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Union Bank of Israel Ltd.[1]

Monitoring Report | January 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.

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[1] Union Bank of Israel Ltd. holds (indirectly) 4.9% of the share capital of Midroog Ltd. through Union Investments and Enterprise (A.S.Y.) Ltd. The Company's shares don't have any means of control.

Union Bank of Israel Ltd.

Baseline Credit Assessment (BCA)	**a2.il**	
Long-term deposits/bonds	**Aa3.il**	**Outlook: Stable**
Subordinated notes (lower Tier 2 capital)	**A1.il**	**Outlook: Stable**
Subordinated capital notes (upper Tier 2 capital)	**A2.il(hyb)**	**Outlook: Stable**
Subordinated notes – CoCos (Tier 2 capital)	**A3.il(hyb)**	**Outlook: Stable**
Short-term deposits	**P-1.il**	

Midroog affirms the baseline credit assessment (BCA) of Union Bank of Israel Ltd. (the "Bank") at a2.il. The BCA's direction of development remains stable.
The Bank's long-term deposits and senior debt rating remains Aa3.il with stable outlook, continuing to incorporate a two-notch uplift from the baseline credit assessment based on an assumption of high probability of external government support.
The rating of subordinated debt (which is not recognized under Basel III) remains unchanged, as follows: subordinated notes (lower Tier 2 capital) – A1.il with stable outlook; subordinated capital notes (upper Tier 2 capital) – A2.il(hyb) with stable outlook. These ratings reflect the contractual terms of the instruments, including the contractual subordination of these debts to the Bank's senior debt, the seniority scale among the subordinated debts themselves and the impact of loss absorption mechanisms (CoCos). The subordinated debt rating also incorporates an assumption of government support.
The rating of subordinated notes with a loss absorption mechanism (CoCos) through write-off or partial write-off (classified as Tier 2 capital) remains A3.il(hyb) with stable outlook. This rating, which is one notch below the baseline credit assessment and three notches below the senior debt rating, reflects the terms of this class of instruments, including contractual subordination and loss absorption mechanisms, without an assumption of external support.
Additionally, Midroog leaves the P-1.il rating for short-term deposits unchanged.

Summary of Rating Rationale

The Bank's baseline credit assessment is supported by a reasonable business profile, based on its being a universal bank providing a wide range of banking and financial services, that over the past few years has implemented a strategic plan focusing on brand strengthening in the retail and small business credit segment. On the other hand, the Bank's small size limits its business profile and ability to retain earnings over the economic cycle and impairs the profitability cushions. Additionally, the protracted uncertainty regarding the Bank's merger with Mizrahi Tefahot Bank Ltd. ("**Mizrahi Bank**"), following the appeal filed against the acting Antitrust Commissioner's veto on the transaction, exposes the Bank to strategic and operational risks, among them inability to optimally implement the strategic plan and a delay in investments in IT and technological innovation, which could adversely affect the overall value proposition for customers and erode the business profile in the medium term. The Bank is characterized by a conservative risk management policy that supports its risk profile, which is displaying improvement, reflected in good asset quality and reduced concentration of the credit portfolio, which, however, remains high due to structural attributes of the local economy and presents a major risk focus for the Bank. The Bank's profitability rates, which, in Midroog's opinion provide an initial loss cushion, are volatile and low for the rating and relative to the banking system. Said rates are impacted by a relatively low financial margin and restricted by a rigid structure of costs, mainly due to diseconomies of small scale, linkage to Bank Leumi's wage agreements, regulatory costs and high computerization costs due to use of Bank Leumi's computer systems. Improving profitability and operational efficiency is one of the key challenges facing the Bank, especially in view of the challenging business and regulatory environment and continuing growth in competition. Midroog estimates that an improvement in the profitability cushions depends, to a great extent, on the Bank's ability to deal with the costs structure and limit operating expenses, With an emphasis on salary expenses and computerization expenses. We note that the Bank is in the process of implementing an efficiency plan for the early retirement of 120 employees during 2016-2019, as well as an efficiency plan for the early retirement of another 70 employees which was announced by the Bank in December 2018. Midroog's base scenario takes the implementation of these efficiency plans into account, along with the offsetting effect of a significant "automatic pilot" component and limited potential for an additional savings in operating expenses in the short to medium term. The Bank's capital cushion is adequate for the rating, absorbing unexpected losses in a reasonable manner under Midroog's stress scenarios. The Bank's compliance within a reasonable margin with the regulatory capital targets is a favorable factor for continued growth of the credit portfolio and for business flexibility. However, the Balance-sheet leverage is poor for the rating, adversely affecting the risk profile, as reflected by a low equity to balance sheet ratio compared to the banking system, notwithstanding an improvement in recent years. The Bank has a high liquidity profile, due to a convenient, wide and diversified structure of sources, which, in line with the banking system, is based on public deposits, which have shown stability even in slowdown periods, as well as on a significant inventory of liquid assets.

