21 Ha'Arba'a St. | Platinum Tower
Tel Aviv, 6473921 Israel
Tel. +972-3-6844700 | Fax. +972-3-6855002
www.midroog.co.il

Israel Discount Bank Ltd.[1]

Monitoring Report | September 2019

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

Contact Persons:

Sophie Tuvuakov
Analyst, Primary Rating Assessor
Sophiet@midroog.co.il

Omer Foremberg, CPA
Team Leader, Secondary Rating Assessor
omer@midroog.co.il

Avi Ben-Noon, VP
Head of Financial Institutions
avib@midroog.co.il

[1] Mr. Yair Avidan is a director in Israel Credit Cards Ltd., IBDNY and Discount Capital Ltd., which are part of the Discount Group as well as an outside director at Midroog Ltd. Mr. Avidan is completely uninvolved in the ratings assigned by Midroog Ltd.

Israel Discount Bank Ltd.

Baseline Credit Assessment (BCA)	aa2.il	
Long-term Deposits and Bonds	Aaa.il	Outlook: Stable
Subordinated Notes (Lower Tier 2 Capital)	Aa1.il	Outlook: Stable
Subordinated Capital Notes (Upper Tier 1 Capital)	Aa3.il(hyb)	Outlook: Stable
Subordinated Notes with a loss absorption mechanism (CoCo)	Aa3.il(hyb)	Outlook: Stable
Short-term Deposits	P-1.il	

Midroog upgrades the Baseline Credit Assessment (BCA) of Israel Discount Bank Ltd. (The "Bank") from aa3.il to aa2.il. The BCA's direction of development remains stable.

As derived, the rating of the Bank's long-term deposits and senior debt have been upgraded from Aa1.il to Aaa.il, continuing to incorporate assumption for high government support, a two-notch uplift relative to the baseline credit assessment.

The ratings of subordinated and hybrid debts have been upgraded as follows: Subordinated notes (lower Tier 2 capital) from Aa2.il to Aa1.il, and the subordinated capital notes (upper Tier 1 Capital) from A1.il (hyb) to Aa3.il (hyb). These ratings reflect the structural subordination of these debts relative to the Bank's senior debt, the seniority scale among the subordinated debts themselves and the impact of loss absorption mechanisms. Additionally, these subordinated debts rating likewise reflect an assumption of government support.

The rating of subordinated notes with a loss absorption mechanism (CoCo) through write-off or partial write-off (classified as Tier 2 capital) has been raised from A1.il (hyb) to Aa3.il (hyb). This rating is one notch lower relative to the baseline credit assessment and three notches lower relative to the senior debt rating, reflecting the terms of this instrument, including contractual subordination and loss absorption mechanisms of this instrument, without the assumption of external support.

Additionally, Midroog affirms the P-1.il rating for short-term deposits.

The rating outlook of all liabilities has been remained stable.

Key considerations for evaluating the baseline credit assessment (BCA) and the Bank's ratings

Midroog's upgrade of the Bank's baseline credit assessment (BCA) and ratings is attributed to the continued improvement in the Bank's financial profile, owing to the steady increase in its assets quality, as reflected in the credit portfolio risk metrics which, coupled with the portfolio's growth potential and the efficiency plans implemented by the Bank, support its profit generation capacity and the build-up of its capital buffer. The latter is absorbing losses in a satisfactory manner and in our opinion, is expected to remain above 10.0% throughout the economic cycle (Tier 1 capital adequacy).

The Bank's favorable positioning in the local banking industry is supported by a strong brand, significant market shares, a wide customer base and diversified revenue sources that contribute to the Bank's ability to generate income. The Bank is a universal bank[2] and in addition to financial intermediation activities provides its customers with a range of banking services. The Bank has a relatively conservative risk management policy, which is commensurate with its risk profile, as reflected in the continued improvement in asset quality metrics and balance sheet leverage ratios over the past few years. On the other hand, the Bank's asset quality is still negatively affected by a credit concentration risk (borrowers and industry-specific risk) in relation to the loss absorption buffer, both in relation to the BCA and the system, and weighs on the Bank's risk profile.

The Bank's profitability margins have shown continued improvement over the past few years, fueled by growing revenues that are attributable to the growth in its credit portfolio, surplus financial margin and streamlining measures, which reduced the Bank's operating expenses and include a transition to direct channels, fewer branches, smaller commercial space and mainly a significant reduction in the number of headcount, alongside managerial flexibility. These factors lead to continued improvement in the Bank's operating efficiency ratio as well as enhanced profit generation capacity going forward. In our estimation, the return on assets (ROA) and core yield on risk weighted assets during the forecast period are expected to be 1.9%-2.0% and 0.7%-0.8%, respectively, supporting our rating upgrade.

The key underlying assumptions regarding the Bank's profitability in Midroog's baseline scenario are as follows: (1) a credit portfolio growth of 4.5%-7.0% annually, mainly vis-à-vis the Bank's customer base and amid fierce competition in the business sector and continued competition in the retail sector; (2) a continued low inflation and interest rate environment while focusing on housing loans and business-retail credit; (3) credit loss expense ratio of 0.35%-0.40%; (4) negligible growth in payroll expenses in accordance with the new Group wage agreements amid the favorable effects of staff reduction in line with the Bank's efficiency plans and scaled back branch network.

