with a growing population and a lack of government initiatives to address supply shortages, will continue to push up prices and lending. We expect the market to slow as rising interest rates, higher inflation, and regulatory measures weigh on lending expansion and price dynamics in 2022 and 2023. That said, we expect prices to remain above the pre-pandemic level, with an average annual change over the past four years of about 5%-6% (see chart 3). This will increase imbalances in the economy.

Chart 3

Average Annual Change Over The Last Three Years And Current Year Estimate In Key Index For National Residential House Prices (Real)



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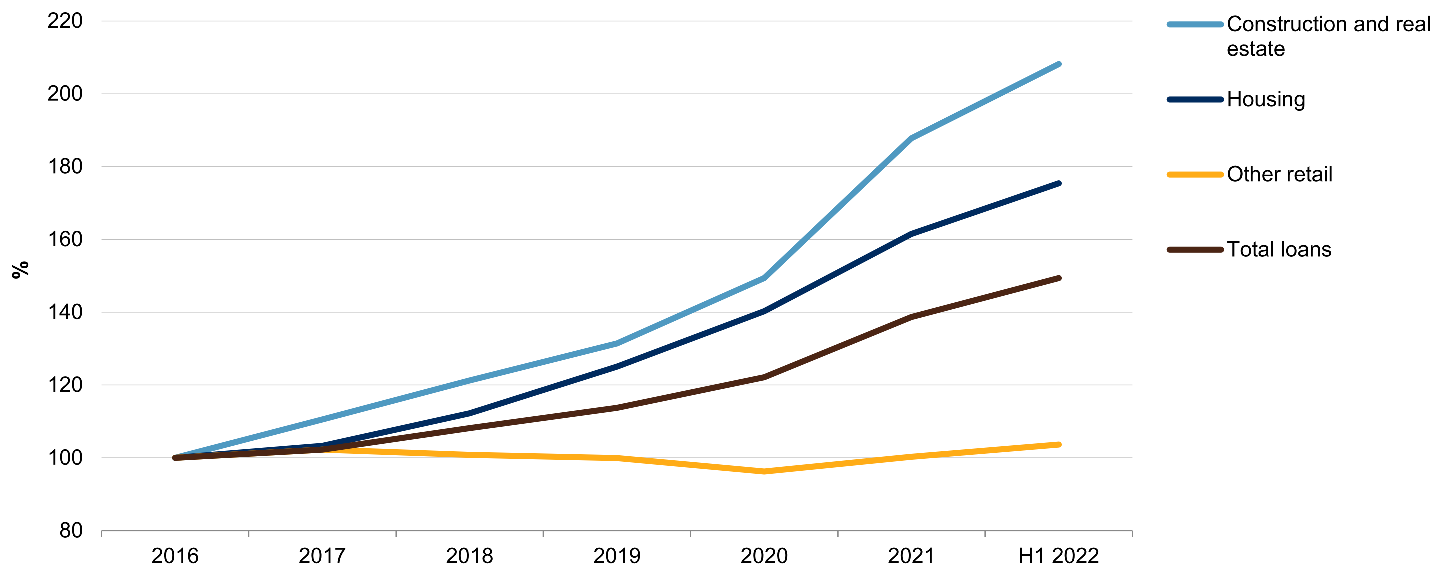
We estimate that the banking sector will sustain annual credit growth of about 6% for the next three years. Between the start of 2021 and mid-2022, credit expanded by an exceptional 25%, fueled by real estate-related lending. We estimate this segment grew by a cumulative 18% in 2021 and an additional 9% in the first half of 2022 (see chart 4). Although real estate-related lending is likely to continue to drive credit growth, we expect its growth to slow. Meanwhile, the recovery in unsecured consumer credit continues.

Chart 4



Israel's substantial net external asset position of about 40% of GDP is one of the highest among noncommodity exporting sovereigns. Israel has been running a current account surplus for the past 18 years, primarily supported by the fast expansion of high-value-added ICT services exports. Strong global demand for Israeli services, as well as gas exports from the new fields, should keep the current account surplus close to 4% of GDP over the medium term.

Table 2

Israel--Economic Imbalances

(Mil. ILS)	2024f	2023f	2022f	2021	2020	2019
Annual change in total private sector debt (% of GDP)	(0.3)	0.6	0.7	0.8	5.2	(1.3)
Annual change in inflation-adjusted housing prices (%)	2.5	2.8	5.3	10.0	4.5	2.5
Current account balance/GDP (%)	3.8	3.9	4.2	4.4	5.6	3.8

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Table 2

Israel--Economic Imbalances (cont.)