The key assumptions regarding the Bank' profitability on which Midroog bases its baseline scenario for the years 2018-2019 are as follows (1) Credit portfolio growth at an average annual rate of 3%; (2) Continued slow growth in the Bank of Israel interest rate, and a marginal improvement in the expected inflation rate, resulting in a marginal increase in the financial margin; (3) Continued focus on household consumer credit and on credit for small and medium enterprises (SME), which are characterized by a higher margins; (4) Credit losses in the range of 0.45%-0.60%; (5) A continuing "creeping" effect in the expense base due to an effective "automatic pilot" countered by the efficiency plans described above. In this scenario, Midroog foresees that the Bank's profitability ratios will remain low for the rating, with the core yield on risk weighted assets and the return on assets expected to be in the range of 0.9%-1.3% and 0.1%-0.4%, respectively in the forecast years.

The capital cushion will continue to expand due to accumulated earnings, with the Bank's capital adequacy ratios (relative to the growth in the baseline scenario) improving marginally such that the Tier 1 capital adequacy ratios will be in the range of 10.0%-10.30% in the short to medium term, due to the following factors: (1) accumulated earnings; (2) continued change in amount and management of risk assets and continued focus on retail activity, with the credit portfolio growing, in our estimation, at an annual rate of 3% and risk assets cumulatively up to 3%

as a function of risk asset management and allocation; (3) no dividend distribution was assumed within the forecast range.

The rating of the Bank's long-term deposits and senior debt was uplifted two notches from the baseline credit assessment, reflecting our assessment of a high probability of external support in the event of need. The rating of the Bank's subordinated debt which is not recognized under Basel III also assumes a high probability of government support. The rating of debt recognized under Basel III (CoCo) reflects our estimation that it will not enjoy government support and will bear losses in the event of need, as discussed below.

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, maintaining risk measurements in the credit portfolio and loss absorption cushions within a range that is appropriate for the rating, in parallel with moderate growth of the credit portfolio. The stable outlook also reflects our assessment that the Bank will experience difficulty in significantly improving the profitability cushion and operating efficiency in the short term, also in view of the prevailing uncertainty at the Bank following the merger agreement with Mizrahi Bank.

Union Bank of Israel Ltd. - Key Financial Indicators, NIS in millions

	30.09.2018	30.09.2017	2017	2016	2015	2014
Cash and deposits at banks	8,725	8,492	8,226	3,901	6,668	9,848
Securities	6,138	6,958	7,032	11,584	10,371	6,789
Net credit to the public	25,138	25,424	24,675	23,684	22,315	21,713
Deposits from the public	32,735	33,870	32,752	32,756	32,466	31,498
Equity attributable to the Bank's shareholders	2,569	2,508	2,513	2,342	2,403	2,275
Total assets	41,680	42,882	41,892	40,988	40,888	40,858
Net interest income [1]	579	554	745	652	571	567
Credit loss expenses (income)	102	37	56	98	(107)	95
Non-interest income	320	293	406	405	383	386
Operating and other expenses	647	655	890	1,008	836	838
Income before taxes + credit loss expenses	252	192	261	49	118	115
Net income attributable to the Bank's shareholders	106	103	141	(49)	144	23
Equity attributable to the Bank's shareholders/assets	6.2%	5.8%	6.0%	5.7%	5.9%	5.6%
Core capital adequacy	10.1%	9.8%	10.0%	9.7%	9.8%	9.6%
Total capital adequacy	14.1%	14.5%	14.4%	14.0%	14.8%	15.6%
Liquidity/total assets [2]	36%	36%	36%	38%	42%	41%
ROA (annualized) [3]	0.3%	0.3%	0.3%	-0.1%	0.4%	0.1%
Profit before tax + credit loss expenses/average risk-weighted assets (annualized)	1.3%	1.0%	1.0%	0.2%	0.5%	0.5%
Credit loss expenditure/credit to the public (annualized)	0.5%	0.2%	0.2%	0.4%	-0.5%	0.4%
Problem debts/credit to the public	2.2%	2.5%	2.6%	2.9%	2.1%	3.0%