Over the past few years the Bank has improved its capital buffer while maintaining proper capital adequacy ratios for the BCA, and in good gap from regulatory capital requirements, which constitutes a positive factor for the Bank's growth potential and business flexibility. It is noted that the Bank has a large loss absorption capital buffer under Midroog's stress scenarios, supporting the Bank's stability throughout the economic cycle. Midroog anticipates that the Bank's capital buffer will continue to build up alongside a marginal improvement in the capital adequacy ratios under baseline scenario, as a result of the following factors: (1) accumulated earnings; (2) dividend distributions at 10% to 15% of the net profit and possibly higher during the forecast period; (3) an increase in risk weighted assets, in line with the rate of growth in credit portfolio.

The Bank has a high liquidity profile, due to a convenient, wide and diversified sources structure, which is based on significant share of stable (retail) deposits, an inventory of substantial, low-risk liquid assets and a favorable liquidity coverage ratio (LCR) that supports business flexibility.

[2] The Bank has a wide range of activities, including retail credit, business credit, deposits, capital market activity, consulting and operations.

The ratings of the Bank's long-term deposits and senior debt have been set two rating notches above the BCA, which embodies our assessment of high probability of external support when necessary. The rating of the Bank's subordinated debt which is not recognized under Basel III also assumes a high probability of government support. It is our assessment that the subordinated debts rating for the purposes of Basel III (CoCo) will not benefit from government support and will bear losses when necessary, as specified below.

The BCA development direction and rating outlook

The stable direction of development of the BCA and the stable outlook for the Bank's ratings reflects Midroog's assessment that the Bank will keep an appropriate financial profile throughout the cycle, while maintaining risk measurements in the credit portfolio and loss absorption buffers within Midroog's baseline scenario.

Factors that could lead to raising the BCA and the Bank’s ratings:

- Significant improvement in the level of profitability over time.
- Significant reduction in borrower and sector concentration.

Factors that may lead to lowering the BCA and the Bank’s ratings:

- Deterioration in the Bank's position in the local banking industry.
- Erosion of the capital and profitability buffers.
- Deterioration in the credit portfolio quality.

Israel Discount Bank Ltd. - key financial data and ratios, in NIS Millions and in percentages:

NIS millions	30.06.2019	2018	2017	2016	2015	2014
Credit to the public	174,553	167,078	150,868	142,904	129,268	122,172
Deposits from the Public	192,814	188,916	175,170	172,318	157,875	153,418
Total equity	18,168	17,151	15,594	14,512	13,288	12,599
Total assets	244,313	239,176	221,221	219,577	205,260	207,185
Profit before taxes + provision for credit losses	1,766	2,872	2,639	2,182	1,551	952
Net profit	950	1,505	1,259	905	750	505
(%)						
Exposure to the largest sector relative to the core capital (Tier 1)	182%	182%	176%	169%	174%	166%
Exposure to the largest borrowers relative to the core capital (Tier 1) [1]	NA	39%	38%	52%	64%	92%
Problematic debts / credit to the public	2.3%	2.3%	2.8%	3.6%	3.6%	5.0%
Problematic debts / (Total equity and provision for credit losses)	19.1%	19.1%	23.5%	30.3%	29.3%	40.5%
Provision for credit losses / Average credit to the public	0.31%	0.34%	0.39%	0.34%	0.15%	0.14%
Net profit / Average assets [2]	0.79%	0.65%	0.57%	0.43%	0.36%	0.25%
Provision for credit losses / Average risk weighted assets [2]	2.02%	1.74%	1.69%	1.48%	1.09%	0.70%
Efficiency ratio	61.4%	68.2%	68.3%	72.6%	78.7%	87.1%
Tier 1 capital adequacy ratio	10.4%	10.2%	10.0%	9.8%	9.5%	9.4%
Total equity / Total assets	7.4%	7.2%	7.0%	6.6%	6.5%	6.1%
Less stable [3] financing sources / Total assets	9.2%	8.6%	8.8%	8.4%	7.6%	NA
Liquid balances [4] / Deposits from the Public	27%	28%	32%	36%	38%	33%

[1] total balance sheet credit above 5% of the Bank's equity
[2] total net profit – annualized
[3] deposits from institutional (wholesale) investors, bonds and subordinated notes repayable within one year and bank deposits
[4] cash and deposits at banks, Israeli and US government bonds and assets backed by the US government

Details of the primary considerations for evaluating the baseline credit assessment (BCA)

A high business profile, growth potential and diversification of income sources supports its ability to return income

For the last five years, Discount Bank has been Israel's fourth largest banking group, with a 15% market share of assets as of June 30, 2019 (and a similar share of total credit to the public and deposits from the public). However, the Bank enjoys more substantial market shares in Commercial loans and non-housing loans to privet persons (19% and 21%, respectively, as of that date), ranking third in the banking sector. The Bank's business positioning is also supported due to its being a universal bank, offering a wide range of banking and financial services, a strong brand, a wide and diversified customer base, a large branch network, holdings in Israel Credit Cards Ltd. ("**ICC**")[3] as well as added value and digital innovation which, in our opinion, bolster the Bank's ability to return income and maintain a high business profile throughout the economic cycle.

