

**ANNUAL  
REPORT 2010**

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TO THE GENERAL MEETING OF THE  
SHAREHOLDERS**

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**BOARD OF DIRECTORS**

**DR. JOSEPH BACHAR**

Chairman of the Board

**ILAN (EILON) AISH**

**ILAN BIRAN**

(Outside Director)

**JOSEPH CIECHANOVER - ITZHAR**

**ILAN COHEN**

**ELI ELIEZER GONEN**

**BEN-ZION GRANIT**

**EDITH LUSKY**

(Outside Director)

**RICHARD MORRIS ROBERTS**

**DR. YITZHAK SHARIR**

**YALI SHEFFI**

**ZVI STREIGOLD**

**JORGE ZAFRAN**

**PROF. BEN ZION ZILBERFARB**

\* Details regarding members of the Board of Directors and Management see p. ???

**MANAGEMENT**

**REUVEN SPIEGEL**

President & Chief Executive Officer

**DORIT BENSIMON**

Senior Executive Vice President  
Finance Division

**JOSEPH BERESSI**

Senior Executive Vice President  
Chief Accountant Accounting Group

**ESTHER DEUTSCH**

Senior Executive Vice President  
Legal Adviser  
Legal Advisory Group

**YUVAL GAVISH**

Senior Executive Vice President  
Banking Division

**AMNON GIDEON**

Senior Executive Vice President  
Human Resources Group

**NOAM HANEGBI**

Senior Executive Vice President  
Strategy marketing and service  
division

**ORIT ALSTER**

Executive Vice President  
Corporate Banking Division

**SHLOMO AVIDAN**

Executive Vice President  
Operation and Logistic Division

**YAIR AVIDAN**

Executive Vice President  
Chief Risk Officer  
Risk Management Group

**SHAI VARDI**

Executive Vice President  
Technologies & Planning Division

**RAFI BICHLER**

Acting Internal Auditor

**RUTH MOSHKOVITZ**

Corporate Secretary

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The Board of Directors, on March 31, 2011, approved and authorized for publication the Bank's consolidated financial statements and its subsidiaries for the year ended December 31, 2010.

## THE DISCOUNT GROUP - GENERAL OVERVIEW AND STRUCTURE OF THE GROUP

Israel Discount Bank Ltd. (hereinafter: "the Bank") was incorporated in Palestine in 1935, as a public company under the Companies Ordinance. The Bank was founded by the late Mr. Leon Recanati. The Bank is a banking corporation having a banking license under the provisions of the Banking Law (Licensing), 1981 (hereinafter: "the Banking Law (Licensing)").

During the seventy six years of its operation the Bank has developed a chain of branches and a wide variety of commercial banking activities in all banking spheres. The Discount Group is the third largest banking group in Israel.

### DOMESTIC OPERATIONS

Discount Bank is a universal bank, offering its customers comprehensive banking services, in all areas of financial activity, through 147 branches in Israel, direct banking services, on-line banking and Internet services.

The Bank has two banking subsidiaries in Israel - Mercantile Discount Bank Ltd. - a commercial bank serving customers in all fields of financial activity through 77 branches, and Discount Mortgage Bank Ltd., serving as the main arm of the Group in the mortgage loan field.

The activities in Israel also include:

- Credit cards - The Bank controls Israel Credit Cards Ltd. (hereinafter: "ICC") and Diners Club Israel Ltd. ("Diners"), which issue and market "VISA", "Diners" and "MasterCard" credit cards, both for domestic and overseas use;
- Securities portfolio management - the subsidiary, Tachlit Investment House Ltd., (hereinafter: "Tachlit") which manages securities investment portfolios for private customers, corporations, not-for-profit organizations and institutional bodies;
- Non-financial investments and underwriting - the subsidiary "Israel Discount Capital Markets and Investments Ltd." engages in investment banking, investments in private equity funds, in venture capital funds and in other non-financial investments.

This subsidiary also engages in underwriting and managing the issue of securities.