[1] Before provision for credit losses.
[2] Cash and bank deposits + securities.
[3] Net annual income attributable to the Bank's shareholders (a time t), to average assets/equity attributable to the Bank's shareholders (t,t-1)

Detailed BCA Considerations

A reasonable business profile and low ability to return profits given the Bank's relatively small size; the ongoing uncertainty regarding the continuation of the Bank's independent operations in view of the merger transaction with Mizrahi Bank, weighs on the business profile

Union Bank is Israel's sixth largest bank, with a 2.5% market share of assets, credit to the public and deposits from the public, though trailing considerably behind the Big Five banks. The Bank's rating is supported by its being a universal bank, providing customers with a wide range of banking and financial services. The Bank has for several years been implementing a strategic plan that focuses on retail and small enterprise credit, contributing to its stability and income diversification due to heterogeneous attributes, as well as to the durability of its credit portfolio over the economic cycle, and likely also to bolster the Bank's future profit potential. This focus is reflected in significant growth in recent years in credit to households (including housing) and small enterprises, accounting for 73% of the credit portfolio as of September 30, 2018 compared to 61% in 2015, at the expense of corporates, whose share decreased to 16% from 26% in the same period. However, in our opinion, the Bank's relatively small size continues to hamper its ability to generate income over the economic cycle, depressing its business positioning and rating.

Midroog considers that the diversification of the Bank's income sources among its principal lines of business is relatively good and supports its ability to return income, constituting a positive factor for the rating that is not expected to change in the medium term.

On the other hand, the Bank's profit stability is below par for the rating, reflecting high profit volatility in recent years also as a result of one-time events. This metric is negatively affected by significant (albeit reduced) exposure to the business sector, which is characterized by volatility and higher exposure to economic cycles that is not compensated by adequate income from households and income from fees. The latter income items have significant exposure to capital market volatility, resulting in relatively low returned income (credit card fees). We do not expect the profit stability to change significantly in the short to medium term, in view of the challenging business environment, regulatory changes, the uncertainty in the financial markets and low geographical diversification. However, we do foresee a slight moderation in the level of volatility, in light of the Bank's strategy to continue focusing on retail and small enterprise credit.

The Antitrust Commissioner's vetoing of the merger transaction with Mizrahi Tefahot and the filing of an appeal by the parties to the transaction – the controlling shareholders, Mizrahi Tefahot and the Bank in September 2018, are prolonging the uncertainty regarding the Bank's existence as an independent bank, also affecting the implementation of its strategic plan. This is partially reflected in the low growth rate of the credit portfolio during 2018 compared to the banking system (2% for the Bank versus 5% for the banking system during the first nine months of 2018). Additionally, this uncertainty initially led to the departure of employees from the Bank, although recently the Bank's workforce and execution ability have stabilized. Furthermore, the Bank's IT and innovation investments are liable to be halted until matters become clear, placing the Bank in an inferior position vis-à-vis its competitors and harming its business profile. We note that in light of this situation, the Bank has extended its contract with Bank Leumi for computer services by another 18 months, which involves a substantial expenditure for the Bank, limiting its profit potential in this period.

We do not foresee in the short term a significant change in the market share distribution of the local banks, in keeping with our earlier assessment, while the business environment will continue to be challenging, with intensifying competition and an increase in the level of risk in the retail sector. In the medium term, the implementation of the Strum committee's recommendations together with the establishment of a central consumer credit database and lowering of the entry barriers by means of various competitive reforms and technology developments, could result in increased competition in the banking system, leading, in our estimation, to a certain erosion in the market share of the two largest banks, mainly in the household segment. At the same time, we note the great degree of uncertainty regarding the success of these steps and their impact on the structure and level of competition in view of the growth in supply following the separation of the credit card companies from the two large banks, and whether they will present a meaningful alternative.
In the long term we foresee that the main generator of competition will be innovation, with banks that fail to adapt their business model over time experiencing significant erosion of their business profile.

The Bank's risk management policy supports its risk profile, but the credit concentration relative to the capital absorption cushion remains high

The Bank's risk management system includes several control frameworks and supports, including board committees for risk control and management and an independent risk control and management department headed by the Bank's chief risk management officer, who is a member of the management. These arrays support the delineation of a risk management policy, the determination of the Bank's risk appetite and tolerance and regular monitoring of the implementation of the Bank's policy in this regard and the development of risks.