The stability of the Bank’s revenues, as assessed by Midroog is appropriate for the BCA and is positively affected

[3] At least until 2021.

by an appropriate retail revenue mix that accounts for 67% of the Bank's total revenues over the last few years. This contributes to the Bank's ability to generate income while moderating any volatility in its operations. In addition, the percentage of income from operating fees is reasonable (32% over the last three years), albeit down from 36% in 2015, like the system, with ICC's credit card activity accounting for 45% of revenues from fees. It is noted that while the downward trend in interchange fees could scale back revenues from fees, these may be offset by the growth in turnover.

The Bank has a reasonable diversification of income sources, which relies on three principal lines of business, namely the household sector (and private banking), small and tiny businesses and medium and large size businesses (including institutional investors). In addition, the Bank has overseas operations which is bigger in relation to its Israeli peers, represent a small percentage of its income sources, a fact that is not expected to change during the forecast period. Looking ahead (within the range of the forecast) we expect a slight improvement in the Bank's income diversification given its strategic plan to grow its retail loan book, especially housing loans.

In August 2019, the Bank reported an agreement to merge Municipal Bank (formerly Dexia Bank) with and into Mercantile Bank. The completion of the merger agreement is conditional on the fulfillment of all the terms and conditions of the agreement, which is still uncertain. At the same time, in our opinion, even if the transaction is carried out, this will not have a material impact on the Bank's business and financial profile, since Dexia Bank accounts for 0.4% only of the banking sector's assets and 3% of the Bank's assets and profits as of June 30, 2019.

In our opinion, the developments in the business environment, especially the Credit Data Law, create a potential for activity growth, appropriate risk pricing and customer base expansion, but are also likely to increase competition (banking and non-banking) for new customers within the next two years. In the long term, we expect that innovation will become the main competitive force, and banks that fail to adapt their business model to the changing technology will experience significant erosion in their business profile.

The Bank's risk management policy supports its risk profile; however, the credit concentration relative to the capital buffer remains relatively high

Bank Discount's risk management systems are comprehensive, enabling the Bank to formulate a risk management policy, determine a risk appetite which is consistent with the Bank's strategy as well as procedures for risk monitoring and control. In line with the banking industry, Discount Bank has a system in place to manage new risks as they develop, primarily cyber and information security risks. Credit risks are managed by means of statistical rating models and expert assessments, supporting the continued improvement in the quality of the credit portfolio. On the other hand, the credit concentration (in terms of borrowers and sectors) in relation to the capital buffer remains high, compared to the BCA and the banking industry, which weighs on the Bank's risk profile and intensifies its exposure to unexpected losses. The Bank has a high sectoral concentration in its loan portfolio, as construction and real estate account for 182% of the Tier 1 core capital (134% on average in the peer group) as of June 30, 2019, while its exposure to large borrowers, which constitute more than 5% of the Bank's core capital, stood at 39% as of December 31, 2018 (an average 17% in the peer group). In Midroog's estimation, no significant

improvement is expected in the short to medium term in these metrics, also due to the structural features of Israel's banking industry, and despite expectations for the continued build-up of the capital buffer within the range of the forecast. The Bank's market risks are estimated using the VaR model, under conservative assumptions, in line with the industry. To complement the risk assessment, the Bank operates a number of stress scenarios (including holistic scenarios) of varying degrees of severity. Midroog estimates that the Bank's market risk appetite is relatively low and commensurate with the Baseline Credit Assessment, as reflected in a relatively conservative VaR exposure limit of 3.0% of the Tier 1 capital.

Continuous improvement in the quality of the credit portfolio supports its performance throughout the cycle and the BCA upgrade

Over the past few years and in line with the banking system, the Bank has exhibited a steady improvement in the quality of the credit portfolio, supporting its future ability to return profits and the potential to build a capital buffer, as reflected in good risk measures relative to the BCA, and a relatively high buffer for absorbing expected losses, which enhance the portfolio's performance throughout the cycle. It is noted that this improvement was accompanied by a cumulative 35% growth rate in the loan portfolio from 2015 to June 30, 2019, while the loan mix was changed towards greater focus on retail credit. Thus, the ratio of problematic debts to credit to the public (gross) was 2.3% (2.1% in the peer group) as of June 30, 2019 (2015: 3.6%) and the ratio of impaired debts and in arrears over 90 days was 1.3% (1.2% in the peer group) as of that date (2015: 2.6%). Also, while the Bank's debt coverage[4] is relatively high, it has improved over the years reaching 104% (94% for the peer group) as of June 30, 2019 (2015: 61%). This continued improvement in the quality of the credit portfolio, which is due to significant write-offs over the past few years, and a focus on more diversified segments, provide greater flexibility with regard to credit portfolio management and revenue generation throughout the economic cycle, supports the Bank's financial strength and its ability to build up its capital buffer. On the other hand, and in line with the industry, the quality of the portfolio is adversely affected by a relatively low geographic diversification (albeit better than the peer group owing to IDBNY), structural characteristics of the local market and concentration of the business credit portfolio as well as the high correlation between this portfolio and the economic environment.