(Mil. ILS)	2024f	2023f	2022f	2021	2020	2019
Net external debt/GDP (%)	(49.5)	(50.9)	(53.7)	(54.2)	(53.7)	(47.4)

f--Forecast. ILS--Israeli shekel. Source: S&P Global Ratings.

Credit risk in the economy: Low leverage and wealthy economy support asset quality metrics

Israel's high GDP per capita and lower-than-peers leverage support banks' asset quality. Despite a moderate increase after the pandemic, private sector domestic debt to GDP, remains below the peer average at about 115% at year-end 2021. The structure of the Israeli economy helps to contain private sector leverage; it is strong in services industries--such as high tech, IT, and communications--that are less credit-intensive. In addition, in recent years, regulatory changes have led to the dismantling of several large holding corporations and thus reduced credit to this segment. However, higher housing demand plus rising house prices have created an increase in debt at both the corporate and household level since 2019. Positively, the contained leverage, combined with GDP per capita above $50,000, has made credit risk a strength for the Israeli banking sector.

Tight lending and underwriting standards, as well as macroprudential measures, somewhat mitigate risks stemming from the high exposure to the real estate sector. Macroprudential measures introduced over the past decade included limiting loan-to-value (LTV) ratios for first home buyers, introducing maximum payment-to-income (PTI) ratios, and requiring additional capital cushions for mortgage lending. More recently, to address the increase in construction loans, the BoI introduced a new regulation aiming at increasing the risk weighting for land loans to 150% (from 100% before) if the LTV ratio is greater than 80%. Macroprudential measures have resulted in low average LTVs in the mortgage book--54.8% at year-end 2021--and a steady average PTI ratio of about 27.3%. In addition, most of the other exposures linked to the real estate sector relate to the residential market. These include sale guarantees and the financing of construction projects and the banks also maintain tight standards in relation to these products. All this limits the risks related to banks' growing exposure to real estate lending.

Household financial assets are substantial (324% of GDP at year-end 2021). Although we consider the liquidity of these assets to be limited because they are largely invested in pension or insurance assets and residential real estate, the size of these assets helps to mitigate gross private-sector debt, in our view.

Unsecured retail loans carry a higher credit risk. Nonbank players are more exposed to these loans than banks, in our view. The banks have been tightening their underwriting standards and reducing their risk appetite for this segment. As a result, most of the growth in this type of loan (and likely the credit risk) has migrated to nonbank players such as credit card companies and institutional investors.

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Base-Case Credit Losses: Trending To A More Normal Level After Strong Release In 2021

After a strong increase in collective provisions in 2020 and partial recovery over the past six months, we expect credit losses will gradually normalize to pre-pandemic levels of about 25 basis points (bps) by 2024. Inflationary pressures, rising interest rates, and high lending growth will contribute to the increase.

Asset quality metrics remain resilient, boosted by access to payment deferrals, government guarantees for small and midsize enterprises, and the strong economic recovery post-pandemic. We expect some asset quality deterioration in the next two to three years, from a very low 1.2% nonperforming loan ratio.