The Bank's credit risks are managed using semi-statistical rating models (consumer credit) and expert assessments (business credit). Similarly to the banking system, the Bank applies a relatively conservative credit policy and, in our opinion, implements underwriting, monitoring and securities management processes (especially vis-à-vis capital market players) that support the rating. On the other hand, the credit concentration (in borrower and sector terms) relative to the capital cushion remains high, compared both to the rating and to the banking system, weighing on the Bank's risk profile and aggravating the exposure to unexpected losses, notwithstanding an improvement in this regard. Thus, exposure to the largest sector (construction and real estate) relative to the core capital stood at 112% as of September 30, 2018, and exposure to the 20 largest borrowers still accounts for a substantial proportion of the capital. In Midroog's estimation, no significant improvement is expected in the short to medium term in these metrics, notwithstanding our expectation for a certain improvement due to the continuing growth of the Bank's capital.

Cyber and IT security threats pose a significant evolving threat. Given the Bank's reliance on Bank Leumi-managed IT systems, as well as the resulting exposure, the Bank endeavors to strengthen the work interfaces with Leumi's cyber and IT security units. As noted, the more protracted the merger transaction, the more likely it is to expose the Bank to technological risks. An especially high risk is presented by the project for the replacement of the core systems, considering the date currently known to the Bank for its separation from Leumi's computer services and the potential risk to the Bank's ability, should it be required to complete the project for the replacement of its core systems within the relevant times. We note that the Bank is considering the possibility of extending the receipt of computer services from Bank Leumi for an additional period beyond the known date of separation, which has been set for June 30, 2021.

The Bank's market risks are estimated using the VaR model, under conservative assumptions, the same as the entire banking system. The Bank supplements the risk assessment by conducting several stress tests (including holistic testing) at varying levels of severity. The Bank's market risk appetite is estimated by Midroog as adequate to the rating; however, the limitation threshold is high relative to the banking system (6% of Tier 1 capital as of September 30, 2018). The Bank's liquidity risk is managed using an internal model that includes stress tests and is monitored on a daily basis. In Midroog's estimation, the bank’s liquidity management is adequate with its risk profile, in view of a substantial rate of stable deposits. The liquidity management is also supported by a good liquidity coverage ratio (LCR) of 130% as of September 30, 2018, which is higher than both the regulatory requirement (100%) and the internal target of 120% set by the Bank.

A high liquidity profile that is supported by a comfortable funding structure and a significant inventory of liquid assets

The Bank's funding structure relies, similarly to the entire local banking system, primarily on a broad deposits base that has demonstrated stability during previous crises, has shown growth throughout the cycle and that is favorably affected by the savings culture in the local economy. The Bank's funding structure consists of a substantial proportion of stable deposits widely diversified over long period of time (households, private banking and small enterprises), accounting for 63% of total deposits as of September 30, 2018, considered by Midroog as being more stable throughout the economic cycle. The wholesale funding rate (institutional bodies) is relatively moderate (an average of 13% over time), while the exposure to funding from the capital market (bonds and subordinated notes) is reasonable, accounting for 9% of the total balance sheet as of September 30, 2018. These are estimated by Midroog as being less stable throughout the economic cycle; however, the latter supports a better duration match between assets and liabilities.

The Bank is characterized by a good ratio over time of loans to deposits, standing at 78% as of September 30, 2018 and comparing favorably with the average for the banking system. The Bank's securities portfolio represents 15% of total assets as of September 30, 2018 and is characterized by a relatively low level of credit risk, in view of a substantial component of Israeli and U.S. government bonds, accounting for 73% of the total securities portfolio as of September 30, 2018. Nevertheless, we would note that the Bank has upped the portfolio risk in recent years, with the rate of corporate bonds increasing from 9.7% in 2016 to 19.4% as of September 30, 2018, mainly at the expense of government bonds. The significant scope of the portfolio supports the management of liquidity surpluses, including asset diversification and management of sources and exposures, but exposes the Bank to market risks, in particular, interest rate risks of all kinds, which are intensified by the current and forecast interest rate environment.