The Bank has reasonable exposure to the mortgage and real estate sectors which, in aggregate, accounted for 38% of the total sum of the Bank’s loan book as of June 30, 2019, below the peer group (50% as of that date). The Bank's exposure to the real estate market is relatively high (19% of the Bank’s debts) also in comparison to the peer group (15% as of that date), and characterized by relatively high risk, due to homogeneous features, and in relation to the capital loss-absorption buffer, as stated. On the other hand, the Bank's exposure to the mortgage sector (19% of the Bank's balance sheet credit) is characterized by relatively moderate risk, due to favorable risk metrics. In our estimation, despite significant price inflation in recent years, and a declining ability to buy apartments, the quality of the mortgage portfolio will be impaired only in the event of a double-digit unemployment rate, combined with a higher interest rate environment, preceded by a deteriorating performance

[4] Provision for loan losses, impaired debts and in arrears over 90 days

of the business sector. In our opinion, the Bank's conservative underwriting processes moderate the rapid growth in this segment and improve the quality of the credit portfolio, as reflected in Loan-to-Value ratios above 60% (35%) and a rate of payment to income above 40% (0.4% of the housing loan performance) in the first six months of 2019. In recent years, retail credit risk has developed due to rapid growth in the Bank's and the industry's credit balances. This was accompanied by an increase in total household leverage, and together with the new insolvency law, will continue to have a negative impact on the quality of the Bank's loan portfolio, also as a result of the rapid growth in ICC's activity. Midroog's baseline scenario regarding the quality of the Bank's credit portfolio is based on several macroeconomic exogenous influences, including: (1) GDP growth of 3.1%-3.5% in the next two years; (2) a continued low and stable unemployment rate with a moderate growth in real wages; (3) a low and stable interest rate environment; (4) a moderate inflation environment at the lower range of the Bank of Israel's target; (5) continued competition by the non-bank debt market with regard to business loans and an increase in the credit supply in the retail sector. It is noted that the future effects of smaller information gaps due to the establishment of credit bureaus are not part of Midroog’s base scenario at this stage.

In this scenario, the Bank's credit portfolio is expected to grow at an annualized rate of 4.5%-7.0%, with varying growth among the different segments, and above the GDP growth rate. In our estimation, the Bank will continue to focus on housing loans as well as retail and business credit and therefore, despite the aforesaid high growth rate, the Bank's risk profile is not expected to increase. We believe that following a rise in household credit risk, and in line with the sector, the Bank's growth rate in this segment will moderate, but remain relatively high due to the continued growth in the credit portfolio of the Bank's subsidiary – ICC. The growth potential is also supported by a favorable capital adequacy ratio in relation to the regulatory barrier and a supportive macroeconomic environment, which contribute to higher revenues and profit and therefore support the decision to upgrade the BCA.

In addition, Midroog examines the development of the Bank's credit portfolio quality in the short and medium term also on the basis of several leading macroeconomic indicators[5], which point to relative stability (varying between the different segments of the credit portfolio) in the quality of the portfolio in the short term. We predict a slight increase of 0.35%-0.40% in the ratio of loan loss provisions to total portfolio, with lower collection potential and higher risk levels, as stated, in the retail and SME segment.

The BCA is supported by continued improvement in the Bank's profitability; expected improvement during the forecast range, driven by revenue growth and continued implementation of efficiency measures

The Bank's profitability has improved during the last few years, among others, due to a continued increase in revenues as a result of substantial growth in the credit portfolio (9% on average in the last three years) and an improvement in the financial margins, above those of peer banks (2.64% in 2018 compared to 2.13% in 2015). In addition, a successful implementation of efficiency plans, which cut back operating expenses in the past few years,

[5] A loan loss provision for impaired debts and debts in arrears above 90 days

has contributed to the Bank's ability to generate profits. It is noted that the Bank's has a favorable revenue potential, which is driven by the high growth and excess financial margin, as stated, despite being limited by the Bank's loan loss provision, which is high compared to the peer group and despite the continued improvement in the quality of the credit portfolio. In addition, the Bank's operating efficiency is still low, weighing down on profit margins, but has nevertheless improved over the last few years. The Bank's efficiency ratio decreased from 79% in 2015 to 68% in 2018, owing to significant streamlining measures that included a cutback in the number of positions (7% of the Group's workforce since 2015[6]) and in real estate space (30 branches since 2015[7]), a transition to direct channels and amendments to wage agreements at the Bank and its subsidiaries (the linkage to Bank Leumi wages was cancelled by Mercantile bank). As a result, in 2018 profitability, core yield on risk weighted assets and return on assets were 1.7% (2015:1.1%) and 0.7% (2015: 0.4%) similar to the peer group average (1.7% and 0.6%, respectively) as of that date. In Midroog's estimation, the continued improvement in profitability is one of the Bank's biggest challenges, among others, due to a challenging business environment, since revenues usually depend on exogenous factors outside the control of the banking industry, which requires a continued control on expenditures. In our estimation, the continued implementation of different efficiency plans and the retirement of 191 employees in 2019 and 2020[8] contribute to the improvement in profitability, coupled with a favorable revenue generation potential, assuming the Bank's credit portfolio will continue to grow.

