MIZRAHI TEFAHOT BANK LTD
No. with the Registrar of Companies: 520000522

To	Israel Securities Authority	To	Tel Aviv Stock Exchange Ltd	T125 (Public)	Date of transmission: September 6, 2018
	www.isa.gov.il		www.tase.co.il		Ref: 2018-01-083353

Immediate Report on the Rating of Bonds/Rating of a Corporation or Rating Cessation

On September 6th, 2018, *Midroog* published:

⦿A rating report/notice *updated*

○A notice regarding rating cessation

1. Rating report or notice

☑ Corporation's rating: *Midroog Aaa.il stable*

Comments/Notice summary: *Other*
Reaffirmation.

Ratings history in the three years prior to the date of the rating/notice:

Date	Rating subject	Rating	Comments/Notice summary
December 14, 2017	Mizrahi Tefahot Bank Ltd.	*Midroog Aaa.il stable*	*Other Reaffirmation*
September 10, 2017	Mizrahi Tefahot Bank Ltd.	*Midroog Aaa.il stable*	*Initial rating*

Explanation: The ratings history should only detail the rating history of the company rating the subject of the immediate report

☑ Rating of the corporation's debentures:

Name and type of security	Security number on the stock exchange	Rating company	Current rating	Comments/Notice summary
Deferred Bonds	0	Midroog	Midroog *stable Aa3.il*	Rating affirmation
Series A Deferred Capital Notes	6950083	Midroog	Midroog *stable Aa2.il*	Rating affirmation

Ratings history for the three years prior to the rating/notice date:

Name and type of security	Security number on the stock exchange	Date	Type of rated security	Rating	Comments/Notice summary
Deferred	0	*December*	*Deferred CoCo*	Midroog	Rating affirmation

Bonds		*14, 2017*	*bonds*	*stable Aa3.il*	
Series A Deferred Capital Notes	6950083	*December 14, 2017*	*Deferred capital notes*	Midroog *stable Aa2.il*	Rating affirmation
Deferred Bonds	0	*September 10, 2017*	*Deferred CoCo bonds*	Midroog *stable Aa3.il*	Initial rating
Series A Deferred Capital Notes	6950083	*September 10, 2017*	*Deferred capital notes*	Midroog *stable Aa2.il*	Initial rating

Explanation: The ratings history should only detail the rating history of the company rating the subject of the immediate report

Attached rating report finalfollowupreportmizrahitefahotbank06092018_isa.pdf

2. On _______, __________ announced that it would cease rating __________

On September 6th, 2018, Midroog reaffirmed the bank's issuer rating, which is at Aaa with a stable outlook
The above report was signed by Ms. Maya Feller, Bank Secretary

The reference numbers of previous documents on the subject (reference does not constitute incorporation by reference):

Securities of a Corporation Listed for Trading on the Tel Aviv Stock Exchange
Form structure revision date: September 4, 2018
Abbreviated Name: Mizrahi Tefahot
Address: 7 Jabotinsky Street Ramat Gan, 52520, Israel
Tel: 03-7559720 Fax: 03-7559923
E-mail: mangment@umtb.co.il

Previous name of the reporting entity: United Mizrahi Bank Ltd.

Name of the person reporting electronically: Feller Maya Position: Bank Secretary Name of Employing Company:
Address: 7 Jabotinsky Street, Ramat Gan, 52520, Israel Tel: 03-7559720 Fax: 03-7559923 E-mail: mangment@umtb.co.il

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Mizrahi Tefahot Bank Ltd
Follow-Up | September 2018

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Mizrahi Tefahot Bank Ltd

Baseline credit assessment (BCA) for the bank	aa2.il	
Long-term deposits/Bonds	Aaa.il	Rating outlook: stable
Deferred bonds (lower tier II capital)	Aa1.il	Rating outlook: stable
Deferred capital notes (upper tier II capital)	Aa2.il (hyb)	Rating outlook: stable
Deferred bonds with contractual loss absorbency (CoCo)	Aa3.il (hyb)	Rating outlook: stable
Short-term deposits	P-1.il	

Midroog is maintaining the baseline credit assessment (BCA) of Mizrahi Tefahot Bank Ltd (the "Bank") at aa2.il. The BCA's direction of development is stable.
The rating of the Bank's long-term deposits and senior debt remains Aaa.il with a stable outlook and continues to embody the assumption of high external support from the state, at two rating levels (notches) relative to the BCA.
The ratings of the Bank's subordinated debts have remained unchanged, as follows: Aa1.il with a stable outlook for deferred bonds (lower tier II capital) and Aa2.il (hyb) with a stable outlook for deferred capital notes (upper tier II capital). These ratings reflect the structural subordination of these debts relative to the Bank's senior debt, the seniority scale among the subordinated debts themselves, the impact of the loss-absorbing mechanisms embodied therein and the assumption of high external support from the state, as with the senior debt. The rating of the deferred bonds with contractual loss absorbency (CoCo) through a write-off or partial write-off (classified as tier II capital) remains Aa3.il (hyb) with a stable outlook. This rating is one notch lower than the BCA and reflects the structural subordination and loss-absorbing mechanisms of this instrument, without an assumption of external support.
Midroog is likewise maintaining the P-1.il rating for short-term deposits unchanged.

The main considerations in making the baseline credit assessment

The Bank's baseline credit assessment (BCA) is supported by the Bank's good positioning in the local banking system, which is based on a strong brand name, significant absolute market shares and leadership in the mortgage sector, which - together with a broad, dispersed customer base – support the Bank's good profitability, despite the concentration of the income sources. The Bank is a universal bank[1], and provides its customers with a variety of banking services in addition to financial intermediation activities.

[1] A bank engaged in a variety of activities, including retail credit, business credit, deposit recruitments, capital market activities, advising, operation and more.