Based on Midroog's liquidity model, and under various assumptions and scenarios regarding the structure of assets and liabilities, the Bank has adequate liquidity against its liabilities for up to twelve months forward and stable funding that is commensurate with the amount of its long-term assets – which constitute a positive factor in the Bank's rating, as was the case in our previous assessment. Thus, in Midroog's base scenario for the next twelve months, the Bank has liquid assets constituting 19% of total assets, a significantly higher rate than the proportion of short-term liabilities from the Bank's total assets (4%). Additionally, the Bank enjoys stable and adequate funding against long-term assets, as reflected by the difference between the proportion of stable deposits and long-term liabilities from total assets (96%) and the proportion of non-liquid assets from total assets (81%).

As a supplementary measure in analyzing liquidity, Midroog examines the Bank's inventory of liquid assets relative to total deposits, which as of September 30, 2018 stood at 40%, a favorable ratio that supports the Bank's good liquidity. Midroog predicts that the Bank's comfortable funding structure and its good liquidity will be maintained over the short and medium term, inter alia, in view of our assessment regarding the growth potential of the credit portfolio, the absence of a change in the savings culture and good access to financing sources, which enable the extension of the funding duration. Thus, we expect that the liquidity profile will remain at a high level in the next two years and continue to be a positive factor in the Bank's rating.

The credit portfolio is characterized by a favorable level of risk relative to the rating, but the concentration risk remains high

The Bank is characterized by a quality credit portfolio that supports its future ability to return earnings, as reflected by good risk metrics relative to the rating, and it also maintains a reasonable buffer for the absorption of expected losses (provision for credit losses) relative to the impaired debts, which supports the portfolio's performance throughout the cycle. The Bank, similarly to the banking system, has in recent years improved the credit portfolio quality metrics, which are good relative to the rating. Thus, the ratio of problem debts to credit to the public stood at 2.2% on September 30, 2018 (2014: 3.0%), and the coverage ratio[2] maintained relatively stable, standing at 70% as of that date (2014: 77%). This continuing improvement in the quality of the credit portfolio, which also results from significant write-offs during recent years and a focus on more diversified segments, allows the Bank great

[2] The balance of the provision for defective debts and debts in arrears of more than 90 days.

flexibility in the management of the credit portfolio, and supports its financial strength and the ability to return earnings and build the capital cushion throughout the economic cycle.

The concentration risk remains a key risk in the Bank's credit portfolio, the same as for the entire banking system and despite an improvement trend. This is due to low geographical diversification (99% of total credit is in respect of activity in Israel), structural attributes of the local market and concentration of the business credit portfolio. The positive correlations between the credit portfolio and the economic environment, and among the various components of the credit portfolio, could harm the quality of the Bank's assets and its ability to return future profits, beyond our base scenario, in the event of unexpected difficulties arising in the business environment – which risk materialized several times in recent years, and led to a decrease in profit due to higher credit loss expenses.

The Bank has a significant exposure to the real estate sector (including mortgages), similarly to the peer group, which has grown in recent years to account for 47% of the Bank's total debts as of September 30, 2018, out of which exposure to mortgage loans constitutes 35.9% and has been trending upward in recent years (2015: 31.4%). The commercial real estate sector (11.5% of the total portfolio) is estimated by us at a relatively high level of risk, in view of homogenous attributes, the Bank's exposure to this sector being low relative to the average for the Big Five banks. In our estimation, a meaningful risk to the quality of the Bank's mortgage portfolio, in spite of significant price inflation in recent years, which moderated lately, and erosion of the housing purchasing ability, will occur only if unemployment rates advance in the double digit direction, combined with a rise in interest rates, a prior indicator for this being a decline in the performance of the business sector. Additionally, the significant growth in the housing loans and consumer credit portfolios of the Bank and in the banking system, which was accompanied by an increase in the total level of leverage of households, also in view of an increase in supply, and consequently also in the risk levels, coupled with regulatory changes such as the new Insolvency Law, constitutes, in our view, a developing risk focus. We note that this leverage is still within reasonable bounds compared to the Western world, which, together with relatively conservative underwriting processes, supports the quality of the portfolio (as reflected in the LTV ratios and rate of return from disposable income).

Midroog's base scenario estimates that the Bank's credit portfolio will grow by an annual average of 3.0% in the years 2018-2019, the growth composition varying between the different segments, with a continued focus on retail and small enterprise credit. This growth potential is also supported by a satisfactory margin, by adequate capital relative to the regulatory barrier and by a supportive macroeconomic environment. However, the business environment will remain challenging with an increase in competition across all the sectors.

This scenario is based on several macroeconomic exogenous influences, among them: (1) average GDP growth of 3.3% in the coming two years; (2) a continued low and stable unemployment rate and continued real wage growth; (3) a continued slow rise in the interest rate in 2019; (4) a certain rise in inflation, as derived from the capital market, which however will remain moderate; (5) continuing competition by the non-bank debt market with the business portfolio and an increase in the credit supply in the retail sector.

