BSSCH (ICIC) – The Israel Credit Insurance Company Ltd.

Monitoring | November 2016

Contact Persons:

Omer Foremberg – Analyst, Primary Rating Assessor
omer@midroog.co.il

Avi Ben noon – Head of Financial Institutions
avib@midroog.co.il

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Insurance financial strength rating (IFS)	Aa2.il	Rating outlook: Stable

This credit rating report is a translation of a credit rating report that was written in Hebrew. The binding version of the report is the one in the origin language.

Midroog upgrade the insurance financial strength (IFS) rating of BSSCH – The Israel Credit Insurance Company Ltd. ("BSSCH" or the "Company") from Aa.3il to Aa2.il. The rating outlook is stable. There is no change in our assessment of the Company's intrinsic IFS rating (without external support), which stands at Aa3.il with stable outlook. However, the final IFS rating is upgraded by a notch due to our assessment of high probability of owner support in case of need.

Summery Rating Rationale

The Company's rating reflects a solid business profile in the local market, supported by significant market share in the Company's operating segments and by a reasonable risk profile relative to the rating, based on underwriting flexibility, adequate diversification of the insurance portfolio and a fairly conservative reinsurance policy. The Company's financial profile benefits from good quality of assets and satisfactory profitability relative to the rating, with fair control of the cost structure, resulting in reasonable underwriting profitability and capital adequacy that we believe allows for good loss absorbency. As against this, the Company operates in a niche market that is characterized by high exposure to economic cycles, lack of product diversity that impairs revenue-generating capacity over the cycle, negligible associated revenues and only moderate sector diversification. The Company's small size compared to other insurers operating in all branches of the insurance industry also weighs on the rating. Competition in the sector has recently escalated, following the entry of international credit insurance companies and factoring firms into the Israeli market, and due as well to exogenous factors, including the scope of business activity in the market and the level of exports, which has fallen in recent years, added to the historically low monetary environment.

The Company's investment portfolio shows moderate risk appetite with a high percentage of holdings in government bonds and cash and a negligible ratio of intangible assets from equity, allowing greater certainty regarding the amount of the capital buffer.

The Company's capital adequacy is good relative to the rating and results, in part, from a conservative management policy to reduce insurance exposure through extensive use of reinsurance. Leverage ratios are favorable over time, as reflected also in significant regulatory capital surpluses (both under the existing capital regime and under Solvency II), which support business flexibility and enhance the potential for expansion. The capital buffer is able to absorb unexpected losses to a satisfactory degree, as demonstrated by stress tests we performed on key risk factors. In these tests, the capital adequacy ratios tested by us – maximum limit of liability to recognized capital net of 10% of assets at risk, and ratio of retained net earned premium and reserves from equity – stood as of June 30, 2016 at 35 and 0.7, respectively, and are expected under various scenarios to be in the range of 37-39 and 0.8-0.9, respectively, reflecting high capital adequacy. In our estimation, the Company will continue building its capital buffer at a steady pace in the short-to-medium term, mainly through the accrual of profits, although profit potential is limited by the challenging economic environment and price pressures resulting from increased competition, in spite of which the distribution of substantial dividends is expected to continue, in line with previous years.

The Company's policy on the estimation of reserves is rather conservative. However, we expect the continuing effects of the challenging macroeconomic environment on the credit risk profile of the insured portfolio to limit the decrease in the estimated cumulative cost of claims for previous underwriting years relative to the retained insurance liabilities.

The Midroog base scenario for 2016-2017 foresees retention of the Company's existing market share in spite of the intensified competition in the sector. Expected premium growth in these years is in the range of 5%-6%, matching the rate of growth projected for the sector, resulting from higher exports and moderate growth in the business GDP, and offset in part by lower prices in the local credit insurance market. The ongoing challenges of the economic environment, along with a reduction in released accruals compared to previous years, will weigh on the Company's profitability, which we estimate will erode in the short-to-medium term, though remaining befit with the rating.