The key assumptions underlying Midroog's baseline scenario regarding the Bank's profitability for the years 2019-2020 are as follows: (1) continued annual increase of 4.5%-7.0% in the credit portfolio, mainly vis-a-vis the existing customer base, amid a fierce competition in the business segment and continued competition in the retail segment; (2) a continued low inflation and interest rate environment alongside continued focus on the housing loans and retail-business credit; (3) a loan loss provision ratio of 0.35%-0.40% as stated; (4) a slow increase in wage expenses in accordance with the new wage agreements in the Group, alongside the offsetting effect of continued reduction in the number of positions, in line with the Bank's efficiency plans and a reduction in the number of branches.

In this scenario, Midroog expects that the Bank’s profitability ratios will continue to improve and support the continued build-up of the capital buffer and the BCA. As a result, the core yield on risk weighted assets and the return on assets are expected to range between 1.9%-2.0% and 0.7%-0.8% respectively during the forecast years. In our estimation, the acquisition of Dexia and its merger into the subsidiary Discount Mercantile Ltd, if it is carried out, is not expected to have a material impact on the Bank's profitability and was not taken into account in the baseline scenario.

[6] For information on Midroog's methodology for assessing the quality of the banks' assets, see: leading indicators for assessing the quality of the assets of the local banking industry – Special Report, January 2015. The reports are available at www.midroog.co.il
[7] No. of positions based on a monthly average in Israel and abroad
[8] Based on the annual financial statements for 2018

The capital buffer characterized by a good and appropriate loss absorption capacity for the BCA, which is appropriate for the BCA and supports financial flexibility; expectation of continued establishment of the capital buffer within the forecast range

The Bank maintains appropriate capital adequacy ratios due to the accumulation of profits and a moderate distribution of dividends[9], optimization and management of the risk assets and asset mix. The Bank's Tier 1 capital adequacy ratio, the primary unexpected loss absorption buffer, was 10.4% on June 30, 2019 (11.2% on average in the peer group), at a favorable margin of 117 basis points above the regulatory barrier, which has improved during 2019 (64 basis points in the same period of 2018). This margin supports the risk profile has a favorable impact on the BCA and contribute to the Bank’s business flexibility and its growth potential. In addition, the Bank’s simple balance leverage level (total equity to total assets), which is commensurate with the BCA, has increased to 7.6% on June 30, 2019 from 6.5% in 2015 and supports a continued improvement in the Bank's risk profile.

Midroog has examined a number of stress scenarios (some of them holistic) at varying degrees of severity with respect to the Bank's loss-absorption buffers relative to its risk profile, assuming variable PD and LGD rates in different industries and under different scenarios, exposure to market risks, the build-up of equity through scenario-adjusted profits, and non-distribution of dividends depending on the scenario. The Bank's Tier 1 capital adequacy ranged between 9.2% for the mild-stress scenario and 8.3% under the severe-stress scenario, allowing the Bank to absorb unexpected losses well and supporting its stability throughout the cycle.

Midroog anticipates that the capital buffer will continue to build up and capital adequacy ratios will improve marginally during the forecast period so that Tier 1 capital adequacy ratios will range between 10.4% and 10.6% under the baseline scenario and as a result of organic growth. This ratio will be affected by the following factors: (1) Accrued earnings; (2) Distribution of dividend at between 10%-15% of the net earnings, and possibly higher during the forecast period; (3) an increase in the volume of risk assets in line with the rate of growth of the credit portfolio.

A high liquidity profile that is supported by a convenient funding structure and a significant inventory of liquid assets, but eroded by the rapid growth in the credit portfolio

The Bank's source structure, like other local banks, mainly relies on a wide deposit base, which remained stable throughout the cycle and is positively affected by the local savings culture. A substantial component of these resources is the Bank's highly diversified and stable (retail) deposits (47% of households and private banking and 18% of small and tiny businesses, as of June 30, 2019) which, in Midroog's estimation, correspond with the Bank's risk profile. The Bank's ratio of less-stable financing sources to total assets is 9%, which stands out favorably in comparison to the industry's average (16% on average in the peer group). The Bank has a relatively favorable loans-to-deposits ratio, which has eroded over time, of 90% as of June 30, 2019 (2015: 82%), above the average 83% ratio in the peer group, as a result of the rapid growth in the credit portfolio. In addition, the Bank's NSFR

[9] On March 10, 2019, the Bank's board of directors decided to increase the dividend ratio, commencing from the fourth quarter of 2018, from 10% to 15% of the quarterly profits.

