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Mizrahi Tefahot Bank Ltd

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February 12, 2015

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Contents

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Mizrahi Tefahot Bank Ltd

Issuer's Rating	ilAAA/Stable

Strengths	Weaknesses
• Adequate business status in the local market. • Good credit quality. • Systematic importance in the local banking sector.	• High credit concentration in the local residential real estate sector. • High concentration in the corporate credit portfolio. • Challenging business environment with limited growth possibilities.

Outlook: stable

S&P Maalot's stable rating forecast for Mizrahi Tefahot Bank Ltd (Mizrahi Tefahot) reflects our assessment, in the base scenario, that the bank's corporate and financial profile will remain relatively unchanged over the next two years, while maintaining a Risk Adjustment Capital (RAC) ratio before adjustments of over 7%. This while taking into account the possibility of some economic slowdown in Israel, as well as a moderate price amendment in the residential real estate sector.

We may lower the bank's rating in case of a significant deterioration in the Israeli economy, which may be caused due to a global crisis or due to a localized geo-political event and will be accompanied by significantly high unemployment rates or a significant amendment of the housing prices, which will lead to pressure on the bank's asset quality.

Furthermore, considering the concentration of the borrowers in the bank's corporate credit portfolio, despite this having declined in recent years, a continuation of the financial pressures on some of its big borrowers may harm asset quality and likewise lead to a negative rating action.

Main Rating Considerations

Mizrahi Tefahot's rating reflects our assessment of the Israeli banking sector from a global perspective (BICRA – Banking Industry Country Risk Assessment), rated 4 (on a 1 to 10 scale, with 1 representing the lowest risk). In addition, the bank's rating reflects its adequate business status in the local banking system, its good credit quality and its importance to the local financial system, reflected by the support embodied in the final rating. These factors are somewhat offset by the high concentration of the credit portfolio in housing loans, as well as its high exposure to the Israeli market, which is relatively small and has a limited growth potential.

The risk of the Israeli banking sector remains stable; credit concentration and high exposure to the real estate sector remain a central risk factor

S&P's rating methodology for banking institutions is based on the BICRA as an anchor for the bank's rating. The BICRA score for the Israeli banking system is 4. The BICRA score relies on our assessment of the economic risk and the sectorial risk. We see Israel's economic indicators as supportive of the banking sector, with adequate resistance and without significant disequilibrium forces. However, the situation could quickly deteriorate considering the country's geo-political risk. We think that the market's credit risk is medium, due to a significant borrower concentration, although this has declined slightly, and due to a large exposure to real estate (including mortgages). With regard to industry risks, the Israeli banking sector has an adequate institutional framework, supported by a large and stable base of core retail deposits. We expect that the banking system will maintain its high stability, despite the extra-banking forces operating mainly in corporate financing.

Table 1

Mizrahi Tefahot Bank Ltd. Key Figures

	--Year-ended Dec. 31--				
(Mil. NIS)	2014*	2013	2012	2011	2010
Adjusted assets	195,054.0	179,526.0	162,155.0	150,159.0	133,179.0
Customer loans (gross)	148,302.0	140,185.0	130,561.0	121,162.0	110,739.0
Adjusted common equity	10,638.0	9,714.0	9,165.0	7,997.0	7,369.0
Operating revenues	3,721.0	4,959.0	4,787.0	4,611.0	4,326.0
Noninterest expenses	2,266.0	2,957.0	2,786.0	2,667.0	2,566.0
Core earnings	898.0	1,122.0	1,126.0	1,083.3	818.7

NOTE: Data is Standard & Poor's adjusted. *Data as of Sept. 30. NIS--New Israeli shekel.