Table 3

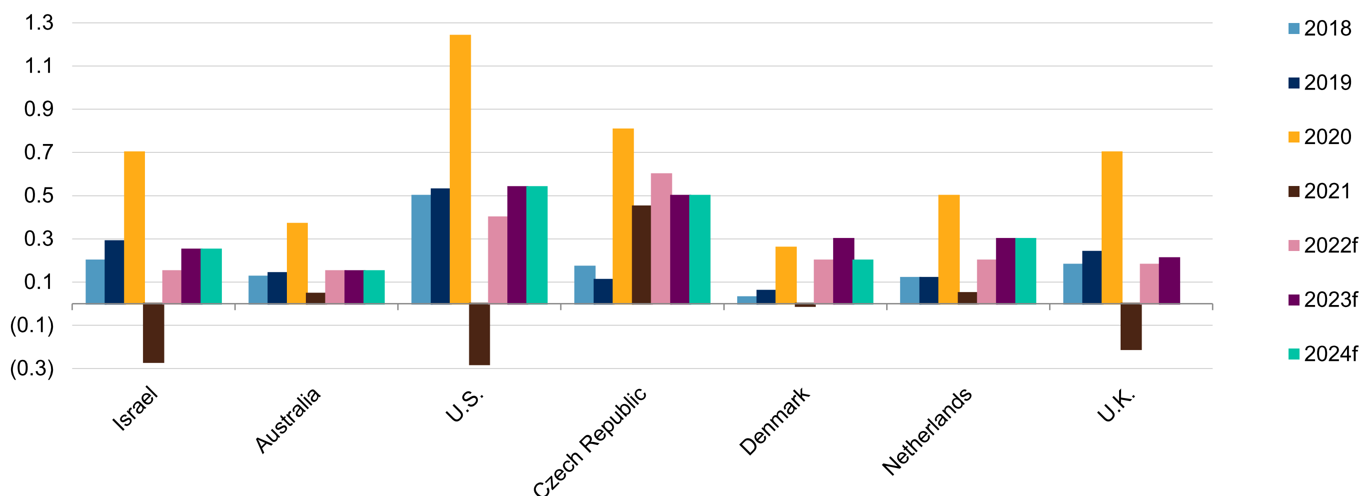
Israel--Credit Losses

(Mil. ILS)	2024f	2023f	2022f	2021	2020	2019
Credit losses (% of total loans)	0.3	0.3	0.2	(0.3)	0.7	0.3

f--Forecast. ILS--Israeli shekel. Source: S&P Global Ratings.

Chart 5

Credit Losses Are Expected To Normalize While Remaining In The Lower Range Compared To Peers



f--Forecast. Credit losses as a % of total loans. Source: S&P Global Ratings.

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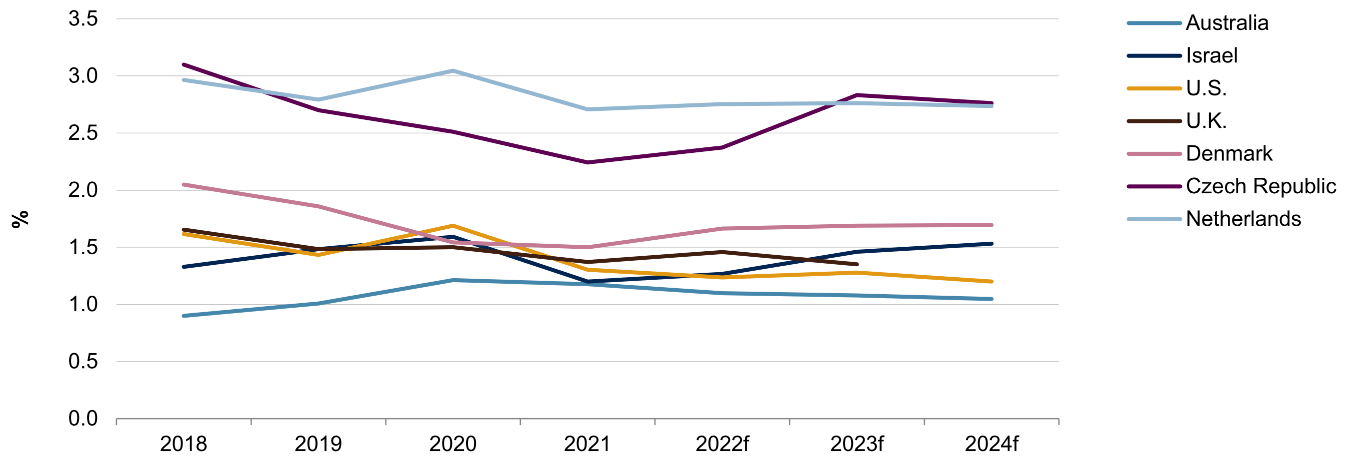
Chart 6



f--Forecast. Source: S&P Global Ratings.

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Table 4

Israel--Credit Risk In The Economy

(Mil. ILS)	2024f	2023f	2022f	2021	2020	2019
GDP per capita ($)	58,721.7	55,044.6	54,646.8	51,502.1	44,181.2	43,969.2
Total private-sector debt (% of GDP)	116.2	116.5	115.9	115.0	114.2	109.0
Household debt (% of GDP)	45.1	45.4	44.8	44.4	43.7	41.4
Household net debt (% of GDP)	(235.4)	(236.6)	(237.1)	(279.4)	(270.6)	(246.1)
Corporate debt (% of GDP)	71.1	71.2	71.1	70.6	70.5	67.5
Nonperforming assets (% of systemwide loans)	1.5	1.5	1.3	1.2	1.6	1.5
Loan loss reserves (% of total loans)	1.3	1.3	1.3	1.3	1.8	1.3

f--Forecast. ILS--Israeli shekel. Source: S&P Global Ratings.