ratio, as calculated by Midroog, is high at 123%, which also reflects the Bank's favorable resource structure.
The Bank's liquidity buffer includes a significant inventory of liquid assets , which is high in relation to total deposits and as of June 30, 2019 was 27% (2015: 38%), although it too has eroded over the last few years due to the rapid growth in the credit portfolio. This inventory primarily consists of cash and deposits as well as a securities portfolio which, as of June 30, 2019, accounted for 15% of total assets, with a reasonable (credit) risk level, given an asset composition of 66% of Israeli government bonds, 22% of US government mortgage-backed securities and 2% foreign government bonds (mostly US). This portfolio is a tool for absorbing excess liquidity and managing the Bank's market exposures, but also exposes it to all types of credit risks, which is intensified in the current interest rate environment. In addition, the Bank's liquidity management is also supported by a liquidity coverage ratio (LCR) of 133% as of June 30, 2019, substantially higher than the regulatory threshold (100%) and favorable in comparison to the industry's average. This ratio also reinforces the Bank's liquidity profile and business flexibility. Midroog anticipates that the Bank's source structure and favorable liquidity portfolio will be maintained in the short and medium term since, among other reasons, the local savings culture is not expected to change. That said, the continued growth in the credit portfolio could further erode the liquid asset inventory if the Bank continues to use these assets to finance its growth.

Structural considerations and external support

Characteristics of the subordinated instruments

According to Midroog's methodology, the rating of the Bank's subordinated debts (subordinated notes) is based on the Bank's BCA, the anchor for rating the Bank's liabilities, which reflects the risk of failure and the Bank's ability to service its obligations independently, without assuming external support. Subsequently, we adjust the rating to the credit risk of the subordinated debt instrument, according to its specific characteristics – taking into consideration the extent of the instrument's structural subordination, the loss absorbency mechanisms per the instrument's terms and the uncertainty regarding their point of activation (at the contractual trigger or at the discretion of the Supervisor of Banks). We reduce one rating notch from the BCA for rating subordinated notes (lower Tier 2 capital). The downward notching embodies the legal/contractual subordination of these debts relative to the Bank's senior debt. We reduce three notches from the BCA for rating subordinated capital instruments (additional Tier 1 capital), which embody the legal/contractual subordination of these debts relative to the Bank's other obligations (except for upper Tier 2 capital, Tier 1 instruments and shareholders' equity) and a contractual loss-absorbency mechanism. Given the Bank's BCA rating, the current and anticipated capital adequacy levels, and the favorable prominent liquidity profile, the uncertainty regarding the likelihood of reaching the regulatory intervention is low and therefore, it was not embodied in a further notch downgrade.
We are reducing one rating notch from the Bank's BCA for rating subordinated notes with a loss absorption mechanism (CoCo). The notch downgrade embodies the legal-contractual subordination to the Bank's other obligations (excluding Tier 1 instruments and equity) as well as the contractual loss-absorbency mechanism. Given the Bank's BCA rating, the current and anticipated capital adequacy levels, and the favorable prominent liquidity

profile, the uncertainty regarding the likelihood of reaching the "non-viability point" is low and therefore, it was not embodied in a further notch downgrade.

External support

The ratings for the deposits, senior debt and subordinated debts, excluding subordinated notes with a loss-absorbency mechanism (CoCo), have benefited from a two-notch uplift, due to the high probability of external support from the government, according to Midroog's JDA model. The assumption of the probability of external support throughout the entire liability structure (excluding CoCo) is based on the following reasons: The high importance of the banking system for the local economy and the payment system, and the need to maintain its stability; the high concentration of the banking and financial system; 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 degree of uncertainty concerning the behavior and confidence of the different debt holders in relation to bail-ins close to the point of failure, in the absence of previous experience. Furthermore, the Israeli government has proven in the past, its willingness to support failed banks, and we do not assume any change in this policy.

The assumption of a high probability of support for subordinated debts (excluding CoCo) stems from the fact that no significant change has been observed in Israel's system support paradigm in recent years. To date, 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 might imply that a change has occurred in subordinated debt risk from a legal standpoint. It is our understanding that the recommendations of the Committee for Dealing with Failed Banks are unlikely to include a proposal for bail-in of old subordinated debts (not recognized for Basel III purposes) also out of a desire to retain the trust of the public, who had invested in these instruments in the past assuming support, as well as due to subordinated notes inclusion of a contractual loss-absorbency mechanism (CoCo), the only tool for raising subordinated debt, while making timely repayment of old debts.

We should note that even after the weighting of external support in the rating of subordinated debts, Midroog generally maintains a minimum possible gap of at least one notch between the rating of the Bank's senior debt and the rating of its subordinated debts, reflecting the higher relative expected loss in these debts compared to the senior debt.