The Bank is characterized by a conservative risk management policy that is consistent with its risk profile, and an outstanding asset quality which is steadily improving, as reflected by the quality indicators of the credit portfolio in recent years. The quality of the assets is also supported by a continuous decline of the borrower concentration risk, but the exposure to big borrowers relative to the Bank's capital is still high relative to the rating. These factors, along with profitability rates which are reasonable relative to the rating, but favorable relative to the comparison group as a result of the relatively good operational efficiency, support the ability to generate future profits and the ongoing building of the capital buffer. In addition, the Bank is characterized by a favorable liquidity profile, in view of a significant inventory of liquid assets. On the other hand, the Bank's internal BCA is negatively affected by the concentration in the credit portfolio and its income sources, with substantial exposure to the housing sector. This concentration hampers the risk profile, along with a high balance sheet leverage compared to the other banks and a capital adequacy margin which is low relative to the regulatory barrier on the total capital, which harms the business flexibility. Thus, the provisions in respect to US customers (see below) led to an erosion of capital adequacy and even to a decline below the regulatory barrier regarding total capital. However, we note that the capital buffer continues to absorb unexpected losses in a manner adequate relative to Midroog's stress tests.

Like the other major banks, the Bank has formulated efficiency steps which are expected to continue to support its good operational efficiency and profitability margins. These include the early retirement of approximately 300 employees over the next 5 years, and the sale and lease back of the Bank's headquarter offices, in order to concentrate them in Lod in the future. We estimate that the continued growth anticipated for the credit portfolio, the good asset quality and the continued control over the expenses structure will enable the Bank to continue to present relatively good profitability ratios throughout the cycle. Midroog's baseline scenario for the next 12-18 months assumes that the business climate will continue to be challenging, with a low interest rate environment adversely affecting the financial margin at least until the end of 2018 – after which, it may be very slowly raised, along with a stable growth of the GDP, some improvement of the inflation environment and competition continuing in most sectors of activity. Under this scenario, the risk indicators of the Bank's credit portfolio are expected to remain relatively stable (depending on the segment), with some increase in provisions to credit losses (0.20%-0.25%), in part due to our assessment that the risk in the retail sector will rise, the collection of past debts will decrease, and regulatory changes will occur. The Bank's provision due to the legal procedures vis-à-vis the US Department of Justice is expected to put a strain on short-term profitability, which was captured in the rating capacity. The profitability buffer, net of the provisions, is reasonable relative to the rating, while the future profit potential supports the ongoing building of the

capital buffer. The implementation of the aforesaid efficiency steps, along with the continued growth of the credit portfolio (albeit at a low rate compared to the past) up to the improvement of the capital adequacy will cause the core yield and the return on assets (ROA) to be in the range between 1.5%-2.0% and 0.4%-0.6%, respectively, in 2018 and 2019, assuming no further provisions are made. In light of this, our assessment is that the Bank is expected to continue building the capital buffer and support the improvement of the capital adequacy ratios. It should be noted that we have examined the possibility of full provision due to the demand of the US Department of Justice – in which case, the core capital adequacy would decline below the regulatory requirement and the Bank's profitability will suffer significantly; however, we assume that the Bank will be able to repair these ratios relatively quickly, so the current rating contains this scenario as well.

Midroog predicts an improvement in the capital adequacy ratios as a result of the following factors: (1) A good profit generation potential, due to good operational efficiency that supports profit accumulation; (2) Continued management of the volume and mix of risk assets including the sale of housing loans portfolios, despite the risk weight having increased somewhat in view of the credit portfolio's growth mix; (3) Refrainment from dividend distribution in the short term (until the end of 2018) and a return to a 40% distribution rate after the end of the US Department of Justice's investigation; (4) A raise of deferred bonds (CoCo) due to the erosion in short-term regulatory capital and further debt raising, depending on the rate at which old subordinated debts are reduced and the growth of the credit portfolio.

The BCA's direction of development and the outlook for the Bank's ratings have remained stable, reflecting Midroog's assessment that the Bank is expected to maintain a strong financial profile throughout the economic cycle, alongside with its ability to return to appropriate levels of capital adequacy.

Mizrahi Tefahot Bank Ltd, main financial data, in ILS M:

	June 30 2018	June 30 2017	2017	2016	2015	2014
Cash and deposits at banks	42,380	39,146	41,130	41,725	30,489	26,798
Securities	9,926	10,560	10,133	10,262	11,845	14,259
Loans to the public, net	187,055	177,133	181,118	171,341	159,204	147,569
Deposits from the public	189,900	180,680	183,573	178,252	162,380	152,379
Equity attributed to the shareholders	13,986	13,276	13,685	12,714	11,847	10,797
Total assets	246,593	235,056	239,572	230,455	209,158	198,513

Income from interest, net [1]	2,426	2,200	4,347	3,778	3,534	3,375
Credit loss expenses (income)	172	91	192	200	211	173
Non-interest income	967	754	1,653	1,862	1,858	1,612
Operational and other expenses	2,237	1,700	3,611	3,299	3,226	3,039
PPP [2]	1,156	1,254	2,389	2,341	2,166	1,948
Net profit attributed to the Bank's shareholders	550	721	1,347	1,266	1,134	1,092

	June 30 2018	June 30 2017	2017	2016	2015	2014
Equity attributed to the Bank's shareholders/Assets	5.7%	5.6%	5.7%	5.5%	5.7%	5.4%
Tier I capital adequacy	10.0%	10.1%	10.2%	10.1%	9.5%	9.1%
Total capital adequacy	13.3%	13.4%	13.9%	13.8%	13.3%	13.0%
Liquidity/Total asset balances [3]	21%	21%	21%	23%	20%	21%
ROA (annual gross-up) [4]	0.5%	0.6%	0.6%	0.6%	0.6%	0.6%
PPP/Risk asset average	1.6%	1.9%	1.8%	1.8%	1.7%	1.6%
Credit loss expenditure (income)/Loans to the public (annual gross-up)	0.2%	0.1%	0.1%	0.1%	0.1%	0.1%
Troubled debt/Loans to the public	1.5%	1.5%	1.4%	1.4%	1.4%	1.4%