The IFS rating of the insurance policies has been upgraded from Aa3.il to Aa2.il, based on our assessment of strong external support resulting in a one-notch upgrade above the rating without support. This upgrade reflects our assessment of strong probability of support by the shareholders (Harel Insurance Investments and Financial Services Ltd. and Euler Hermes), in case of need, based on a contractual commitment, given the extent of the required support relative to the shareholders' financial profile, and considering that the Company forms part of the Euler Hermes global network. The probability for support is further bolstered by joint branding and business strategy mainly with Euler Hermes, the Company's operational dependence on the shareholders' systems, in terms of current operations as well as in terms of customer management, and the goodwill risk which the absence of support could create among reinsurers and customers.

The stable rating outlook reflects our belief that the Company will maintain the key metrics within the range of our base scenario.

BSSCH – The Israel Credit Insurance Company Ltd. – Key Financial Indicators (NIS in millions)

	30/06/2016[1]	2015	2014	2013	2012	2011
Gross earned premium	121	121	119	138	138	122
Retained earned premium	56	57	57	62	60	54
Total comprehensive income	32	35	36	34	38	22
Total equity	177	164	179	143	185	147
Midroog adjusted ratios						
Reinsurance assets from equity	38%	71%	39%	54%	49%	59%
Intangible assets and DAC from equity	2%	2%	1%	2%	2%	2%
Retained combined ratio[2]	58%	50%	54%	78%	68%	95%
Return on capital (ROC)	17%	21%	23%	21%	23%	16%
Return on assets (ROA)	8%	9%	10%	9%	10%	6%
Debt-to-Cap ratio	1.7%	1.5%	1.3%	1.0%	0.8%	0.8%

[1] The resultant figures relate to the 12 months ended June 30, 2016.
[2] Ratio of payments and changes in retained liabilities for insurance contracts and investment contracts, general and administrative expenses and deferred marketing and acquisition fees to retained earned premium.

Detailed Rating Considerations

Solid business profile in the local market, constrained, however, by activity in a niche market that is exposed to economic cycles

BSSCH is one of three major credit insurance companies operating in Israel (together with Clal Credit Insurance Ltd. and Ashra – The Israeli Foreign Trade Risk Insurance Corporation Ltd.[1]), as reflected in the significant market share held by it over time in its operating segments, in spite of a continuing decline in overall market share (42% of gross premiums as of June 30, 2016 compared to 50% as of December 31, 2011), attributable mainly to the foreign trade segment (43% of gross premiums as of June 30, 2016 compared to 62% as of December 31, 2011). The Company's significant market share in the local market supports its business position throughout the cycle and its ability to recover profits. The business profile is also supported by a fairly strong brand in the local market, by a broad and diverse customer base, and by expertise and experience deriving in part from cooperation with the shareholder Euler Hermes, one of the world's largest credit insurance companies.

On the other hand, the business profile is constrained by a scope of operations that does not compare favorably with other insurance sectors, in view of a low penetration rate and the niche nature of the market, which is characterized by exposure to economic cycles, lack of diversification affecting revenue visibility, and global competition in some of the operating segments.

Competition in the sector has recently escalated, among local market players as well as due to the entry of international credit insurance companies and the availability of alternative factoring products. We note in this

[1] A government company operating in the field of long-term transactions only, which does not compete with the Company in its main areas of activity.

connection the market entry, in 2015, of Coface, one of the world's largest credit insurance companies, which we estimate will continue to put downward pressure on premium rates, with a view to building market share.

In our estimation, the Company will maintain its business position in the short-to-medium term, while matching the rate of growth projected for the sector. Thus, our base scenario assumes a cumulative growth rate of 5%-6% in the coming two years, taking into account higher exports and moderate growth in the business GDP, offset in part by lower prices mainly in the credit insurance segment, in view of the increased competition, leading to a degree of erosion in profitability.

The Company's distribution model comprises mainly direct activity with customers, without mediation by agents. The Company's marketing department is responsible for both customer recruitment and retention. This dependence on a single marketing channel is, on the one hand, a negative rating factor, since it adversely affects customer recruitment potential and also results in a relatively high ratio of marketing fees and expenses from retained earned premiums, standing in recent years at 35%. On the other hand, this mode of operation allows the Company to maintain direct and unmediated contact with the customer, enhancing underwriting ability. We understand that the Company is working to create additional distribution channels and collaborations with agents and banks, in order to increase customer recruitment potential, with results expected in the medium-to-long term.