In addition, the Bank has an affiliated company, The First International Bank of Israel Ltd., also being one of the five major banking groups in Israel. (For details regarding an agreement according to which the Bank will gradually reduce its holdings in the First International Bank, see Note 6 D to the financial statements).

In the years 2009-2010 the Bank continued to strengthen its position in the retail banking market, by several central processes: attracting State employees and teaching staff, marketing mortgages jointly with the subsidiary Discount Mortgage Bank, and the pension advisory services activity.

Since the middle of 2008 the Bank has been operating against the background of the international financial crisis, while taking the necessary steps required under the circumstances. Alongside the diligent management of the credit portfolio during this period, the Bank made considerable efforts in supporting its longstanding customers also at times of slowdown and crisis.

The year 2010 is marked as the year in which the Bank solidified its capital adequacy. In December 2010 the Bank raised core capital by way of share and rights issues, in a net, total amount of NIS 450 million, and ended the year with a ratio of capital to risk assets of \_\_\_\_%, in terms of Basel II, and \_\_\_\_%, in terms of Basel I (for further details, see "Capital resources" below). The year 2010 has also been a record year regarding the integration of material regulatory requirements: completion of the processes of integrating the various pillars of Basel II at the beginning of the year, including reporting to the public in the 2009 Annual Report, in accordance with the third pillar, and submission of the ICCAP document to the Supervisor of Banks' staff in the middle of the year; completion of the preparations for the transfer of the credit management systems to the regime of the new directive regarding the measurement and disclosure of impaired debts, credit risk and provisions for credit losses; and completion of the preparations for the adoption of international financial reporting standards (IFRS) in respect of a series of matters that are not part of the core banking business.

Mr. Giora Offer retired from the Bank at the end of the year, after ten years in office as President and CEO. Mr. Reuven Spiegel, who in recent years served as President and CEO of the subsidiary IDB New York, has been appointed the Bank's President and CEO with effect as from January 1, 2011. Following and concurrently with the change in this position, changes are being made in the composition of the Bank's management (see "Board of Directors and Management" below) and decisions have been made regarding changes in the Bank's organizational structure (formerly: the Retail Banking Division) For details regarding the reorganization of the service layouts in the Corporate Banking Division and in the Banking Division, see below under "Human resources".

## OPERATIONS ABROAD

Most of the operations abroad are conducted by Israel Discount Bank of New York, which is the largest of all Israeli banks operating abroad. The Bank, through IDB New York, also holds a commercial bank in Montevideo and Uruguay and directly holds a bank in Switzerland, with branches in Geneva and Zurich, which focuses on private banking. The Bank operates a London branch, which provides commercial and private banking services.

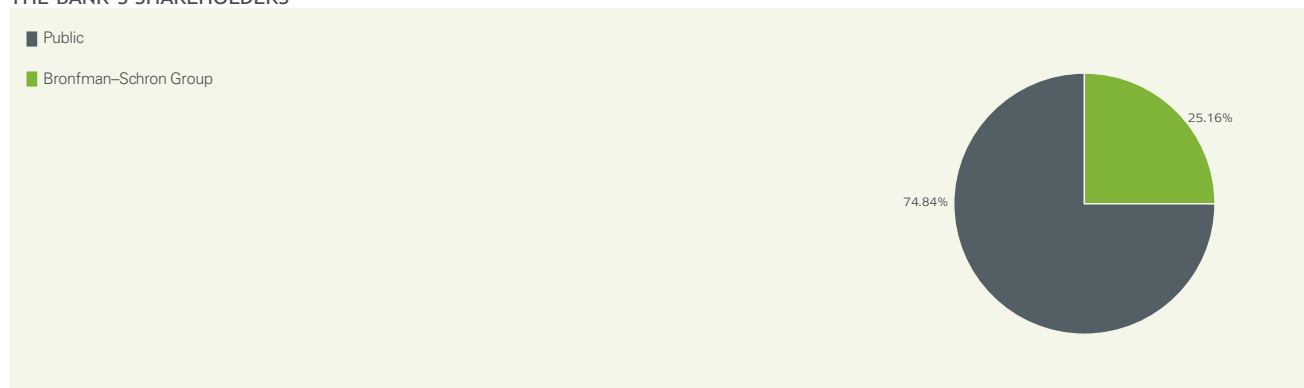
The Bank also has representative offices in Paris, Buenos Aires and Santiago and IDB New York has representative offices in various locations in South America.