[1] Before provision for credit losses

[2] Pre-tax profit + credit loss expenditure

[3] Cash and bank deposits + Securities

[4] Annual net profit attributed to the Bank's shareholders (at t time) to asset/equity average (t, t-1)

Summary of the key factors in evaluating the Bank's BCA

A favorable business profile and the growth potential support the Bank's profitability throughout the cycle despite the portfolio's concentration

Mizrahi Tefahot is the leading banking group in the mortgage segment (approx. 36%) and the third largest in the local economy, as expressed by significant market shares which are growing over time (approx. 16% of all assets in the system, as of June 30th, 2018). Likewise, the business profile is supported by its being a universal bank, which provides a wide range of financial and banking services; a broad and dispersed customer base; a strong brand; and business distinction with respect to its main competitors, including an expansion of the branch network and an emphasis on personal connection with customers, along with a comprehensive value proposition that appeals to a variety of public tastes, despite the business focus. All of these contribute to the Bank's growth potential and profitability, the maintenance of its position throughout the economic cycle and its ability to cope with changes in the business environment. By contrast, the concentration of the credit portfolio, with a substantial bias towards the mortgage industry (approx. 65% of the total portfolio on June 30th, 2018; and 25% of the total income for the first half of 2018) and significantly low exposure to the business sector relative to its size (approx. 8% at the time) create a growth potential in this sector on the one hand, but on the other hand impede the distribution of income sources, which is not particularly outstanding in relation to the rating and in relation to the other major banks. It should be noted that the Bank's strategic plan, which is expected to continue in the upcoming years, supports income source dispersion; however, we estimate that it also indicates a relatively high risk appetite compared to the comparison group, in view of the credit portfolio growth deriving from the plan. Nevertheless, the implementation of the plan is expected, in our assessment, to support the Bank's risk profile over time, while maintaining adequate underwriting processes, as a result of the dispersal of revenues and profits.

In May 2018, the Deputy Antitrust Commissioner decided not to approve the merger signed between the Bank and the controlling shareholders at Union Bank. This transaction, which would have supported the realization of the strategic plan out of non-organic growth, was not considered under our base assumptions on the previous follow-up date; therefore, we do not anticipate any impact due to this decision. It should be noted that the Bank, along with the controlling shareholders at Union Bank and Union Bank, announced in August 2018 that they intended to appeal the decision of the Antitrust Commissioner, with some adjustments to be made to the transaction's price. We continue to believe that the Bank's financial profile will not be substantially affected if the appeal is accepted with marginal erosion in asset value, depending on the Bank's ability to merge with Union Bank and include its organizational

culture and operational efficiency – especially in terms of the Bank's personnel and IT systems.

In early August 2018, the Bank received a notice from the US Department of Justice, according to which they were prepared to propose a settlement with the Bank based on the payment of USD 342 million (approx. ILS 1.3 billion), in order to end the investigation of suspected tax evasions committed by the Bank's American customers. The Bank, following this demand, made an additional provision of approx. USD 116 million during the second quarter of 2018, thereby providing a total of USD 162 million (approx. ILS 600 million) so far. We predict that this notice and the need to create sufficient capital buffers because of it may impede the short-term growth abilities of the Bank's credit portfolio, particularly in segments with a high allocation of risk assets (the business portfolio), up until the Bank will create a satisfactory margin with respect to the regulatory capital requirements. Nevertheless, we predict that in the longer term, the Bank will continue to maintain its business position and current market shares.

We believe that the market share map of the major banks is unlikely to undergo significant changes in the short term, per our previous assessment and despite the challenging business environment, with competition increasing in a number of segments and risks growing within the retail segment. In the medium to long term, the competition in the system is likely to grow, which should manifest itself through some erosion in the market shares of the two major banks, with the implementation of the Strum Committee's conclusions and together with the establishment of a central database of consumer credit information and a lowering of the entry barriers through various pro-competition reforms and technological development. It should be noted that there is a high level of uncertainty regarding the extent to which these measures could succeed, as well as their effect on the structure and level of competition – particularly after the two major banks have separated from their credit card companies. We believe that the key factor to increased competition are the structure and cost of the new entities' resources, as they lack the ability to compete with the banks' funding costs, would strengthen the major banks within the system. In the long run, we believe that innovation will serve as the main generator of competition; and banks that fail to adjust the business model over time might experience substantial erosion in the business profile.

The stability of the Bank's profits, as estimated by us, is adequate for the rating and favorable in relation to the comparison group, as a result of the Bank's retail characteristics, which produce lower exposure to economic cyclicality. By contrast, the Bank has a relatively low rate of recurring income (commissions), partly resulting from a relatively low credit card fees component. We estimate that profit stability is not likely to change significantly in the short-to-medium term (net of the provision due to the US Department of Justice investigation), and

will continue to be supported by the outstanding asset quality and in spite of a challenging business environment, regulatory changes, uncertainty in the financial markets and a relatively low geographical spread.

The risk management policy supports the Bank's risk profile; by contrast, the low margin from the regulatory capital barrier hurts the risk profile over time

The Bank's risk management systems encompass and support the formulation of the risk management policy; the determination of a risk appetite consistent with the Bank's strategy; monitoring; and risk control. Credit risks are managed by means of statistical rating models and expert evaluations, with the underwriting processes – particularly in the mortgage segment – being relatively conservative, as reflected in the credit risk indicators, including the average repayment ability and the moderate LTV rates. By contrast, the concentration level (borrowers and sectorial) in the business portfolio is still high relative to the rating, but it is favorable for the comparison group because of its retail nature. Thus, the Construction and Real Estate sector constituted approx. 105% of the portfolio at the end of March 2018, while exposure to the 20 largest borrowers constituted a substantial proportion of the capital at that time. No substantial improvements are anticipated for these indicators in the short and medium terms (despite our expectation to see some growth in the capital absorption buffer), in part because of the local system's structural characteristics.