Midroog examines the development of the quality of the Bank's credit portfolio in the short and medium term also on the basis of several leading macroeconomic indicators, which point to relative stability (varying between the different segments of the credit portfolio) in the quality of the portfolio in the short term, while over the course of the cycle the Bank is expected to present risk metrics that are appropriate for the rating. Midroog's base scenario for the next 12-18 months foresees a certain increase in the rate of credit loss expenses, which will be in the range of 0.45%-0.60%, also in light of specific events, as mentioned. The business environment supports a certain degree of pressure on the rate of credit loss expenses – the new Insolvency Law is expected to facilitate entry into and exit from insolvency proceedings and is also expected to reduce the rates of return to secured creditors and to harm arrears interest visibility. Therefore, we estimate that the expected loss (EL) will increase in the retail and small enterprise sector throughout the banking system, apart from which a certain moderation is foreseen in the recovery rates compared to previous years. The rate of problem debts from the portfolio is expected to remain stable to a favorable extent relative to the rating and to be in the range of 2.2%-2.5%, as an outcome of which we estimate their rate from the absorption cushions (equity and provision for credit losses) at 21.5%-22.5% within the range of the forecast.

The Bank's profitability is low, volatile and constrained by poor operating efficiency, despite expectations for some improvement within the forecast range

The Bank's profitability is low relative to its rating and compared to the banking system, and is constrained by its rigid expense structure, largely due to diseconomies of small scale, linkage to Bank Leumi's wage agreements and high computerization costs, due, as already noted, to the use of Bank Leumi's computer systems. The Bank's profitability rates weigh on the rating, and in our estimation, do not constitute an adequate security cushion for the current rating of the Bank's loss-absorption capacity. The Bank presents a core yield on risk assets and a return on assets that are lower and more volatile compared to the peer group (1.3% and 0.3% in the first nine months of 2018, respectively, compared to 1.8% and 0.7% for the Big Five banks), primarily due to a low financial margin, stemming from high exposure relative to the banking system and to the monetary environment, given the low fees rate, a significant liquid assets rate, exposure to the business sector, the housing loan-oriented portfolio mix and a dominant value proposition for retail customers. Nonetheless, we would note that the Bank customer profile is deposit-oriented, so that a further base interest rate increase would positively impact the financial margin. The Bank is characterized by low efficiency, which, as noted earlier, constrains its profit potential and its ability to deal with a challenging business environment, where the revenue base depends in large part on exogenous factors outside its control. The Bank has presented a high expense to income ratio over time compared to the average for the major banks, with the ratio presented by the Bank in the first nine months of 2018 standing at 74%[3], compared

[3]Net of onetime revenues from the sale of stock exchange shares totaling NIS 26 million.

to the average rate of 63% for the Big Five banks during the same period. It should be noted, though, that the Bank has succeeded in improving this ratio over recent years (2015: 88%), mainly as a result of revenue base growth.

Improving profitability and operational efficiency is one of the Bank's key challenges, especially in light of the challenging business and regulatory environment, as well as increasing competition. In Midroog's estimation, improvement of the profitability cushion depends in great measure on the Bank's ability to deal with the expenses structure and limit the scope of operating expenses, particularly wage and computerization expenses. At the end of 2016, the Bank approved a manpower efficiency program which includes the early retirement of 120 workers during the years 2016-2019 (some 10% of the Bank's manpower). Additionally, in December 2018, the Bank announced another efficiency plan in which 70 additional workers are to retire, in respect of which the Bank will recognize an expense of NIS 80 million before tax under profit and loss. We would note that the number of job positions decreased by 38 during the years 2016-2017. Implementation of the aforesaid efficiency plans was taken into account in Midroog's base scenario, coupled with the offsetting effect of linking the Bank employees' wages to Bank Leumi's wage agreements, which includes an "automatic pilot" component rate of 3.5% for the years covered in the forecast, so that we anticipate a certain degree of stability for the average efficiency ratio of the Bank for the years 2018-2019.