## MARKET SHARE AND ADITIONAL DETAILS

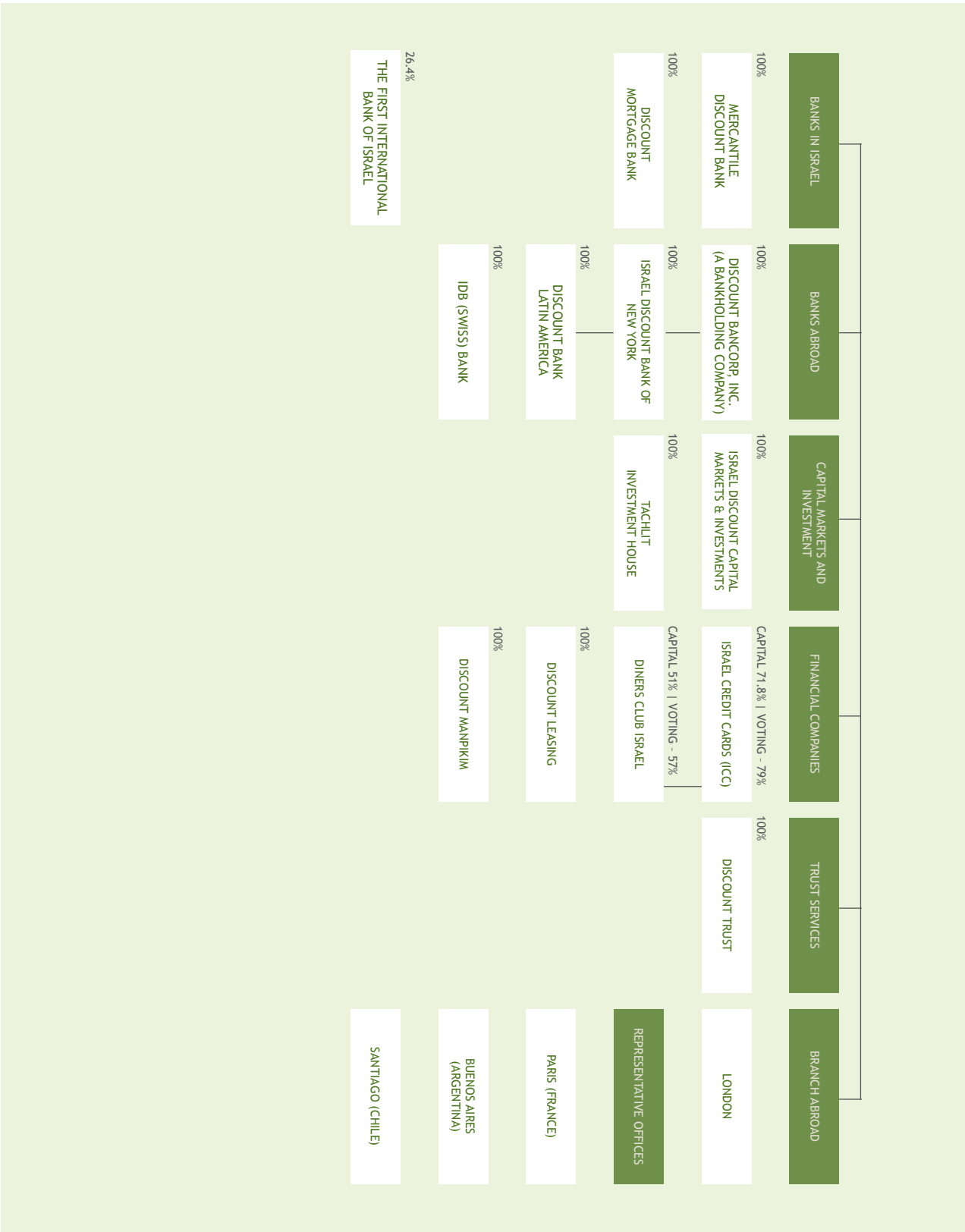
Based on data relating to the banking industry as of September 30, 2010, published by the Bank of Israel, the Discount Bank Group's share in the total of the five largest banking groups in Israel was as follows:

	September 30, 2010	December 31, 2009	December 31, 2008
	In %		
Total assets	17.9	17.9	18.0
Credit to granted the public	16.6	16.6	16.7
Deposits of the public	17.8	17.8	17.8
Earnings from financing operations	23.0	23.0	23.0
Provision for doubtful debts	15.4	15.4	15.4
Operating income	20.4	20.4	19.9
Operating expenses	21.2	21.2	20.9

### THE BANK'S SHAREHOLDERS



DISCOUNT GROUP STRUCTURE



## FORWARD LOOKING INFORMATION

Some of the information detailed in the directors' report, which does not relate to historical facts, comprises forward-looking information, as defined in the Securities Law, 1968.

The Bank's actual results might differ materially from those indicated in the forward-looking information due to a large number of factors, including, among other things, global and local capital market changes, macro-economic changes, changes in the geo-political situation, regulatory changes and other changes, not under the control of the Bank, and which may result in the non-realization of the estimates and/or in changes in the Bank's business plans.

Forward-looking information is typified by terms and words like: "believe", "anticipate", "estimate", "intends", "prepares to...", "might" and similar expressions, in addition to nouns such as: "desire", "anticipation", "intention", "expectation", "assessment", "forecast", etc. Such forward-looking expressions involve risks and uncertainties as they are based on evaluations by management as to future events, which include, among other things, evaluations as to the state of the economy, public preferences, domestic and foreign interest rates, inflation rates, etc. as well as regarding the effects of new legislative and regulatory provisions, relating to the banking industry and the capital market and to other fields that have an impact on the Bank's activity and on the environment in which it operates, and that by the nature of things, their realization is uncertain.

The information presented below relies, among other things, on information in the hands of the Bank, inter-alia, publications by other entities such as the Central Bureau of Statistics, the Ministry of Finance, the Bank of Israel, the Ministry of Housing and other entities, that publish data and assessments as to the Israeli and global financial and capital markets.

The above reflects the Bank's point of view and its subsidiaries at the time of preparation of the financial statements as to future events, based on evaluations that are uncertain. The Bank's evaluations and business plans and its subsidiaries are derived from such data and assessments. As stated above, actual results might differ materially and impact the realization of the business plans or bring about changes in these plans.

## DISCOUNT GROUP SEGMENT OF OPERATIONS - CONDENSED DESCRIPTION

The Bank reports its operations, in accordance with instructions of the Supervisor of Banks, under six operating segments, as follows:

- **Retail Banking - Household Segment:** This segment includes customers the Bank's Banking Division (formerly: the Retail Banking Division) who are private customers, who are defined as customers who are either salaried employees, possess the potential for growth, or may be viewed as VIP customers (the definition excludes customers of the private banking centers). The segment also includes the customers of Mercantile Discount Bank in that bank's household segment - private customers of Mercantile Discount Bank, whose activities are typical of those of households, including credit of a volume not exceeding NIS 200 thousand and deposits of a volume not exceeding NIS 500 thousand.
- **Retail Banking - Small Business Segment:** This segment includes customers of the Bank's Banking Division and customers of Mercantile Discount Bank which are defined as small companies and small businesses with borrowings of up to NIS 10 million.
- **Corporate banking:** The segment includes primarily companies with annual turnovers of over NIS 150 million and/or total indebtedness exceeding NIS 50 million, which are customers of the Bank and of Mercantile Discount Bank. The segment also includes customers of IDB New York's corporate banking segment.
- **Middle Market banking:** This segment includes mainly companies with annual turnovers exceeding NIS 30 million and/or total indebtedness of NIS 10-50 million, which are customers of the Bank and of Mercantile Discount Bank. The segment also includes customers of IDB New York's commercial banking segment.
- **Private banking:** This segment includes, as part of the Bank's domestic operations, customers of the Bank's Banking Division (individuals and corporations) who receive banking services at the private banking centers. These customers are generally Israeli customers with financial wealth held with the Bank of US\$1 million and over, as well as foreign resident customers with financial wealth held at the Bank of US\$0.5 million and above. The segment also includes customers of Mercantile Discount

