[On letterhead of S&P Maalot]

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Mizrahi Tefahot Bank Ltd.

Affirmation of 'ilAA+' Rating following the Revision of the BICRA Methodology; Rating Outlook is Stable

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Overview

- After reviewing the rating of Mizrahi Tefahot Bank Ltd. under S&P's revised BICRA methodology (as published on November 9, 2011) we affirm Mizrahi's ilAA+ issuer rating. The rating outlook remains stable.

- Mizrahi's rating reflects: the BICRA '4' rating of the Israeli banking industry; the bank's adequate business position; the relative moderate levels of capital and earnings; adequate risk profile; the composition of sources which is similar to the local industry; adequate liquidity; and our perception of Mizrahi as a systemically important bank in a country which will support its banking sector if need be.

- The stable outlook reflects our estimate that Mizrahi will maintain its adequate business position in the Israeli market and its adequate risk profile, while possible pressure on the quality of credit, due to economic fluctuations in Israel, is expected to be reasonable for the range of rating.

Rating action

On December 6, 2011, S&P affirmed 'ilAA+' issuer rating of for Mizrahi Tefahot Bank Ltd. The rating outlook is stable.

Rationale

The S&P rating for Mizrahi is based on the bank's adequate business position, the moderate levels of capital and earnings, the adequate risk profile, the composition of sources which is similar to the local industry, and the bank's adequate liquidity. In addition, the rating reflects our estimate that Mizrahi is systemically important in Israel, which we believe will support its financial sector if need be.

S&P's rating methodology for banking institutions is based on Bank Industry Country Risk Analysis (BICRA) as an anchor for the bank's rating. The BICRA rating for the Israeli banking sector is '4' (in a scale of 1-10, such that 1' reflects the lowest risk) which is based on our estimate of the economic risk; we estimate that Israel's economic indicators support the banking sector, together with adequate flexibility and no material forces of imbalance. Nonetheless, Israel's economic condition is sensitive due to the high geopolitical risk, and the credit risk in the Israeli economy is also high due to the high centralization of large groups of borrowers and relatively high credit exposure to the real estate sector.

Regarding the risk of the banking sector itself, we estimate that the Israeli banking sector has an adequate legal and regulatory framework and that its stability is supported also by diversified and stable retail basis. The position of the banking industry is expected to remain stable notwithstanding forces which are external to the banking industry which mainly operate in the corporate financing arena.

Our estimate of Mizrahi's adequate business position reflects its wide retail base, its moderate market share (approx. 12% compared with approx. 30% market share of each one of the big banks in terms of assets, approx. 16% in credit terms) and the relative high exposure of the bank's revenue to the local residential real estate market (revenue from mortgages and loans to the real estate sector constitutes approx. 25% of the total revenue and approx. 55% of the total credit risk). The bank is the fourth largest group in Israel, with total assets of approx. ILS 139 billion, and the leading one in the local mortgage market with a market share of more than 35% in this sector. High geographic centralization is offset, in our opinion, by the diversification of lines of business and client base which support the bank's stability. We estimate, that the bank's long term strategic plan sets challenging growth and earnings targets, considering the current market conditions and the expected regulatory changes.

Our estimate of the bank's moderate earnings and capital base is based on our forecasted capital ratios, based on S&P's internal capital model, for the next 12-24 months, which are 6.3%-6.8% (under the assumption of no dividend distribution due to increased regulatory capital requirements), as well as on the bank's limited ability to absorb losses. The bank's earning buffer is relatively low compared with the global comparison group (approx. 0.6% of risk assets) and therefore, loss absorbing capacity is moderate. We estimate that the low credit losses, which characterized the banking industry in general and the bank in particular in 2010 and H1 2011, were positively affected by the good market conditions and the low interest. In view of above, we expect an increase in credit losses in the next 12-24 months, *inter alia*, due to high refinancing needs of companies, the response to which may be limited, both in the banking sector and in the capital market, due to the regulatory changes in both sectors which refer to the financing of the business sector and capital needs. In addition, we estimate that a low interest environment shall continue to pressure the bank spreads in the near future.

Our estimate of Mizrahi's risk profile is adequate. The growth rates are expected to continue to be higher than within the sector, but lower than the bank's target, *inter alia*, due to the expected regulatory changes. According to our estimate, the bank has a relatively high exposure to the real estate sector due to being the largest lender in the mortgage sector. We do not expect material changes in the bank's exposure. One of Mizrahi's risk factors, similarly to that of its big local competitors, is the high exposure to large groups of borrowers. The centralization of the credit portfolio is a reflection of the Israeli economy's high centralization, which is taken into account in our BICRA estimate. The bank's credit losses history is better than the sector's average, due to being focused on retail credit which is less sensitive to economic cycles due to the high diversification. However, a possible credit crisis in the local real estate sector may harm Mizrahi's further very good performance compared with other banks.

The composition of Mizrahi's financing sources is similar to the average in the local sector, and the state of the bank's liquidity is adequate in our opinion. The composition of sources is well-diversified, similarly to the local big banks. The loans to deposits ratio is approx. 100% compared with the local average of 90%. The sources base is mainly composed of a core of retail deposits, such that the scope of institutional financing is low, similar to the sector. The bank's liquidity is adequate with approx. 14% liquid assets (cash and Israeli government bonds) which constitute approx. 17% of the total deposits.

We assess the bank as a systemically important corporation to the Israeli financial sector. In addition, we assess that the Israeli government will support the financial sector if need be (supportive country). In view of the above, Mizrahi's rating reflects our estimate that it will be supported by the state if need be.

Outlook

Mizrahi's stable rating outlook reflects our estimate that the bank will maintain its strong position in the Israeli market, while negative pressures on the Israeli economy, such as possible slowdown in the residential real estate sector, are expected to affect the bank's financial risk profile in a limited manner, and the bank will maintain stable risk-adjusted capital ratio.

However, a significant deterioration of the Israeli economy, which will be accelerated by sharp price decreases in the financial and real markets, which may develop due to the crisis in the global markets and/or due to the escalation of the security situation in Israel, and will result in significant erosion of the bank's financial performance, negative earnings buffer and erosion of the core capital, may lead to a negative rating action.

If the economic forecasts will be positive again and will have a positive effect on the bank's credit quality, the capital and the core capital, we will consider a positive rating action.

Related Articles

- **Banks: Rating Methodology & Assumptions**, Nov. 9, 2011
- **Group Rating Methodology for Banks**, Nov. 9, 2011
- **Bank Industry Country Risk Assessment Methodology & Assumptions**, Nov. 9, 2011
- **Bank Hybrid Capital Methodology & Assumptions**, Oct. 24, 2011

The aforementioned articles can be found on www.standardandpoors.com/AI4FI

Rating Score Snapshot

Issuer rating ilAA+

Sector risk 4 (BICRA)

Rating profile:

Business position adequate

Capital and earnings moderate

Risk profile adequate

Financing and liquidity average and adequate

Rating list

	Current rating	Previous rating
Issuer rating	ilAA+/Stable	ilAA+/Stable
Deferred liabilities deeds	ilAA	ilAA
Upper tier 2	ilA+	ilA+

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