The key assumptions underlying Midroog's base scenario regarding the Bank's profitability for the years 2018-2019 are as follows: (1) Average annual growth of 3% in the credit portfolio; (2) Continued slow increase in the Bank of Israel's interest rate for 2019 and marginal improvement in the projected inflation, both of which will dictate a marginal increase in the financial margin; (3) Continued focus on consumer credit for households and credit for SMEs, which are characterized by a higher margin; (4) A credit loss rate of 0.45%-0.60%; (5) Continued "creeping" of the expenses base due to an effective "automatic pilot," coupled with the offsetting effect of the streamlining programs as described above. In this scenario, Midroog predicts that the Bank's profitability rates will remain low relative to the rating, with the core yield on risk assets and ROA for 2018 and 2019 expected to range between 0.9%-1.3% and 0.1%-0.4%, respectively.

The capital cushion is appropriate for the rating, provides reasonable loss absorption capacity and supports business flexibility

Similar to other banks in the banking system, the Bank has been working in recent years to improve its capital adequacy ratios through accumulation of current profits, optimization, reduction of risk assets, and non-distribution of dividends. The Bank's Tier 1 capital adequacy, the primary loss-absorption cushion for unexpected losses, stood at 10.1% and 9.8% net of the transition directives and net of the benefit in respect of an efficiency plan as of September 30, 2018 (relative to an average of 10.6% at the Big Five banks), at a reasonable margin of 75 basis points above the regulatory barrier (9.35%). This gap supports the Bank's business flexibility and growth potential. Worthy of positive note are the internal capital adequacy targets set by the Bank's board of directors for compliance with the Tier 1 capital adequacy goal of 10.3% by December 2019, which constitutes a positive factor in risk profile improvement and in business flexibility.

The Bank's balance sheet leverage is unfavorable relative to the rating and impairs the risk profile, as reflected by the equity to total balance sheet ratio of 6.2% as of September 30, 2018, this despite its improvement in recent years. It should be noted, however, that the Bank has a significant proportion of liquid assets in the total assets that negatively influance this ratio.

Midroog has examined a number of stress scenarios (some of them holistic) of varying degrees of severity with respect to the Bank's loss-absorption cushions relative to its risk profile, assuming variable PD and LGD rates in the different industries and scenarios, exposure to market risks, the construction of equity through limited profits adjusted for the scenario, and the non-distribution of dividends in the short- and medium-term. The Tier 1 capital adequacy of the Bank ranged between 8.7% for the mild-stress scenario and 7.1% for the severe stress scenario, allowing for reasonable unexpected loss-absorption by the Bank, and supporting its stability throughout the economic cycle.

Assuming that risk assets will grow cumulatively up to 3% in the years 2018-2019, Midroog anticipates that the capital cushion will continue to be built up and capital adequacy ratios will improve marginally such that Tier 1 capital adequacy ratios will range between 10.0% and 10.30% in the short and medium term as a result of the following factors: (1) Accrued earnings; (2) Continued management of the volume and mix of risk assets and continued focus on retail activity with credit portfolio growth of 3%; (3) No dividend distribution was assumed within the range of the forecast.

We would note that the Bank has further potential for improving its capital adequacy through optimization of risk assets, including, as with other banks, the use of reinsurers for the Sale Law guarantees portfolio. The use of this tool was not taken into account by us in the base scenario.

Structural Changes 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 are lowering the rating for subordinated notes (lower Tier 2 capital) by one notch and the rating for subordinated capital instruments (upper Tier 2 capital) by two notches. The downward notching embodies the legal/contractual subordination of these debts relative to the Bank's senior debt and relative to one another.

We are rating subordinated notes with a loss-absorbency mechanism (CoCo) one notch below the Bank's BCA. The one notch downgrade embodies the legal-contractual subordination to the Bank's other obligations (excluding upper Tier 2 capital, Tier 1 instruments and equity) and the contractual loss-absorbency mechanism. Given the Bank's BCA rating, the current and anticipated capital adequacy levels, and the favorable liquidity profile, the uncertainty regarding the likelihood of reaching the "non-viability point" is low; 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 of government support, according to Midroog's JDA model. The assumption of external support throughout the obligations structure (excluding CoCos) 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 State of Israel has, in the past, proven 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 CoCos) 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 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 contain a proposal for bail-in of old subordinated debts (not recognized for Basel III purposes) out of a desire to retain public trust and also because subordinated notes with a contractual loss-absorbency mechanism (CoCos) are the only tool for raising subordinated debt, while making timely repayment of old debts.

We note that even after the weighting of external support in the rating of subordinated debts, Midroog generally maintains a minimum 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.