Bank and the London branch, of medium and high wealth, all the activity of IDB (Swiss) Bank and the private banking customer activity at IDB New York including all the operations of the subsidiary Discount Bank Latin America.

- **Financial Management Segment:** This segment includes activities that are characterized as banking operations, but do not involve customers of the Group (except for activity with the dealing room, which is part of the segment). These activities are mainly comprised of their own account operations of the Bank, Mercantile Discount Bank and IDB New York involving securities and other banks, as well as management of market and liquidity risks and dealing room operations, including those involving derivatives. This segment also includes the Bank's share in the income of the First International Bank and its share in the income of its affiliated companies which operate in a supporting capacity. The segment also includes the non-financial corporations' sub-segment, which includes the Discount Group activity in non-financial investments.

These segments include also the related part of the operations of the product segments, and Discount Group's international operations.

The Bank reports its activity in four product segments, as follows:

- **Credit Card operations:** The Bank's activity in the credit card field is being conducted both through ICC, a credit card company in which the Bank holds 71.8% in share capital and 79% in voting rights and by the issue as co-issuers of ICC credit cards to the Bank's customers, as part of the services and products basket offered by the Bank.  
The Bank's income from the credit card operations includes, primarily, various commissions related to the credit card activity of ICC (both as an issuer of credit cards and as a clearing agent for credit cards), as well as the financing income from credit granted to transactions effected through off-banking credit cards. In addition, the bank derives income from payments transferred to it in respect of credit cards issued to its customers by ICC, at the Bank's initiative.
- **Operations in the Capital Market:** The operations in the capital market includes securities activity (excluding activity for the Bank's own account), portfolio management and pension products. The activity includes the Bank's operations in the securities field, pension layouts as well as the operations of a specialized subsidiary - Tachlit Investment House and the operations in the capital market of Mercantile Discount Bank.
- **Construction and Real Estate Activity:** This activity includes customers of the Bank's various divisions whose industry classification is construction and real estate. This activity also includes customers of the construction and real estate segment of Mercantile Discount Bank, IDB New York and the London Branch and the loans for the purchase or construction of assets at Discount Mortgage Bank and the building project finance segment at Discount Mortgage Bank.
- **Mortgage Activity - Housing Loans:** This activity includes the mortgage operations of the Discount Group in Israel (Mercantile Discount Bank and Discount Mortgage Bank). This segment includes the granting of loans for housing purposes (purchase, construction etc.) and the granting of loans for any purpose secured by a mortgage on a residential apartment or other property.

For further details, see "Activities of the Group according to principal segments of operations", "Further details regarding activities in certain products" and "International activity" below.

## MAIN FIGURES FROM THE CONSOLIDATED FINANCIAL STATEMENTS

### PROFITABILITY

	For the year ended December 31			Rate of change in %	
	2010	2009	2008	2010	2009
	In NIS millions			Compared with	
			2009	2008	
Income from financing activities before provision for doubtful debts	4,830	4,757	4,127	1.5	15.3
Provision for doubtful debts	812	998	780	(17.7)	27.9
Income from financing activities after provision for doubtful debts	4,009	3,759	3,347	(6.7)	12.3
Non-financing income	2,661	3,091	2,573	(13.9)	20.1
Of which: operating commissions	2,547	2,633	2,504	(3.3)	5.2
Non-financing expenses	5,631	5,486	5,348	2.6	2.6
Operating income before taxes	1,039	1,364	572	(23.8)	138.5
Operating income after taxes	572	857	403	(33.3)	112.7
Income (loss) from income after taxes	36	(20)	(10)	(280.0)	100.0
Net income	724	923	245	(21.6)	276.7
Net earnings per share of NIS 0.1 par value (in NIS)	0.73	0.93	0.25		
The return on shareholders' equity, in %	6.9	9.8	2.7		