The Bank's risk appetite is relatively high, as reflected by the relatively low margin of approx. 30bp from the regulatory capital barrier (tier I capital adequacy) in recent years and also relative to the comparison group. Thus, the provision made by the Bank in connection with the investigation of the US Tax Authorities (approx. USD 116 million) caused an erosion of the margin (in tier I capital adequacy) to approx. 10bp; and an erosion of the total capital adequacy ratio to approx. 5bp below the regulatory barrier, as well as damage to business flexibility. Had the Bank accepted the American settlement proposal of approx. USD 342 million, the tier I capital adequacy ratio would have eroded to approx. 9.7% in the second quarter of 2018, which would have put it 14bp under the regulatory barrier. In spite of this, the Bank's good profit generation potential and the non-distribution of dividends anticipated later in the year will allow the Bank to continue constructing the capital buffer; to comply with the regulatory ratio as early as the upcoming quarter, in our assessment (without further substantial provisions due to the investigation); and to restore the capital buffer.

The market risks at the Bank are also evaluated through the VaR model, under conservative assumptions, similar to the entire banking system and as complementary activity to the risk assessment, the Bank operates a number of stress scenarios (including holistic scenarios) of varying degrees of severity. We estimate that the Bank's market risk appetite is adequate, as also reflected in the relatively low rate of the securities portfolio in relation to the balance sheet over time, and also as a derivative of the moderate VAR exposure limits relative to the core capital and actual results in recent years.

The Bank maintains a relatively good correlation between asset and liabilities duration over the different linkage bases, as reflected in the relatively low duration gaps in spite of relatively long usage, in view of the substantial mortgage portfolio. The Bank's liquidity risk is managed through an internal model that includes stress scenarios and is monitored on a daily basis. Midroog estimates that the liquidity management is adequate for the Bank's risk profile, in view of a liquid asset inventory at a substantial rate of the total balance sheet and a reasonable resource structure relative to usage. It should be noted that the Bank has a relatively high dependence on the capital market, but this support duration adjustment in view of the substantial mortgage portfolio. The adequate liquidity management is also reflected by an LCR (liquidity coverage ratio) significantly higher (120%) than the regulatory barrier (100%) during the second quarter of 2018 - a fact which also supports the liquidity profile and its business flexibility. It should be noted that as with other banks in the system, the Bank has set up a framework to handle cyber and data security threats, which constitute a significant developing risk.

An adequate liquidity profile supported by a favorable liquid asset inventory and a reasonable resource structure

The Bank's resource structure, similarly to the entire local banking system, mainly relies on a broad deposit base, which had been stable over the course of previous crises, shown growth throughout the cycle and is positively affected by the savings culture in the domestic economy. The Bank has a resource structure which, on the one hand, is composed of a substantial proportion of widely-spread stable deposits (from households and small businesses), which constitute approx. 48% of all deposits. However, on the other hand, there is also a relatively high exposure of approx. 21% of all deposits (as of June 30th, 2018) to wholesale financing (financial institutions), which Midroog estimates to be less stable throughout the cycle. The Bank is characterized by a loans-to-deposits ratio which is not outstanding over time (approx. 99% compared to approx. 80% in the comparison group), and , as a derivative of this the Bank has a relatively high dependency on the capital market compared to the other major banks – such that bonds and debentures constitute approx. 12% of all assets over time – significantly above the comparison group. This finance source is

estimated to be less stable throughout the economic cycle by Midroog, but supports a better duration adjustment between assets and liabilities, mainly in view of the composition of the Bank's mortgage-heavy credit portfolio.

The Bank's securities portfolio is not substantial and constitutes approx. 4% of all assets as of June 30th, 2018, similar to recent years. The bond portfolio is characterized by a favorable risk (credit) level, in light of a substantial component of Israeli government bonds (80%) and US government bonds (approx. 15%), supporting resource and exposure management as well as asset dispersion. The relatively low volume and rate of the portfolio attests attest, as aforesaid, a relatively low market risk appetite – particularly to interest rate risks of all varieties (a risk increased by the current and anticipated interest environment) - and supports the liquidity profile, with the cash component being more substantial.

According to Midroog's liquidity model, and under various assumptions and scenarios regarding the structure of the assets and liabilities[2], the Bank has relatively good liquidity against its liabilities in a range of up to 12 months ahead, and stable financing which is adequate for its long-term assets – these constitute a supporting factor in the rating. Thus, in Midroog's base scenario for the next 12 months, the Bank has liquid assets constituting approx. 15% of all assets; a rate significantly higher than the proportion of the Bank's short-term liabilities (approx. 5%). Furthermore, the Bank benefits from a stable and adequate financing against the long-term assets, as reflected in the gap between the proportion of the long-term liabilities out of all assets (approx. 95%) and the proportion of non-liquid assets out of all assets (approx. 85%). As a complementary factor to the liquidity examination, Midroog looks at the Bank's inventory of liquid assets[3] relative to the total deposits, which on June 30th, 2018 stood at approx. 27% - an adequate ratio that supports the Bank's liquidity. Midroog anticipates that the resource structure and the favorable liquidity will be maintained over the short and medium terms, partly in light of our assessment of the lack of change in the savings culture of the local market, and good access to resources in the capital market, which will also support the Bank's growth potential.

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[2] Including the ratio of loan shifting to the public, deposit stability and debt market financing abilities throughout the economic cycle, asset realization abilities and the anticipated discount, the depth of the repo market, the preservation of the liquidity requirement, the existence of pledged assets and level 3 assets (mark to model).

[3] Cash and deposits at banks, Israeli government bonds, US government bonds and bonds backed by the US government.