A reasonable risk profile relative to the rating, supported by underwriting flexibility and adequate diversification of the insurance portfolio, but with a lack of business diversification and associated revenues, which increase the exposure to economic cycles

As mentioned, the sector is characterized by high exposure to economic cycles, with the level of claims liable to rise significantly as economic activity contracts. Companies operating in the credit insurance sector, unlike those operating in the other insurance branches (life, health and P&C), do not benefit from product diversity, insurance bundles and cross-subsidization, a fact which heightens dependence on market tastes throughout the cycle and affects revenue visibility. Moreover, the Company's has only negligible revenues from associated products that are less exposed to economic cycles.

As against this, the Company's insurance portfolio is adequately diversified, in terms of both the exposure mix and the geographical spread, which support the risk profile, while the sector diversification is moderate. The ten largest buyers account for 5% of the Company's total exposure over time and 180% of equity, while the Company's exposure to countries with a challenging business environment (rated C and D) accounts for 18% of the portfolio in recent years. We note, in this context, the Company's conservative reinsurance policy and use of proportional and excess-of-loss reinsurance to offload a significant proportion of the insurance risk (as of June 30, 2016, the gross quota share stood at 7.3 billion dollars and the maximum limit of liability stood at 1.6 billion dollars). The Company works with highly rated insurers (above-A international rating, with the largest reinsurer rated Aa3), but at a low level of diversification. The rating is also supported by adequate underwriting flexibility which counteracts the cycle exposure, with a relatively short duration of policies (less than a year) and an ability to reduce quotas rapidly following an increase in risk.

High quality of assets relative to the rating, supported by a low ratio of intangible assets and high-risk investment assets from the equity

The quality of the Company's assets is good, with a ratio of adjusted "assets at risk"[2] to recognized capital of less than 25%, indicating moderate risk appetite, and a negligible ratio of "softer"-value intangible assets from equity, allowing greater certainty of equity tolerance under stress scenarios. We do not foresee a significant change in these ratios in the short-to-medium term, also in view of the operating and distribution model, while we see moderate potential for building the capital buffer during this time period.

The Company's investment portfolio consists 55% of holdings in government bonds and 7% of cash holdings. ETFs (mainly on bond indices) are another significant component of the portfolio, accounting for 25%. This investment profile underscores the fact that the Company does not rely on investment earnings to generate profitability, maintaining a solid investment policy with respect to liquidity surplus management.

Another metric tested by us for equity tolerance of counterparty risk is the ratio of reinsurance exposure from equity. This ratio is in the range of 25%-50% in recent years, with the main exposure to international reinsurers with a high international rating in the Aa category (and up), and we do not foresee a change in this policy.

Favorable capital adequacy relative to the rating, providing a good loss-absorbing buffer against stress scenarios

In our view, the capital buffer is the primary means of protection against unexpected losses, while the Company's insurance portfolio is the major source of risk in this regard, especially given the exposure to economic cycles and volatile sectors. This risk is mitigated by a conservative reinsurance policy, which in turn creates counterparty risks. Said policy is reflected in management actions to reduce insurance exposure through extensive use of reinsurance, at a rate of 70% of the premium and the quota share claims.

In this connection, Midroog examined two key ratios in the base scenario as well as in stress scenarios, in order to extrapolate the credit risks from the insurance portfolio, the underwriting and reserve risk as well as the market risks in the investment portfolio relative to equity. These ratios – maximum limit of liability to recognized capital net of 10% of assets at risk, and ratio of retained net earned premium and reserves from equity – stood as of June 30, 2016 at 35 and 0.7, respectively, indicating low leverage that is favorable for the rating. Midroog ran several scenarios (some of them holistic) at varying degrees of severity, that examine the insurer's loss-absorbing buffer relative to its risk profile, assuming PD and LGD rates in the different operating segments and in the different scenarios, counterparty risks, exposure to market risks, building of equity from profits and with no distribution of dividends in those scenarios. The capital adequacy ratios in these scenarios range from 37 and 0.8 for the most moderate stress scenario to 39 and 0.9 for the most severe stress scenario, allowing the insurer, in our estimation, to absorb losses in a satisfactory manner that does not destabilize it. These scenarios indicate favorable capital adequacy of the insurer. It should be noted that in spite of the good capital adequacy, the capital buffer in recent years has developed at a moderate rate, due to substantial dividend distributions. Thus, although the Company