About the Bank

Israeli Discount Bank is a commercial bank that provides a wide range of banking services in and outside Israel to commercial, retail and business customers. The Bank has subsidiaries and investee companies in Israel and abroad which together constitute the Discount Group. The Discount Group is the fourth biggest banking group in terms of total assets. The Discount Group carries out its activities in Israel by means of a nationwide network of branches. The Bank has 100% ownership of Mercantile Discount Bank as well as banking operations overseas, which are

carried out by IDB New York, a commercial bank that focuses on the US middle market. Additional subsidiaries are: Discount Capital Ltd. (100%), which has real estate investments and underwriting activities; Tachlit Discount Portfolio Management (100%), which manages investment portfolios for private customers and corporations. The bank's credit card activity is carried out via a 71.8% holding in Israel Credit Card Company Ltd. (ICC). Since 2013, the Bank is owned by the public, with no controlling shareholder. In September 2018, the Bank announced that it signed an agreement with the board of directors of Dexia Bank Israel Ltd. ("Dexia Bank") to acquire its entire share capital and merge Dexia Bank into Bank Discount for NIS 670 million, reflecting a ratio of 1 on Dexia Bank's equity. In August 2018, the Bank reported that it has extended the merger agreement, and the final date for fulfilling the suspensive conditions as stipulated in the agreement would be December 1, 2019. In September, the Bank reported that the Antitrust Commissioner approved a potential buyer for a portion of the Bank's credit portfolio, which constitutes one of the suspensive conditions in the merger agreement. The closing of the transaction is still contingent on fulfillment with additional suspensive conditions and there is no certainty that it will be completed. In June, the Bank's CEO, Ms. Lilach Asher-Toplinsky announced her retirement from the position of CEO to be replaced by Mr. Uri Levine, who served as the CEO of IDB New York in the last two years.

Outstanding subordinated notes and bonds rated by Midroog*:

Series	ISN	Rating	Outlook	Maturity
B	7480023	Aa1.il	Stable	30/11/2019
D	7480049	Aa1.il	Stable	29/10/2022
A	6910095	Aa3.il(hyb)	Stable	01/01/2106
B	6910111	Aa3.il(hyb)	Stable	01/01/2106
J	6910129	Aa1.il	Stable	10/06/2022
K	6910137	Aa1.il	Stable	10/06/2022
L	6910160	Aa3.il(hyb)	Stable	10/01/2027
M	7480155	Aaa.il	Stable	05/12/2024
N	7480163	Aaa.il	Stable	05/12/2030

** Had been issued by Discount Issuers Ltd. - a subsidiary fully owned by the Bank*

The Baseline Credit Assessment (BCA) Score Card

			As of 30.06.2019		Midroog forecast [1]		
Category	**Parameter**	**Sub-parameter**	**Measurement [1]**	**Score**	**Measurement**	**Score**	**Additional considerations**
Business profile	**Business positioning**		-	aa.il	-	aa.il	
	Revenue stability	% retail revenues	72%	aa.il	70%-75%	aa.il	
	Revenue diversification	Number of business lines over 15%	3	a.il	3	a.il	*Overseas segment*
Risk profile	**Corporate governance**		-	aa.il	-	aa.il	
	Risk management policy		-	aa.il	-	aa.il	
	Credit portfolio concentration	The largest sector to core capital	182%	a.il	182%~	a.il	*The real estate sector*
	Credit portfolio concentration	Largest borrowers to core capital	37%*	a.il	37%~	a.il	
	Market risk appetite	VAR limit on core capital	3%*	aaa.il	3%~	aaa.il	
Financial profile	**Asset quality**	Problematic debts for credit extended to the public	2.3%	aaa.il	2.3%-2.3%	aa.il	*Credit portfolio growth*
		Problematic debt to the capital equity and provision for credit losses	19.1%	aa.il	18.6%-19.1%	aa.il	*The coverage ratio*
	Profitability	Net profit to average assets	0.9%	aa.il	0.7%-0.8%	aa.il	
		Profit before tax + loan loss provisions to average risk weighted assets	2.2%	aa.il	1.9%-2.0%	aa.il	
		Efficiency ratio	61%	aa.il	60%-65%	aa.il	
	Capital adequacy ratios	Tier 1 equity to risk weighted assets	10.4%	aa.il	10.3%-10.7%	aa.il	
		Total equity to total assets	7.6%	aa.il	7.5%-8.0%	aa.il	
	Financing and liquidity	Less stable financing to total assets	9%	aaa.il	9%~	aaa.il	
		Liquid assets to public deposits	27%	aa.il	27%~	aa.il	
Derivative baseline credit assessment						**aa2.il**	
Actual baseline credit assessment						**aa2.il**	

[1] The indices presented in the table are after Midroog adjustments and are not necessarily identical to those displayed by the company. Midroog's forecast includes Midroog's assessment in respect of the issuer in accordance with Midroog's base scenario, rather than the issuer's assessments.