### BALANCE SHEET

	As at December 31		Rate of change
	2010	2009	
	In NIS millions		In %
Total assets	185,814	187,817	(1.1)
Credit granted to the public	118,666	114,426	3.7
Securities	37,176	36,338	2.3
Deposits from the public	138,011	141,825	(2.7)
Shareholders' equity including minority interests	11,569	10,292	12.4
Shareholders' equity	11,241	9,994	12.5

## FINANCIAL RATIOS

	As at December 31	
	2010	2009
	In %	
Capital resources in relation to total assets	6.2	5.5
Ratio of capital to risk assets (Basel II)	13.69	12.01
Ratio of the provision for doubtful debts to credit granted to the public	0.66	0.83
Ratio of credit granted to the public to total assets	63.9	60.9
Ratio of credit granted to the public to deposits of the public	86.0	80.7
Ratio of deposits of the public to total assets	74.3	75.5
Ratio of operating income to operating expenses	47.3	56.3
Operating expenses relative to total income	75.2	69.9

## THE STRATEGIC PLAN

### A NEW STRATEGIC PLAN FOR THE YEARS 2011-2013

In recent months, the Bank's Management together with additional agents in the Discount Group is diligently preparing a strategic plan for the years 2011-2013 and according to guidelines determined by the Board of Directors, and forming new principles for the optimal management of the Group, with a view of exhausting the business advantages of the various components of the Group on the one hand, and improvement of the operating efficiency of the Group on the other hand.

The plan will be finalized in the coming months, under the supervision of the Board of Directors, and its final approval is expected towards the third quarter of 2011.

### PRINCIPLES OF THE STRATEGIC PLAN FOR THE YEARS 2011-2013

In March 2011, the bank adopted the principles of the strategic plan for the years 2011-2013. The principles of the strategic plan of the Discount Group are based on the guidelines determined, as stated, by the Bank's Board of Directors, the essence of which is as follows:

- **Profitability** - reaching the maximum potential profitability of the Group;
- **Performance** - increasing performance by creating an organizational culture of executive responsibility, measurement and performance management;
- **Risk management** - maintaining the risk profile of the Group within the limits and guidelines determined and which will be determined by the Board of Directors;
- **Group management** - the creation of an organizational-management structure supporting an effective group management and strictly ensuring that the work plans of the various units complement one another and are in line with the Group strategy;
- **Effective management** - improving efficiency of processes and expanding management flexibility;
- **Efficiency and savings** - while emphasizing manpower, computer and operating costs.

As a consequence of the guidelines of the Board of Directors, the principles of the strategic plan reflect a change in the focus of management of the Group, while emphasizing the following matters:

- Effective management of the Group's capital;
- Striving for a comprehensive and durable solution as regards costs;
- Improving purchasing and operating processes, while utilizing the advantage of size (on a group basis);

- Increasing profitability by reducing the rate of customer desertion, increasing the purse share and enlarging the product and service cover offered to the group's customers;
- Improving performance in areas where the market share of the Group is lower than its share in the industry, in particular: capital market activity, middle market banking, small businesses and private banking for Israelis;
- Leverage of the relative advantage of subsidiaries.

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## FORWARD-LOOKING INFORMATION

The strategic focuses discussed above include assessments and plans considered a forward-looking statement. Such assessments and plans are based on the most recent information and data in the hands of the Bank's management at date of publication of the financial statements and they reflect Management's plans as of that date. Such assessments and plans might change as a result of changes in the economic environment and/or changes in regulations having a material effect, which may require changes in the said focuses and updating of the plans.