The credit portfolio is characterized by an outstanding risk level relative to the rating that supports the ability to generate profits throughout the cycle; we estimate that the growth rate will slow down in the short term due to the capital adequacy handicap

The Bank is characterized by a high-quality credit portfolio, which supports its future profitability, as reflected in the risk indicators which are favorable relative to the rating, and also maintains an adequate buffer for absorbing anticipated losses (provision for credit losses) relative to the impaired debts, which support the performance of the portfolio throughout the cycle. The Bank has been maintaining the quality indicators of the credit portfolio in recent years, which are good in relation to the rating. Thus, the proportion of impaired debts relative to the credit to the public stood at a stable, outstanding rate of approx. 1.4% over recent years, with the coverage ratio[4] moving in the range between 70%-85% during those years. The Bank's substantial mortgage portfolio (approx. 65% of the entire portfolio over time) is characterized by relatively good risk indicators. However, the considerable growth of the mortgage and consumer credit portfolios, within the Bank and the system, which was accompanied by an increase in the overall level of households' leverage (and therefore also raised the risk level), constitutes a developing risk factor - although this is still within reasonable limits compared to the Western world, and the underwriting processes of the Bank are relatively conservative and support the quality of the portfolio. We estimate that a similar trend will also be observed in 2018-2019, alongside a continued growth in credit to businesses. A significant risk to the quality of the Bank's mortgage portfolio - despite the notable inflation in housing prices in recent years and an erosion of the ability to buy a home - could occur only in the event of unemployment rates moving towards double digits, combined with an increase in the interest-rate environment. A preliminary indicator of this would be erosion in the performance of the business sector. This risk is mitigated due to the conservative underwriting processes at the Bank, as reflected in the maintenance of a high repayment capability (which supports a low probability of failure) and an average LTV of 54%, as of end of June 2018 (without adjusting for price increases), with high leverage rates being relatively low (approx. 4% of the portfolio has an LTV above 75%).

Midroog's base scenario estimates that the Bank's credit portfolio is expected to grow at a higher rate than the GDP (approx. 4.0%-5.0% per annum in the next two years, with growth composition differing between the various segments), while focusing on the various segments of business credit and maintaining the strong retail positioning. We estimate that the Bank will be required to manage the regulatory capital surpluses more prudently in the near future, due to the impact of the provision for the US investigation. We estimate that this could hurt the growth pace of the business portfolio due to relatively high risk weights, and lead to some

[4] The provision balance for the total of impaired debts and debts in arrears for over 90 days.

slowdown in the in the growth pace of the SME segment in accordance with the Bank's strategic plan, while the structure of the competition and risk-pricing in the nonbank market will also hamper the growth capacity of the business portfolio.

Our baseline scenario regarding the quality of the Bank's credit portfolio is based on a number of exogenous, macroeconomic influences, including: (1) A GDP growth rate of approx. 3.5%, on average, in the next two years; (2) A continuation of the low, stable unemployment rate alongside the continued growth of real wages; (3) The continuation of a low interest rate environment, at least until the end of 2018, followed by a slow increase afterwards; (4) Some increase of the expected inflation rate, as derives from the capital market; (5) Continued competition from the non-bank debt market in the business portfolio, and an increase of the credit supply in the retail sector.

Midroog is also examining the development of the Bank's credit portfolio quality in the short and medium terms on the basis of leading macro-economic indicators[5], which point to relative stability (varying between the various credit portfolio segments) in the short-term quality of the portfolio, with the Bank expected to present outstanding risk indicators relative to the rating throughout the cycle. Midroog's base scenario for the next 12-18 months anticipates some increase in the proportion of credit loss expenditure to the portfolio total, moving between 0.20%-0.25%, due to our assessment that the new insolvency law will likely to simplify entering and ending bankruptcy procedures, and reduce the rates of return to secured creditors. Therefore, in our assessment, the EL (expected losses) rate is likely to rise in the retail and SME sectors throughout the entire system, while recovery rates are likely to decline somewhat compared to previous years. The percentage of non-performing loans in the portfolio is expected to maintain relative stability; as will the absorption buffers (equity and provision for credit losses), which will be approx. 1.4%-1.5% and approx. 18%-19%, respectively.

The profitability of the Bank is reasonable relative to the rating and supported by a good operational efficiency; profitability rates are expected to improve somewhat net of the impact of the provision due to the US Tax Authorities

The Bank's profitability has maintained stability in recent years and remains favorable with respect to the comparison group due to the high asset quality, which supports low credit loss expenses, primarily due to good operational efficiency over time relative to the rating and to the comparison group. This is despite the relatively low financial margin and commission

[5] For details regarding the manner in which Midroog examines the quality of the banking system's assets, see: "Leading Indicators for Examining the Quality of the Local Banking System's Assets - Special Report, January 2015. The reports are published on the Midroog website: www.midroog.co.il

rate, due to the mix of the portfolio and the business model. The profitability buffer constitutes a reasonable safety buffer for the current rating, in terms of the Bank's ability to absorb losses and the ongoing construction of the capital buffer. The Bank presents a stable and high core yield on risk assets, compared to the comparison group (1.8% per annum on average in the last three years, compared to 1.5% in other major banks) and a reasonable return on assets. The Bank’s outstanding operational efficiency ratio, which has been below 60% in recent years, is supported by the business model and the extent of the inputs required relative to the asset's life span, managerial focus, employee characteristics (a young average age relative to the system) and an ongoing growth in activity. We estimate that the Bank is expected to maintain good operational efficiency in the next two years (net of the provisions in connection with the investigation by US authorities) which will support the Bank's profitability, also due to its growth potential.

Maintaining and improving profitability is one of the Bank's central challenges, especially in light of the challenging business and regulatory environment. The improvement of the profitability buffers depends to a great extent on the Bank’s ability to maintain control of the expense structure and to limit the scope of operating expenses, inter alia, which is partly contingent on the savings that would arise from the development of the Bank's business model, with many factors on the side of income (particularly the interest rate) being exogenous to the Bank. In this context, we note that the Bank recently approved a number of organizational and operational changes in order to save on operating expenses, including the sale and lease back of the headquarter offices, with the intention to later assemble them at a site in the city of Lod, a voluntary early retirement program for approx. 300 employees over five years, and the signing of a new collective employment agreement at the end of 2017 - which improved the managerial flexibility at the Bank, but also increased expenses by ILS 100 million compared with 2017. Midroog’s outlook for the next 12-18 months takes into account the effect of the aforementioned efficiency measures, as well as that of the natural retirement of employees.