[2]High-risk assets include, generally speaking, all financial investment assets excluding cash, government bonds and corporate bonds with an investment rating, the latter being weighted at a partial reliance rate reflecting the risk of a possible decrease in value over the credit cycle due to credit, market or liquidity risk.

earned an aggregate profit of NIS 165 million in the last five years, it declared 75% of this amount as a dividend, inter alia following changes in ownership in these years.

Good capital adequacy is also indicated by significant capital surpluses both under the existing regulatory capital requirements, amounting to 386% as of June 30, 2016, and under the Solvency II Directive, with a solvency ratio of 338% as of December 31, 2015 according to the IQIS5 exercise. This significant capital surplus supports the Company's business flexibility as well as its ability to take advantage of business opportunities, to expand its operations and even to continue paying dividends to the shareholders. Midroog foresees further building up of a capital buffer in the short-to-medium term, although at a relatively moderate pace, in view of profit potential that is limited by the challenging business environment and by a conservative reinsurance policy, added to a continuing expansive dividend distribution policy.

A conservative dividend determination policy, and estimated slowing in the rate of release of reserves in the near future

Changes in the reserves are a determining factor in the insurer's financial results, given the direct correlation between a change in the reserves and the equity buffer. In recent years the Company has consistently reduced the retained provision for the cumulative cost of claims in respect of events from previous years. We note that the reduction in reserves in itself is evidence of a relatively conservative policy applied in the first calculation of reserves, while, on the other hand, an overly rapid rate of release, in large amounts, can also attest to difficulty in relying on the reserves and a more significant reserve risk, leading to undesirable volatility in the level of the reserves, in the total profit and in the capital buffer. The weighted average of the retained cumulative cost of claims in respect of events from previous years and the retained reserves stood at -5%, which is befit with the rating level, but does not absolutely reflect the amount of the economic liability, also because of the accounting calculation method which creates noise in the reserves due to the gap between profit accrual and release. We note that in 2015 the Company substantially increased its gross reserves by NIS 60 million, in view of the suspension of proceedings granted to the Mega retail chain, in spite of which the retained amount increased by only NIS 4 million due to the Company's conservative reinsurance policy, as discussed above.

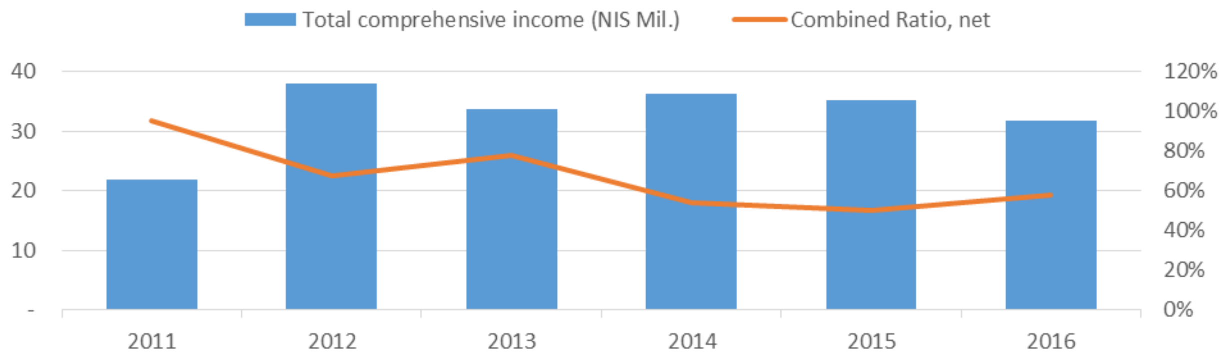
In our estimation, the continuing effects of the challenging business environment on the credit risk profile of the insured portfolio will limit the decrease in the estimated cumulative cost of claims for previous underwriting years relative to the retained insurance liabilities; nevertheless, the adequacy of the reserves will remain good relative to the rating.