Bank Debt Ratings

	Baseline credit assessment (BCA)	Owners' and/or related parties' support	Adjusted BCA	Subordination and loss absorption mechanism	Government support	Rating
Deposits and Bonds	aa2.il	0	aa2.il	0	+2	Aaa.il
Subordinated notes (lower Tier 2 capital)	aa2.il	0	aa2.il	-1	+2	Aa1.il
Subordinated notes (Additional Tier 1 capital)	aa2.il	0	aa2.il	-3	+2	Aa3.il(hyb)
Subordinated capital notes with a contractual mechanism for absorbing losses (Tier 2 capital)	aa2.il	0	aa2.il	-1	0	Aa3.il(hyb)

Related Reports

Israel Discount Bank Ltd. - Related Reports

Bank Ratings - Methodology Report March 2019

Affiliations and Holdings Chart

Midroog's Rating Scale and Definitions

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

General Information

Date of rating report:	23.09.2019
Date of last revision of the rating:	20.12.2018
Date of first publication of the rating	22.12.2005
Rating commissioned by:	Israel Discount Bank Ltd.
Rating paid for by:	Israel Discount Bank Ltd.

Information from the Issuer

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

Rating Scale for Baseline Credit Assessment (BCA)

aaa.il	**Issuers or issues rated aaa.il present, according to Midroog's judgment, internal or independent financial strength that is the highest compared to other domestic issuers, in absence of any possibility of external support from an affiliated company or from the government.**
aa.il	**Issuers or issues rated aa.il present, according to Midroog's judgment, internal or independent financial strength that much higher compared to other domestic issuers, in absence of any possibility of external support from an affiliated company or from the government.**
a.il	**Issuers or issues rated a.il present, according to Midroog's judgment, internal or independent financial strength that is higher compared to other domestic issuers, in absence of any possibility of external support from an affiliated company or from the government.**
baa.il	**Issuers or issues rated baa.il present, according to Midroog's judgment, internal or independent financial strength that is the intermediate compared to other domestic issuers, in absence of any possibility of external support from an affiliated company or from the government and may have certain speculative characteristics.**
ba.il	**Issuers or issues rated ba.il present, according to Midroog's judgment, internal or independent financial strength that is weak compared to other domestic issuers, in absence of any possibility of external support from an affiliated company or from the government and have speculative characteristics.**
b.il	**Issuers or issues rated b.il present, according to Midroog's judgment, internal or independent financial strength that is very weak compared to other domestic issuers, in absence of any possibility of external support from an affiliated company or from the government and have significant speculative characteristics.**
caa.il	**Issuers or issues rated caa.il present, according to Midroog's judgment, internal or independent financial strength that is the weakest compared to other domestic issuers, in absence of any possibility of external support from an affiliated company or from the government and have most significant speculative characteristics.**
ca.il	**Issuers or issues rated ca.il present, according to Midroog's judgment, internal or independent financial strength that is extremely weak, in absence of any possibility of external support from an affiliated company or from the government and are very close to default with some likelihood of principal and interest recovery.**
c.il	**Issuers or issues rated c.il present, according to Midroog's judgment, internal or independent financial strength that is the weakest, in absence of any possibility of external support from an affiliated company or from the government and are typically in default with faint likelihood of principal and interest recovery.**

Note: Midroog uses numeric variables 1,2, 2 and 3 for each of the rating categories from aa.il to caa.il. Variable '1' indicates that the debenture is at the high end of its rating category, as denoted by the letters. The variable ‘2’ indicates that it is at the middle of its rating category; while the variable ‘3’ indicates that the debenture is at the bottom part of its rating category, as indicated by letters.

Midroog does not publish outlook for the baseline credit assessment (BCA) as opposed to the previous publications so as to differentiate the BCA from credit rating

Long-Term Rating Scale

Aaa.il	**Issuers or issues rated Aaa.il are those that, in Midroog judgment, have highest creditworthiness relative to other local issuers.**
Aa.il	**Issuers or issues rated Aa.il are those that, in Midroog judgment, have very strong creditworthiness relative to other local issuers.**
A.il	**Issuers or issues rated A.il are those that, in Midroog judgment, have relatively high creditworthiness relative to other local issuers.**
Baa.il	**Issuers or issues rated Baa.il are those that, in Midroog 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 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 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 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 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 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 obligation 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 obligation ranks in the lower end of that category, denoted by letters.

Short-Term Rating Scale

P-1.il	**Issuers or issues rated Prime-1.il are those that, in Midroog judgment, have a very good ability to meet their short-term liabilities relative to other local issuers.**
P-2.il	**Issuers or issues rated Prime-2.il are those that, in Midroog judgment, have a good ability to meet their short-term liabilities relative to other local issuers.**
P-3.il	**Issuers or issues rated Prime-3.il are those that, in Midroog judgment, have a moderate ability to meet their short-term liabilities relative to other local issuers.**
NP.il	**Issuers rated Not Prime.il do not belong to any of the prime categories**

The relationship between the long-term rating scale and the short-term rating scale

The table below lists the long-term ratings that correspond to the short-term ratings as long-term ratings exist[10]

Long-term Rating	Short-term Rating
Aaa.il	
Aa1.il	
Aa2.il	
Aa3.il	Prime-1.il
A1.il	
A2.il	
A3.il	
Baa1.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	NotPrime
Ca.il	
C.il	

[10] Short-term structured financing ratings are usually based on the short-term rating of the liquidity to the transaction or on the estimated free cash flow to repay the rated liability.

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