4 Industry Risk

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

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Bank regulatory coverage is broad, and risks are closely and frequently monitored in a hands-on manner. BoI supervises banks, credit card companies, and the payments system. Israeli regulation is aligned with international best practices. It applies close monitoring of emerging risks and uses active macroprudential measures to contain them. This includes imposing limitations on leveraged finance and single-name and group concentrations, as well as macroprudential measures to moderate the risk from housing loans. In particular, the BoI has set limitations on mortgage lending that target leverage, repayment ability, and the interest-rate mix. Banks must also hold an additional capital buffer that is in proportion to the size of their mortgage portfolio. Israeli banks operate under Basel III capital and liquidity requirements.

The banking system has weathered all major global and domestic crises over the past 20 years. Those include the second intifada, the bursting of the dot-com bubble during 2001-2003, the 2008 global financial crisis, and the COVID-19 pandemic. BoI's response during the pandemic helped maintain liquidity and credit flows in the banking system. Since then, supervision and limitations have been tightened even further.

Basel III Specificities In Israel

Under Israel's standardized approach, its local banks are required to have a minimum 9.2% common equity Tier 1 ratio and the two domestic systemically important banks (DSIBs) are required to increase this to 10.2%. The capital requirements include an additional specific requirement for mortgage exposure, estimated at 0.3%-0.9% of RWA, depending on the size of the mortgage book, and more recently for construction lending. As a result, the required total capital ratios for Israeli banks are more conservative than typical Basel III requirements.

Banks have had to comply with minimum 5% leverage ratios (and 6% for DSIB) since Jan. 1, 2018.

Basel III liquidity measurements have been fully implemented since Dec. 31, 2021, when the directive regarding net stable funding ratios came into effect.

The BoI does not supervise the growing number of nonbank lenders that are expanding their share of the lending market. These include financial service providers and insurance companies, which are supervised by the Capital Markets and Insurance Authority. Although the various regulatory bodies do cooperate, differences in approach are sometimes apparent. This creates the potential for the emergence of financial risks that are not fully supervised, or that could impede efficient risk transfer between banks and institutional investors.

In our opinion, transparency is adequate. Quarterly reporting is extensive, accurate, and transparent. Financial reporting standards are an unusual mix of Israeli, U.S. generally accepted accounting principles, and International Financial Reporting Standards.

Competitive dynamics: Traditional and concentrated banking sector

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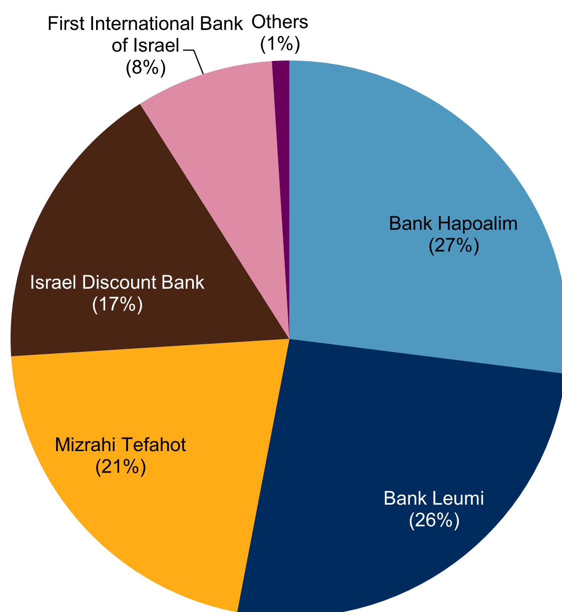
Strong concentration in the system supports banks' profitability. The two largest banks account for about 58% of loans and deposits and the top five banking groups represent almost the entire market (see chart 7). The banking system has recorded a positive return on equity (ROE) each year since 2006, including during the various economic and financial crises and the pandemic. Israeli banks engage in simple and traditional banking and do not offer complex or high-risk innovative products. Competition is intense in certain plain-vanilla products and in corporate lending from institutional investors, and at the same time, regulatory pressure on fees remains strong. However, Israeli banks' profitability benefits from strong lending expansion and efforts to reduce costs, particularly at the largest banks. Cost-to-income ratios have declined meaningfully. Most banks aim to converge to a cost-to-income ratio of 50%-55%, and the systemwide average was 50% in the first half of 2022. We forecast that ROE will be slightly above 10% in 2022, down from about 13.9% in 2021. It will then normalize at around 9%-10% in 2024.

Chart 7

Israeli Banking Sector Is Concentrated
Loans market share as of June 2022



Source: S&P Global Ratings.

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Banks accelerated their digitalization process during the pandemic, and regulatory initiatives are likely to encourage the process to continue. We expect banks will continue to focus on the use of digital channels as part of their efficiency efforts. This should allow further cost savings and increase their loss absorption capacity in the medium term. Recent regulatory initiatives include allowing contactless payments and the concept of open banking, which will increase transparency in the banking system while strengthening customers' bargaining power by widening their banking

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choices. Although this could threaten the profitability of the system over the longer term, so far it has adapted well to the upcoming changes, though a variety of different strategies. Smaller banks and nonbank lenders that have narrower revenue bases could be more vulnerable to the changing competitive landscape.