The Bank’s provision of approx. ILS 425 million due to the legal procedures vis-à-vis the US Department of Justice, and the uncertainty regarding the time at which this matter will end and the final provision sum could continue to pressure the profitability buffer in the short term, although we estimate that the Bank has a good profit generation potential in the medium term, which will likely continue to support the construction of the capital buffer.

The main assumptions relied upon in the baseline scenario regarding the Bank’s profitability are as follows: (1) A growth of 4.0%-5.0% per annum in the credit portfolio, alongside high competition in the business sector and continued competition in the retail sector; (2) A continuation of the low interest environment, at least until the end of 2018, followed by a

slow increase afterwards, dictating further pressure on the financial margin; (3) Credit losses at a rate of 0.20% to 0.25% from the gross credit to the public, even in view of the focus on business; (4) A continued "creeping" of base expenses, in view of a 2.5% auto-pilot in 2018-2019 and an increase in the number of employees and branches alongside an offsetting effect caused by early retirement, as described above. In this scenario, the core yield on risk assets and ROA are expected to move between approx. 1.5%-2.0% and 0.4%-0.6%, respectively, in 2018 and 2019, assuming no further provisions.

The loss absorption capacity of the capital buffer is still adequate, despite relatively high balance sheet leverage, but an erosion of the margin from the regulatory barrier hurts business flexibility

As is the case with other banks, the Bank has been working in recent years to improve its capital adequacy ratios through profit accumulation; a moderate dividend distribution (30% of the net profit[6]); optimization, management and reduction of risk assets – partly by selling mortgage portfolios to financial institutions; and changing the asset mix. The Bank maintains capital adequacy ratios at a margin which is low relative to the other major banks; the tier I capital adequacy and total capital gap stood at approx. 0.3% and 0.2% at the end of March 2018, compared with an average of approx. 0.8% and 0.6%, respectively, at the other major banks. This low margin led to non-compliance with the regulatory total capital ratio, as aforesaid, and to an erosion of the business flexibility following the additional provision due to the investigation by the US tax authorities (in our assessment). However, the loss absorption capacity of the capital buffer remains good, in our assessment, while the Bank's profit generation potential along with the non-distribution of dividends in the short term should assist with the construction of the capital buffer and compliance at a certain margin with regulatory requirements, in the near future. Thus, Midroog has examined a number of stress scenarios (some of which are holistic), at varying degrees of severity, with respect to the Bank's loss-absorption buffers relative to its risk profile - assuming for various PD and LGD rates in the different industries and scenarios, exposure to market risks, the construction of equity via limited profits adjusted to the scenario, as well as the non-distribution of dividends in some scenarios. Under these scenarios, the tier 1 capital adequacy of the Bank ranged between 8.6% in the easy scenario and 6.8% in the extreme scenario, allowing the Bank to absorb unexpected losses and supporting its stability throughout the cycle.

[6] In early 2018, the Bank announced that the distribution percentage would increase to approx. 40%.

It should be noted that the Bank's leverage level is high relative to the rating and to the other major banks and hampers the Bank's risk profile, as reflected in the 5.7% ratio of equity to total assets at the end of June 2017, compared to an average of 7.2% at the other major banks for that time.

Midroog anticipates that the improvement of the capital adequacy ratios in the coming year will occur as a result of the following factors: (1) The profit generation potential will continue to be favorable, due to good operational efficiency that supports profit accumulation; (2) Continued management of the volume and mix of risk assets, despite the risk weight having increased somewhat in view of the credit portfolio's growth mix; (3) Refrainment from dividend distribution in the short term (until the end of 2018) and a return to a 40% distribution rate after the end of the US customers issue; (4) Raising deferred notes (CoCo) due to the erosion in regulatory total capital in the short term and further debt raising, depending on the rate at which old subordinated debts are reduced and the growth of the credit portfolio.

Structural changes and external support

Characteristics of the subordinated instruments

According to Midroog's methodology, the rating of the subordinated debts (the Bank's deferred bonds and capital notes) is based on the Bank's BCA, which is the anchor for rating the Bank's liabilities and reflects the possibility of failure and the Bank's ability to serve its liabilities independently, without the assumption of external support. Afterwards, we adjust the rating to the credit risk of the subordinated debt instrument, according to its specific characteristics and its location on the scale between debt and capital – taking into consideration the extent of the instrument's structural subordination, the loss absorbency mechanisms per the instrument's conditions and the uncertainty regarding their point of activation (at the contractual trigger or at the discretion of the Supervisor of Banks). We are removing one rating level (notch) off the Bank's BCA for the rating of the deferred bonds with contractual loss absorbency (CoCo). The reduction embodies the legal-contractual deferral with respect to the rest of the Babk's liabilities (excluding upper tier II capital, tier I instruments and shareholders' capital) and the contractual loss absorbency mechanism. Considering the Bank's BCA, current and anticipated capital adequacy levels and the adequate liquidity profile, the uncertainty regarding the likelihood of reaching the 'nonviability point' is low; therefore, it was not embodied by the reduction of another notch.

External support

The rating of the deposits, the senior debt and the subordinated debts, excluding deferred bonds with contractual loss absorbency (CoCo) are granted the benefit of two rating levels (notches) due to the high probability of external support from the state, according to Midroog's JDA model. The assumption of external support throughout the entire liabilities structure (without CoCos) is based on the following reasons: the banking system's high importance to the local economy and the payment system, and the need to maintain its stability; the high concentration of the banking and financial systems; the relatively high connectivity between the banking system and institutional bodies; the local financial system serving as a central credit provider to the government; some uncertainty regarding the behavior and reliability of the different debtors, in terms of bail-ins close to the point of failure, in the absence of previous experience. Furthermore, the State of Israel had, in the past, proved its willingness to support failed banks, and we do not assume any change in this policy.