Profitability befit with the rating, with a degree of erosion foreseen in profitability in the short-to-medium term

The Company's profitability is affected by the mix of operations, which is fairly balanced between the two primary operating segments, with the foreign trade insurance segment characterized by lower loss ratios over time and higher profitability. The Company's profitability is also affected by exogenous factors, including the level of business activity in the economy, the level of exports and the monetary environment. At the same time, the Company has good control over the pricing of policies and the expense structure, while the extensive use of reinsurance contributes an additional flow of income in the form of annual commissions and reduces the volatility in results, as demonstrated in the Mega event.

In recent years the Company has enjoyed adequate profitability, as indicated by an ROC rate in the range of 20%-22%, which also reflects relatively low volatility. This profitability is supported by combined ratios which, although extending over a relatively wide range of 50%-80% in recent years, nevertheless indicate fairly good underwriting profitability.

Our base scenario for 2016-2017 foresees continued pressure by the macroeconomic environment on the Company's profitability, as well as a continuing decrease in the release of accruals (excess income over expenses) from the reserves for foreign trade insurance, due to a certain increase in the number of claims. In addition, the intensifying competition will continue to weigh on prices, with resulting impairment of the profitability buffer. Taking into account the profitability ratios determined by us together with our forecast, as well as the results of previous years, which we believe reflect a business cycle, we estimate the Company's profitability throughout the cycle as befit with the rating, although it is expected to erode, as explained, in the short-to-medium term.



*The figures for 2016 refer to the 12 months ended June 30, 2016.

Source: Company data and Midroog data processing

Owner Support

The rating of the insurance policies is strengthened by our assessment of strong owner support in case of need, resulting in a one-notch upgrade above the intrinsic IFS (which assumes no support), setting the final rating at Aa2.il with stable outlook. This upgrade reflects our assessment of strong probability of support by the shareholders (Harel and Euler Hermes), in view of a formal commitment by both shareholders to supplement the Company's capital in case of need, as well as a backing commitment for specific transactions provided from time to time by Euler Hermes (one of the world's three largest credit insurers, with an Aa3 international rating), given also the extent of the required support relative to the shareholders' financial profile, and considering that the Company part of the Euler Hermes global network. The probability for support is further bolstered by joint branding and business strategy mainly with Euler Hermes, the Company's operational dependence on the shareholders' systems, in terms of current operations as well as in terms of customer management (use of the Euler Hermes risk management and pricing systems), and the reputation risk which the absence of support could create among reinsurers and customers.

Rating Outlook

Factors that could lead to a rating downgrade:

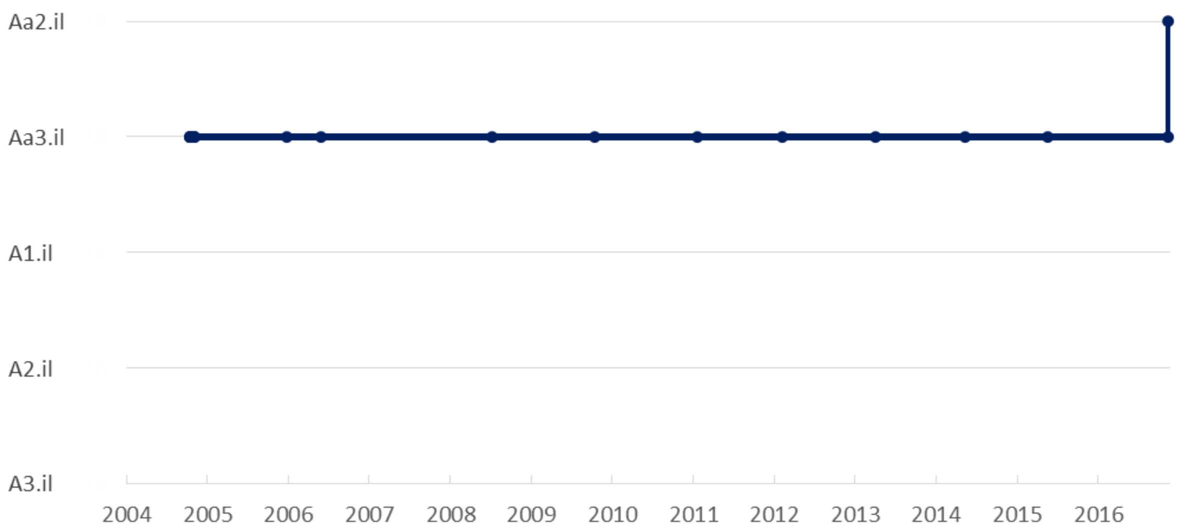
- A downturn in global macroeconomic conditions, exposing the Company to political and economic risks.
- Significant deterioration in the financial strength of reinsurers to which the Company has a material exposure, or reduction in the reinsurance coverage rates.
- Significant impairment of the capital buffer and of the capital adequacy ratios.
- Midroog assessment of reduced probability of and/or capacity for owner support for the Company.