Table 5

Israel--Competitive Dynamics

(Mil. ILS)	2024f	2023f	2022f	2021	2020	2019
Return on equity (ROE) of domestic banks (%)	9.5	9.5	11.5	13.9	5.9	7.8
Systemwide return on average assets (%)	1.0	1.0	1.2	1.4	0.7	1.0
Net interest income to average earning assets for banking sector (%)	2.5	2.5	2.4	2.4	2.4	2.4
Net operating income before loan loss provisions to systemwide loans (%)	1.9	1.9	1.8	1.8	1.9	1.8
Market share of largest three banks (%)	76.0	76.0	76.0	76.1	75.8	75.1
Annual growth rate of domestic assets of resident financial institutions (%)	5.0	5.0	8.0	15.7	17.0	3.3

f--Forecast. ILS--Israeli shekel. Source: S&P Global Ratings.

Systemwide funding: Strong core customer deposit base with increasing recourse to capital market

The Israeli banking system benefits from a solid core customer deposit base, which entirely covered domestic loans over the past two years. The public has displayed a stronger propensity to save during the pandemic. We anticipate that deposit growth will slow down over the next two years--public savings will be lower and will be moderately eroded by a rebound in consumption and increasing inflation. At the same time, we expect lending growth to moderate compared with the past 18 months, while remaining higher than the pre-pandemic average. We forecast that domestic loans, as a percentage of domestic core customer deposits, will moderately increase, but remain below 130%.

The Israeli banking sector has very low reliance on external funding and is a net external creditor, and this is unlikely to change in the near term. The sector has not needed to rely on external funding because it has a strong deposit base and there is strong demand from domestic investors. In addition, Israeli banks have reduced their exposure to foreign operations; in some cases, overseas subsidiaries have been either sold or closed .

Israel has an active domestic debt market. There is demand for debt issued by investment-grade entities--which are mainly banks and government-related entities--as well as for that issued by speculative-grade corporate entities. Private sector debt issued in the domestic market stood at about 27.4% of GDP as of 2021, and we think it will remain relatively stable for the next two to three years. Israeli banks have little need to rely on more-expensive funding sources, such as long-term debt issuance because they have access to a cheap and loyal retail deposit base.

Local banks are generally liquid. Historically, the banking system has not needed any large liquidity injections or government guarantees. However, in our opinion, should the need ever arise, the central bank has the willingness and adequate capacity to support the industry's funding

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needs.

Table 6

Israel--Systemwide Funding

(Mil. ILS)	2024f	2023f	2022f	2021	2020	2019
Systemwide domestic loans (% of systemwide domestic core customer deposits)	118.1	114.8	107.6	101.8	99.8	111.1
Net banking sector external debt (% of systemwide domestic loans)	(5.8)	(6.2)	(7.1)	(7.7)	(7.1)	(8.8)
Outstanding of bonds and CP issued domestically by the resident private sector (% of GDP)	26.3	25.8	25.9	27.3	27.6	28.2

f--Forecast. ILS--Israeli shekel. Source: S&P Global Ratings.

Government Support: Assessment

We believe the Israeli government is likely to intervene directly in support of systemically important banks, if needed. In general, the government and the BoI have a strong interest in, and ability to, preserve the stability of the banking sector. Over the past few decades, the Israeli banking system has not faced any significant systemic crises that required extraordinary government support. During the 2008-2009 global financial crisis, the government put in place a scheme to backstop banks' funding, liquidity, and capital needs, but the domestic banks did not need to resort to such facilities. The BoI provided some liquidity during the pandemic, such as a government bond-buying program of up to Israeli new shekel (ILS) 50 billion (which was later expanded by another ILS35 billion) and introducing shekel/U.S. dollar swap transactions to mitigate the dollar liquidity stress in the market.

Related Criteria

- Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- Financial Institutions Rating Methodology, Dec. 9, 2021
- Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Sovereign Rating Methodology, Dec. 18, 2017
- Country Risk Assessment Methodology And Assumptions, Nov. 20, 2013
- Banking Industry Country Risk Assessment Update: September 2022, Sept. 28, 2022
- Research Update: Israel Ratings Affirmed At 'AA-/A-1+'; Outlook Stable, May 13, 2022
- Ratings Affirmed On Three Israeli Banks On Solid Domestic Economic Performance, July 20, 2022

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