The assumption of high support for subordinated debts (excluding CoCos) also derives from the fact that no significant change has been observed in Israel's system support paradigm in recent years. So far, Israeli regulators have not had to deal with significant stress scenarios in the banking system; and unlike other regions in the world, no legislation was enacted and no directives were given that may imply a change has occurred in subordinated debt risk from a legal standpoint. Our understanding is that the recommendations of the Failed Banks Committee are not expected to impose bail-ins on old subordinated debts (which are not eligible for Basel III), partly in order to preserve the trust of the public, which had previously invested in these instruments under the assumption of support and due to the loss-absorbing containing contractual mechanism bonds (CoCo) being the only funding tool of a subordinated debt, with a temporary repayment of old debts.

We note that even after external support is weighted for the rating of subordinated debts, Midroog usually keeps it so that the minimum possible gap between the rating of the Bank's senior debt and its subordinated debts is at least one rating level (notch), reflecting the relatively higher loss levels that are likely for these debts compared to the senior debt.

Rating outlook

Factors that could lead to raising the baseline credit assessment and the Bank's ratings:

- A significant improvement of activity mix dispersion
- An ongoing improvement of the profitability buffer and its stability over time

Factors that could lead to lowering the baseline credit assessment and the Bank's ratings:

- Damage to the Bank's status in the local banking system map
- Erosion of the profitability and capital buffers
- A significant worsening of the credit portfolio's quality

About the bank

Mizrahi Tefahot Bank was among the first banks to be established in Israel (1923) and is one of the five largest banking groups in Israel.

In 2005, two banks – United Mizrahi Ltd. and Tefahot Israel Mortgage Bank Ltd. – were merged together into Mizrahi Tefahot Bank Ltd.

The Bank group operates in Israel and abroad and includes Yahav Bank, which is held at 50%. The group engages in commercial (business and retail) banking activities, and mortgage activities in Israel, through a nationwide chain of 187 branches and business centers (as of the end of 2017). The Bank's international activities are conducted through 3 banking units (two branches and a subsidiary) and two representative offices in Europe and in South America. In addition to its banking activities, the Bank Group is engaged in various activities related to the capital market, including: Consultancy for capital market activities, management of security portfolios for customers, pension advisory service, trust services, distribution of mutual funds, operation of provident funds and distribution of mortgage insurance. The Bank's controlling shareholders are the Ofer and Wertheim families and the CEO of the Bank is Mr. Eldad Fresher.

Bonds and deferred bonds rated by Midroog, issued by the Bank and by Mizrahi Tefahot Issuing:

Series	Security No.	Rating	Outlook	Final Repayment Date
Series A Capital Notes	6950083	Aa2.il(hyb)	Stable	Jan 1 2016
31	2310076	Aa1.il	Stable	Sep 19 2019
35	2310118	Aaa.il	Stable	Jan 22 2019
37	2310134	Aaa.il	Stable	Jun 1 2020
38	2310142	Aaa.il	Stable	Sep 11 2021
39	2310159	Aaa.il	Stable	Feb 1 2020
40	2310167	Aaa.il	Stable	Jun 7 2025
41	2310175	Aaa.il	Stable	Jun 7 2022
42	2310183	Aaa.il	Stable	Jun 7 2030
43	2310191	Aaa.il	Stable	Jul 31 2021
44	2310209	Aaa.il	Stable	Sep 25 2022
45	2310217	Aaa.il	Stable	Sep 28 2024
46	2310225	Aaa.il	Stable	Sep 28 2027
Contingent subordinated notes	Not tradable	Aa3.il(hyb)	Stable	Jan 31 2024
47	2310233	Aa3.il(hyb)	Stable	Dec 18 2027

Related reports

Mizrahi Tefahot Bank Ltd

Methodology for Rating Banks – Methodology Report, November 2017

Short-Term Rating of Commercial Securities – Methodology Report, July 2015

Connections and Holdings Table

Midroog Rating Scales and Definitions

The reports are published on Midroog's website: www.midroog.co.il

General information

Rating report date:	September 6, 2018
Last date on which rating was updated:	December 14, 2017
Date on which rating was first published:	September 10, 2017
Name of the rating initiator:	Mizrahi Tefahot Bank Ltd
Name of the party paying for the report:	Mizrahi Tefahot Bank Ltd

Information from the issuer

In its ratings, Midroog relies, inter alia, on information received from authorized parties at the issuer.

Baseline Credit Assessment (BCA) Scale

aaa.il	Issuers and issues assessed at aaa.il are those that, in Midroog's judgment, have the highest internal or independent financial strength, relative to other local issuers, absent any possibility of external support from an affiliate or the government.
aa.il	Issuers and issues assessed at aa.il are those that, in Midroog's judgment, have very high internal or independent financial strength, relative to other local issuers, absent any possibility of external support from an affiliate or the government.
a.il	Issuers and issues assessed at a.il are those that, in Midroog's judgment, have relatively high internal or independent financial strength, relative to other local issuers, absent any possibility of external support from an affiliate or the government.
baa.il	Issuers and issues assessed at baa.il are those that, in Midroog's judgment, have moderate internal or independent financial strength, relative to other local issuers, absent any possibility of external support from an affiliate or the government, and may have certain speculative characteristics.
ba.il	Issuers and issues assessed at ba.il are those that, in Midroog's judgment, have relatively weak internal or independent financial strength, relative to other local issuers, absent any possibility of external support from an affiliate or the government, and have speculative characteristics.
b.il	Issuers and issues assessed at b.il are those that, in Midroog's judgment, have very weak internal or independent financial strength, relative to other local issuers, absent any possibility of external support from an affiliate or the government, and have significant speculative characteristics.
caa.il	Issuers and issues assessed at caa.il are those that, in Midroog's judgment, have excessively weak internal or independent financial strength, relative to other local issuers, absent any possibility of external support from an affiliate or the government, and have very significant speculative characteristics.
ca.il	Issuers and issues assessed at ca.il are those that, in Midroog's judgment, have extremely weak internal or independent financial strength, relative to other local issuers, absent any possibility of external support from an affiliate or the government, and are very near default, with some prospect of recovery of principal and interest.
c.il	Issuers and issues assessed at c.il are those that, in Midroog's judgment, have the weakest internal or independent financial strength, relative to other local issuers, absent any possibility of external support from an affiliate or the government, and are usually in default, with little prospects of recovery of principal and interest.