Business status: good business status in the local market, a leading player in the residential mortgage sector

Our estimation of Mizrahi Tefahot's "adequate" business status reflects its good positioning in the local banking industry, as the third largest in terms of credit to the public. As of September 2014, the bank's total assets stood at approx. NIS 195 Bil, representing 14% of the total assets of the local banking industry. This assessment also reflects Mizrahi Tefahot being a leading player in the residential mortgage sector, with a market share of approx. 35%, as well as its business lines and diverse customer base, which support business stability. These are offset by the bank's high exposure to the local real estate market, with housing loans constituting approx. 46% of total assets and approx. 61% of the total credit to the public. The bank also has a high exposure to the Israeli market and less than 5% of its assets are outside of Israel.

The bank operates mainly in retail banking. As of the end of September 2014, household loans (including mortgages and private banking) constituted approx. 76% of the total credit to the public and approx. 55% of revenue.

In recent years, Mizrahi Tefahot presented high credit growth rates compared to the local banking sector and compared to the growth of the GDP, due in part to an increase in its mortgage operations. We estimate that this trend will continue in the near future, as mortgage demand remains high.

We estimate that the bank will aim to increase corporate credit, both to large companies and small and medium businesses, in order to diversify its activities and in accordance with its strategic plan. However, the execution of this strategy may be challenging due to the limited growth opportunities mainly in the field of credit for large companies, due to the low credit demand from these companies and the competition from non-banking financing entities. Increased competition is also expected in the field of non-mortgage retail credit, because this field is marked as an engine of growth in the local banking industry in general.

In our opinion, this strategy indicates Mizrahi Tefahot has a high risk appetite compared to other local banks, yet we believe that a controlled increase of the bank's asset portfolio distribution – which is currently leaning towards real estate credit - may reduce the possible negative consequences of an upheaval in the local real estate market on the bank's credit portfolio and diversify its revenue sources.

In addition, we believe that the bank's management is experienced and stable, and the changement risks in the near future are low.

Table 2

Mizrahi Tefahot Bank Ltd. Business Position

		--Year-ended Dec. 31--			
(%)	2014*	2013	2012	2011	2010
Total revenues from business line (mil. NIS)	3,721.0	4,959.0	4,787.0	4,611.0	4,326.0
Commercial banking/total revenues from business line	39.6	37.9	39.0	36.3	35.6
Retail banking/total revenues from business line	55.1	55.2	55.1	56.5	53.1
Commercial & retail banking/total revenues from business line	94.7	93.1	94.1	92.8	88.7
Trading and sales income/total revenues from business line	5.1	7.0	5.9	7.1	11.3
Other revenues/total revenues from business line	0.2	(0.1)	N/A	0.0	N/A
Investment banking/total revenues from business line	5.1	7.0	5.9	7.1	11.3
Return on equity	11.2	11.6	13.1	14.0	11.7

NOTE: Data is Standard & Poor's adjusted. *Data as of Sept. 30. NIS--New Israeli shekel. N/A--Not applicable.

Equity and profitability: equity is expected to strengthen due to regulatory requirements, decrease in the dividend rate

Our assessment of Mizrahi Tefahot's equity and profitability as "adequate" is based on our outlook that the RAC ratio before adjustments will amount to more than 7% in the next 18-24 months. Our outlook takes into account the regulatory requirements to increase the equity base due to the bank's mortgage portfolio and a decline in the rate of dividend distribution, in accordance with the bank's current policy.

In addition, in our RAC outlook, we do not assume a significant effect from potential fines or other expenses in connection with the U.S. Department of Justice's investigation of the bank's Swiss subsidiary. The scope of the investigation and its results are not known at this stage, as well as its potential effects on the bank's equity, if these will occur. However, in our base scenario, we do not assume a significant harm to the bank's equity base.

As of the third quarter of 2014, the bank reported a regulatory tier 1 equity ratio at a level of 9.01% in terms of Basel 3, when according to the Bank of Israel's instructions, it had to reach a regulatory tier 1 equity ratio of at least 9%, in terms of Basel 3, by the end of 2014. In addition, the bank has to gradually increase this ratio until the end of 2016, at a rate expressing 1% of its total housing loans, in accordance with the updated Bank of Israel instructions.