About the Company

BSSCH – The Israel Credit Insurance Company Ltd. was established in 1999 and is held in equal shares (50:50) by Harel Insurance Investments and Financial Services Ltd. and by Euler Hermes S.A., a member of Allianz, the world's largest insurance group. The Company's CEO is Ms. Hagit Chitayat-Levin.

The Company engages in credit insurance and foreign trade risk insurance and in the provision of guarantees. In foreign trade risk insurance the Company insures the supplier against nonpayment by the buyer due to economic difficulties, resulting from two types of risk: commercial risk and political risk. In credit insurance the Company provides insurance in the local market against commercial risks only.

Rating History



Related Reports

[BSSCH – The Israel Credit Insurance Company Ltd. – Monitoring Report – November 2016 (Hebrew)]

[BSSCH – The Israel Credit Insurance Company Ltd. – Monitoring Report – May 2015 (Hebrew)]

[Methodology for Rating Credit Insurance Companies – December 2012]

[Midroog Rating Scales and Definitions]

The reports are published on the Midroog website at www.midroog.co.il

General Information

Date of rating report:	November 21, 2016
Date of last revision of the rating:	May 26, 2015
Date of first publication of the rating:	October 17, 2004
Rating commissioned by:	BSSCH – The Israel Credit Insurance Company Ltd.
Rating paid for by:	BSSCH – The Israel Credit Insurance Company Ltd.

Information from the Issuer

Midroog relies in its ratings inter alia on information received from competent personnel at the issuer.

Local Long-Term Rating Scale

Aaa.il	**Issuers or issues rated Aaa.il demonstrate, in Midroog's judgment, the strongest creditworthiness relative to other domestic issuers.**
Aa.il	**Issuers or issues rated Aa.il demonstrate, in Midroog's judgment, very strong creditworthiness relative to other domestic issuers.**
A.il	**Issuers or issues rated A.il demonstrate, in Midroog's judgment, above-average creditworthiness relative to other domestic issuers.**
Baa.il	**Issuers or issues rated Baa.il demonstrate, in Midroog's judgment, average creditworthiness relative to other domestic issuers and may possess certain speculative characteristics.**
Ba.il	**Issuers or issues rated Ba.il demonstrate, in Midroog's judgment, below-average creditworthiness relative to other domestic issuers and may possess speculative characteristics.**
B.il	**Issuers or issues rated Ba.il demonstrate, in Midroog's judgment, weak creditworthiness relative to other domestic issuers and possess speculative characteristics.**
Caa.il	**Issuers or issues rated Caa.il demonstrate, in Midroog's judgment, very weak creditworthiness relative to other domestic issuers and possess very significant speculative characteristics.**
Ca.il	**Issuers or issues rated Ca.il demonstrate, in Midroog's judgment, extremely weak creditworthiness and are very near default, with some prospect for recovery of principal or interest.**
C.il	**Issuers or issues rated C.il demonstrate, in Midroog's judgment, the weakest creditworthiness and are typically in default, with little prospect for recovery of principal or interest.**

Note: Midroog appends numerical modifiers 1, 2, and 3 to each rating category from Aa.il to Caa.il. The modifier 1 indicates that the bond 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 bond ranks in the lower end of its rating category, which is denoted by letters.

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