Note: Midroog appends numeric modifiers 1, 2, and 3 to each rating category from aa.il to caa.il. The modifier '1' indicates that the debenture ranks in the higher end of its rating category, which is denoted by letters. The modifier '2' indicates that it ranks in the middle of its rating category and the modifier '3' indicates that the debenture ranks in the lower end of that category, denoted by letters

Local Long-Term Rating Scale

Aaa.il	Issuers or issues rated Aaa.il are those that, in Midroog's judgment, have the highest creditworthiness relative to other local issuers.
Aa.il	Issuers or issues rated Aa.il are those that, in Midroog's judgment, have very high creditworthiness relative to other local issuers.
A.il	Issuers or issues rated A.il are those that, in Midroog's judgment, have relatively high creditworthiness relative to other local issuers.
Baa.il	Issuers or issues rated Baa.il are those that, in Midroog's judgment, have relatively moderate credit risk relative to other local issuers, and could involve certain speculative characteristics.
Ba.il	Issuers or issues rated Ba.il are those that, in Midroog's judgment, have relatively weak creditworthiness relative to other local issuers, and involve speculative characteristics.
B.il	Issuers or issues rated B.il are those that, in Midroog's judgment, have relatively very weak creditworthiness relative to other local issuers, and involve significant speculative characteristics.
Caa.il	Issuers or issues rated Caa.il are those that, in Midroog's judgment, have excessively weak creditworthiness relative to other local issuers, and involve very significant speculative characteristics.
Ca.il	Issuers or issues rated Ca.il are those that, in Midroog's judgment, have extremely weak creditworthiness and very near default, with some prospect of recovery of principal and interest.
C.il	Issuers or issues rated C are those that, in Midroog's judgment, have the weakest creditworthiness and are usually in a situation of default, with little prospect of recovery of principal and interest.

Note: Midroog appends numeric modifiers 1, 2, and 3 to each rating category from aa.il to caa.il. The modifier '1' indicates that the debenture ranks in the higher end of its rating category, which is denoted by letters. The modifier '2' indicates that it ranks in the middle of its rating category and the modifier '3' indicates that the debenture ranks in the lower end of that category, denoted by letters.

Local Long-Term Rating Scale

aaa.il	Issuers or issues rated Aaa.il are those that, in Midroog's judgment, have the highest creditworthiness relative to other local issuers.
aa.il	Issuers or issues rated Aa.il are those that, in Midroog's judgment, have very strong creditworthiness relative to other local issuers.
a.il	Issuers or issues rated A.il are those that, in Midroog's judgment, have relatively high creditworthiness relative to other local issuers.
baa.il	Issuers or issues rated Baa.il are those that, in Midroog's judgment, have relatively moderate credit risk relative to other local issuers, and could involve certain speculative characteristics.
ba.il	Issuers or issues rated Ba.il are those that, in Midroog's judgment, have relatively weak creditworthiness relative to other local issuers, and involve speculative characteristics.
b.il	Issuers or issues rated B.il are those that, in Midroog's judgment, have relatively very weak creditworthiness relative to other local issuers, and involve significant speculative characteristics.
caa.il	Issuers or issues rated Caa.il are those that, in Midroog's judgment, have extremely weak creditworthiness relative to other local issuers, and involve very significant speculative characteristics.
ca.il	Issuers or issues rated Ca.il are those that, in Midroog's judgment, have extremely weak creditworthiness and very near default, with some prospect of recovery of principal and interest.
c.il	Issuers or issues rated C are those that, in Midroog's judgment, have the weakest creditworthiness and are usually in a situation of default, with little prospect of recovery of principal and interest.

Note: Midroog appends numeric modifiers 1, 2, and 3 to each rating category from aa.il to caa.il. The modifier '1' indicates that the debenture ranks in the higher end of its rating category, which is denoted by letters. The modifier '2' indicates that it ranks in the middle of its rating category and the modifier '3' indicates that the debenture ranks in the lower end of that category, denoted by letters.

Local Short-Term Rating Scale

P-1.il	Issuers rated Prime-1.il, in Midroog's judgment, have a very good ability to repay short-term obligations relative to other local issuers.
P-2.il	Issuers rated Prime-2.il, in Midroog's judgment, have a good ability to repay short-term obligations relative to other local issuers.
P-3.il	Issuers rated Prime-3.il, in Midroog's judgment, have a moderate ability to repay short-term obligations relative to other local issuers.
NP.il	Issuers rated Not Prime.il do not belong in any of the Prime categories.

The Connection between the Long-Term and Short-Term Rating Scales

The following table shows the long-term ratings consistent with short-term ratings, when such long-term ratings exist[7].

Long-term rating	Short-term rating
Aaa.il Aa1.il Aa2.il Aa3.il A1.il A2.il A3.il	Prime-1.il
A3.il Baa1.il Baa2.il	Prime-2.il
Baa2.il Baa3.il	Prime-3.il
Ba1.il,Ba2.il,Ba3.il B1.il,B2.il,B3.il Caa1.il,Caa2.il,Caa3.il Ca.il C.il	Not Prime

[7] Structured finance short-term ratings are usually based on the short-term rating of a liquidity provider for the transaction or an assessment of cash flows available to repay the rated obligation.

[Midroog disclaimer]