The bank adapted its dividend policy in part due to the updated equity requirements, and is expected to distribute up to 15% of its current profit between 2015 and 2016, when the last dividend distribution was carried out in September 2013, in the amount of NIS 75 Mil.

We estimate that the bank has better operational efficiency than its local competitors, which is expected to continue to benefit its performance in the near future. The ratio of the bank's operational efficiency was 61% in the first nine months of 2014, compared to a ratio of 60% in 2013, and an average of 71% and 69%, respectively, among the five largest local banks.

We estimate that this relative efficiency results from the growth in the bank's activity in recent years, when revenue growth rate exceeded expenditure growth rate, due to managerial attention to this issue, the bank's focus on the mortgage field, generally characterized by a relatively short interface with the customer compared to the life of the asset, as well as the fact that the bank has a relatively young workforce compared to the industry.

In our base scenario, we assume that credit losses will increase from the current level of 0.02% in the next 18-24 months, but will remain at a reasonable level lower than 0.5%. The bank's credit losses were lower in recent years compared with its local colleagues, given its focus on the mortgage field, which remained stable in recent years. In addition, the low credit losses were supported by the recoveries due to credit previously provisioned for in accordance with the general trend in the industry, which we estimate will not continue at a similar pace in the future.

Although this scenario is not part of our base scenario, a continuing economic slowdown in Israel, accompanied by a significant increase in unemployment or a substantial correction in housing prices, as well as a significant interest rate increase, may put pressure on the quality of the bank's asset portfolio and its profitability.

The bank's net income for the nine months ending in September 2014 stood at NIS 870 Mil compared to NIS 826 Mil during the same period last year, when profit was affected by a onetime general provision for the mortgage portfolio, in accordance with the Bank of Israel's instructions. In our estimation, the low interest rate environment may put pressure on the bank's interest margins.

Table 3

Mizrahi Tefahot Bank Ltd. Capital And Earnings

		--Year-ended Dec. 31--			
(%)	**2014***	**2013**	**2012**	**2011**	**2010**
Tier 1 capital ratio	9.0	9.0	8.6	7.8	8.0
S&P RAC ratio before diversification	N.M.	7.6	5.9	N.M.	5.8
S&P RAC ratio after diversification	N.M.	6.7	5.4	N.M.	5.2
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	68.0	69.9	67.1	69.9	69.3
Fee income/operating revenues	27.7	29.4	30.3	29.1	30.9
Market-sensitive income/operating revenues	3.5	0.3	2.0	0.5	(0.9)
Noninterest expenses/operating revenues	60.9	59.6	58.2	57.8	59.3
Preprovision operating income/average assets	1.0	1.2	1.3	1.4	1.4
Core earnings/average managed assets	0.6	0.7	0.7	0.8	0.7

NOTE: Data is Standard & Poor's adjusted. *Data as of Sept. 30. RAC--Risk-adjusted capital. N.M.--Not meaningful.

Table 4

Mizrahi Tefahot Bank Ltd. Risk-Adjusted Capital Framework Data

(Mil. NIS)	Exposure*	Basel II RWA	Average Basel II RW (%)	Standard & Poor's RWA	Average Standard & Poor's RW (%)
Credit risk					
Government and central banks	30,018	976	3	1,513	5
Institutions	4,459	1,390	31	1,342	30
Corporate	46,902	45,651	97	51,867	111
Retail	102,274	54,334	53	53,979	53
Of which mortgage	88,409	43,889	50	39,784	45
Securitization§	0	0	0	0	0
Other assets	4,026	2,902	72	6,183	154
Total credit risk	187,679	105,253	56	114,884	61
Market risk					
Equity in the banking book†	218	158	100	2,034	933
Trading book market risk	–	842	–	1,263	–
Total market risk	–	1,000	–	3,297	–
Insurance risk					
Total insurance risk	–	–	–	0	–
Operational risk					
Total operational risk	–	7,154	–	9,298	–

(Mil. NIS)	Basel II RWA	Standard & Poor's RWA	% of Standard & Poor's RWA
Diversification adjustments			
RWA before diversification	113,407	127,479	100
Total Diversification/concentration adjustments	–	16,656	13
RWA after diversification	113,407	144,136	113

(Mil. NIS)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	Standard & Poor's RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	10,217	9.0	9,714	7.6
Capital ratio after adjustments‡	10,217	9.0	9,714	6.7

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA–Risk-weighted assets. RW–Risk weight. RAC–Risk-adjusted capital. NIS–New Israeli Shekel. Sources: Company data as of Dec. 31, 2013, Standard & Poor's.