Rating Outlook

Factors that could lead to a rating upgrade:

- Improvement in business profit, reflected in growth in the Bank's market share, especially in the retail credit sector, while maintaining the quality of assets and capital adequacy.
- Significant improvement in the level of profitability and structure of costs.
- Significant reduction in borrower and sector concentration.

Factors that could lead to a rating downgrade:

- Significant deterioration in the credit portfolio quality.
- Erosion and destabilization of the capital and profitability cushions.
- Protraction of the period of uncertainty regarding the merger with Mizrahi Bank, adversely affecting the business and risk profiles.

Bank’s Profile

Union Bank of Israel Ltd. was founded in 1951 by the Palestine Economic Corporation (U.S.A.) of New York and the Economic Company Ltd. of London, which continued the operations of the banking division of the Palestine Corporation which had commenced operations in Mandatory Palestine already in 1922. From 1983 until May 17, 1993, control of the Bank was held by the State of Israel (through B.L.L. Securities) and by Bank Leumi Le-Israel Ltd., which purchased the shares of the Bank in 1954 and 1961. Further to an agreement to sell the controlling interest in the Bank, the controlling interest was transferred in 1993 to Shlomo Eliahu Holdings Ltd., Yeshayahu Landau Holdings (1993) Ltd. and David Lubinski Properties (Holdings) 1993 Ltd. On October 29, 2012, Shlomo Eliahu Holdings Ltd. ceased to be part of the controlling interest of the Bank, following the completion of the acquisition of control of Migdal Insurance and Financial Holdings Ltd. by Mr. Shlomo Eliahu through Eliahu Insurance Company Ltd. The Bank's shares are listed on the Tel Aviv Stock Exchange Ltd. The Bank has 36 branches and extensions across Israel (including a private banking center), providing customers with a variety of banking services. Union Bank is Israel's sixth largest bank, with a 30% market share as of September 30, 2018. On July 30, 2017, the Bank was notified by its controlling shareholders that they intended to sell their holdings in the Bank. On November 27, 2017, the shareholders gave notice of their intention to merge the Bank with Mizrahi Tefahot Bank Ltd. On May 30, 2018, the acting Antitrust Commissioner ruled against the merger. On August 6, 2018, the Bank joined the controlling shareholders and Mizrahi Bank in an appeal against the anti-merger ruling of the acting Antitrust Commissioner, which was filed in September 2018.

Outstanding subordinated notes and bonds rated by Midroog*:

Series	ISN	Rating	Outlook	Maturity
R	1121854	A1.il	Stable	01.12.2019
H	1133503	Aa3.il	Stable	01.06.2020
G	1131762	Aa3.il	Stable	27.03.2021
S	1124080	A1.il	Stable	04.07.2021
J	1154764	Aa3.il	Stable	15.09.2022
I	1139492	Aa3.il	Stable	01.03.2025
T	1139153	A3.il(hyb)	Stable	11.09.2026
U	1141878	A3.il(hyb)	Stable	10.09.2027
Capital Note 1	1115278	A2.il (hyb)	Stable	10.09.2059
Capital Note 2	1115286	A2.il (hyb)	Stable	10.09.2059

**Issued by Union Issuances Ltd. (a subsidiary of the Bank), with the proceeds deposited at the Bank.*

Related Reports

Union Bank of Israel Ltd. – Related Reports

Rating Banks – Methodology Report, November 2017

Short Term Commercial Paper Rating – Methodology Report, July 2015

Table of Affinities and holdings

Midroog Rating Scales and Definitions

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

General Information

Date of rating report: January 17, 2019

Date of last revision of the rating: January 23, 2018

Date of first publication of the rating: February 27, 2006

Rating commissioned by: Union Bank of Israel Ltd.

Rating paid for by: Union Bank of Israel Ltd.

Information from the Issuer

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

Local 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 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.

Unlike the previous publications, Midroog does not publish an outlook for baseline credit assessment (BCA), in order to differentiate the BCA from a credit rating.

Local 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.

Local Short-Term Rating Scale

P-1.il	Issuers rated Prime-1.il have, in Midroog's judgment, a superior ability to repay short-term obligations relative to other local issuers.
P-2.il	Issuers rated Prime-2.il have, in Midroog's judgment, a strong ability to repay short-term obligations relative to other local issuers.
P-3.il	Issuers rated Prime-3.il have, in Midroog's judgment, an acceptable ability to repay short-term obligations relative to other local issuers.
NP.il	Not-prime issuers 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 corresponding to short-term ratings as long-term ratings exist

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

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