Risk profile: high exposure to the local residential real estate field.

Mizrahi Tefahot's risk profile is "adequate", in our assessment. The loan portfolio's growth rate is expected to be 4% -5% - higher than the industry average and the growth of the GDP, due to the continued high demand for mortgages. However, these growth rates are lower than the growth in recent years, as a result of higher equity requirements and regulatory burdening in the housing loan field.

We do not expect a significant change in the risk profile of the bank in the next 18-24 months. The main risk factor for the bank is its high exposure in the field of local real estate, and deterioration in its asset quality in the event of a significant increase in the unemployment or interest rates, and to a lesser degree in the event of a significant price correction in the housing market - although these scenarios are not part of our base scenario for the next 18-24 months. Likewise, we estimate that the bank has a proper credit underwriting policy, and good credit monitoring and review tools to reduce the possible risks resulting from its real estate credit activity.

Another risk for the bank, as well as its local competitors, is the high credit concentration for large, local corporations, which is a reflection of the concentrated structure of the Israeli market, and is incorporated into our BICRA evaluation. As of September 2014, Mizrahi Tefahot had no exposure to a borrower group over 15% of its total regulatory equity, compared with exposure to one such borrower group as of September 2013.

The bank's provision rate for credit losses of the total credit to the public stood at 0.02% as of September 2014, compared to a provision rate of 0.21% in 2013 (including a general provision due to the mortgage portfolio according to the instruction of the Bank of Israel, carried out at the first half of 2013), compared to an average of 0.02% and 0.26%, respectively, in the local banking industry.

The bank's problem loans rate (non-performing, restructured and at arrears of more than 90 days) of the total credit to the public was 1.4% in September 2014, compared to 1.7% at the end of 2013 - lower than the average level among the five largest local banks, which stood at 2.3% and 2.8%, respectively.

The bank's provision coverage ratio (provision for credit losses as a percentage of problem loans) stood at 65% as of the third quarter of 2014, slightly higher than the local industry average, which stood at 62%.

Table 5

Mizrahi Tefahot Bank Ltd. Risk Position

		--Year-ended Dec. 31--			
(%)	2014*	2013	2012	2011	2010
Growth in customer loans	7.7	7.4	7.8	9.4	12.0
Total diversification adjustment/S&P RWA before diversification	N.M.	13.1	10.5	N.M.	10.6
Total managed assets/adjusted common equity (x)	17.5	18.5	17.7	18.8	18.1
New loan loss provisions/average customer loans	0.0	0.2	0.2	0.3	0.5
Net charge-offs/average customer loans	(0.0)	0.4	0.3	0.5	0.2
Gross nonperforming assets/customer loans + other real estate owned	1.4	1.7	2.5	2.8	3.2
Loan loss reserves/gross nonperforming assets	64.7	55.4	47.9	48.3	101.1

NOTE: Data is Standard & Poor's adjusted. *Data as of Sept. 30. RWA--Risk-weighted assets. N.M.--Not meaningful.

Financing and liquidity: average resource structure and adequate liquidity.

Mizrahi Tefahot's financing profile is "average", while the liquidity status is "adequate" in our estimation - similar to these characteristics in the local banking industry in general.

Like the other local banks, the bank will adopt liquidity requirements in accordance with the Basel 3 regulations in the first quarter of 2015, which according to our estimation will reduce the reliance on short-term deposits from institutional investors.

As of September 2014, the ratio of credit to public deposits was 98%, compared with a range of 79%-98% in the local banking industry.

The deposits of institutional investors constituted 30% of the total public deposits, as of the end of September 2014 - a very high rate compared to the other local banks. We estimate that some of these deposits are long-term deposits that the bank recruits to finance its long assets, but most of them are short-term deposits - under a year - deposited mainly by monetary funds and ETFs. Household and corporate deposits constituted 46% and 24% of the total public deposits, respectively.

The average duration gap between assets and liabilities remained stable compared to the end of 2013, due in part to bond issues made by the bank in the domestic equity market, which extended the average maturity of its liabilities. The bank's asset profile is characterized by a longer duration than that of its local peers, mainly due to mortgage operations, which should lead to a lower reliance on short-term deposits from institutional investors.

As mentioned above, the implementation of Basel 3 regulations is expected to also lead to a decreased reliance on short-term deposits.

In addition, the average maturity mismatch between assets and liabilities exposes the bank to changes in the financing costs in the event of floating-rate assets, as the spread of floating-rate assets is "locked" for a longer period than that of the liabilities.

The bank's liquidity is "adequate". As of September 2014, cash and bank deposits constituted 13% of the total assets and approx. 17% of the total deposits from the public. Deposits and cash with banks together with the bank's bond portfolio, which is largely held in government bonds of the State of Israel, constituted approx. 26% of the total deposits from the public and approx.21% of the total liabilities.

Table 6

Mizrahi Tefahot Bank Ltd. Funding And Liquidity					
		--Year-ended Dec. 31--			
(%)	2014*	2013	2012	2011	2010
Core deposits/funding base	86.9	88.4	89.0	89.3	89.5
Customer loans (net)/customer deposits	97.5	98.3	100.4	100.2	101.1
Long-term funding ratio	99.1	96.5	96.8	96.8	96.7
Stable funding ratio	114.0	106.6	104.2	103.4	N/A
Short-term wholesale funding/funding base	1.0	3.7	3.3	3.3	3.4
Broad liquid assets/short-term wholesale funding (x)	17.9	4.0	3.7	3.5	N/A
Net broad liquid assets/short-term customer deposits	24.2	15.6	12.4	11.7	N/A
Short-term wholesale funding/total wholesale funding	7.6	32.2	30.3	30.9	32.5

NOTE: Data is Standard & Poor's adjusted. *Data as of Sept. 30. N/A--Not applicable.

External support: systematically-important bank

The bank's rating includes state support, which reflects its systematic importance in Israel, as well as a "supportive" government policy towards the local financial system, where necessary.

Additional factors affecting the rating: none

No further factors affected this rating.

Ratings Score Snapshot	
Issuer rating	ilAAA
Sector risk	4 (BICRA)
Rating profile:	
Business status	Adequate
Equity and profitability	Adequate
Risk profile	Adequate
Financing and liquidity	Average and Adequate

Methodology and related Research

- Banking Industry Country Risk Assessment: Israel. December 17, 2014;
- Bank Rating Methodology. November 9, 2011;
- Banking Industry Country Risk Assessment Methodology and Assumptions. November 9, 2011;
- Bank Capital Methodology and Assumptions. December 6, 2010;
- Bank Hybrid Capital and Nondeferrable Subordinated Debt Methodology and Assumptions. September 18, 2014;

The articles can be found on the S & P Maalot website at www.maalot.co.il or on the Standard & Poor's website at www.standardandpoors.com

General details (as of February 12, 2015) list

Mizrahi Tefahot Bank Ltd (Mizrahi Tefahot Issuing Company Ltd)	
Issuer Rating	ilAAA/Stable
Bond Series 33, 34, 35, 36, 37, 38, 39	ilAAA
Subordinated Notes 27, 30, 31	ilAA+
Upper Tier 2 Capital Series A	ilA+

Issuer rating history	
December 23, 2014	ilAAA/Stable
November 15, 2010	ilAA+/Stable
September 14, 2009	ilAA+/Negative

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