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## INCOME AND PROFITABILITY

**The Group's net income** in 2010 amounted to NIS 724 million, compared with NIS 923 million in 2009, a decrease of 21.6%.

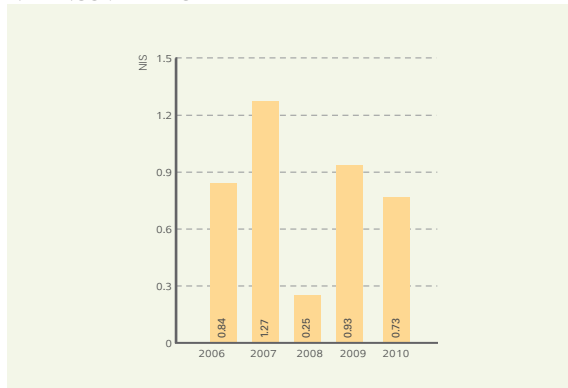
**Return on shareholders' equity** for 2010 was 6.9%, compared with 9.8% in 2008.

**Net earnings per one share of NIS 0.1 par value** amounted in 2010 to NIS 0.73, compared with NIS 0.93 in 2009.

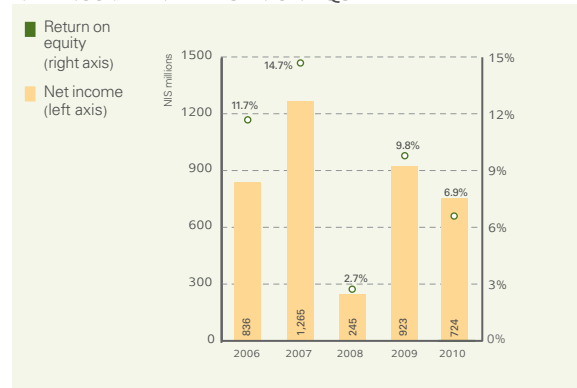
Following are the main factors that had an effect on the business results of the Group in 2010, compared with 2009:

- (a) An increase of 1.5% in income from financing activities before provision for doubtful debts.
- (b) A decrease of 17.7% in provisions for doubtful debts.
- (c) A decrease in operating and other income at the rate of 13.9%, affected by a decrease of 3.3% in operating commissions, a decrease of NIS 178 million in other income, mostly due to profits recorded by the severance pay funds, and a decrease of NIS 166 million in profits on investment in shares.
- (d) An increase in operating and other expenses at the rate of 2.6%, affected from an increase of 0.5% in payroll and related expenses, an increase of 11.2% in buildings and equipment depreciation and maintenance expenses and an increase at the rate of 1.1% in other expenses.
- (e) A tax expense of NIS 467 million on earnings from ordinary operations in 2010, compared with NIS 507 million in 2009.
- (f) The Bank's share in earnings from ordinary operations of affiliates in 2010 amounted to earnings of NIS 186 million (including an amount of NIS 53 million in respect of the reversal of a part of the provision for taxes in respect of the investment in the First International Bank), compared with NIS 158 million in 2009 (including an amount of NIS 10 million in respect of the reversal of a part of the provision for taxes regarding the investment in the First International Bank).
- (g) Net profit from extraordinary operations after tax amounted in 2010 to NIS 36 million, compared with a loss of NIS 20 million in 2009.

NET INCOME PER SHARE



NET INCOME AND RETURN ON EQUITY



## DEVELOPMENTS IN INCOME AND EXPENSES

Income from financing activities before provision for doubtful debts amounted to NIS 4,830 million in 2010, compared with NIS 4,757 million in 2009, an increase of 1.5%.

After eliminating adjustments to fair value of derivative financial instruments, the effect of tax hedging, gains and provisions for impairment of bonds, earnings from financing operations before provision for doubtful debts amounted to NIS 4,675 million, compared to NIS 4,713 million in 2009, a decrease of 0.8%.

Following are details of the impact of certain components on financing income:

	2010				
	Annual	Fourth quarter	Third quarter	Second quarter	First quarter
	In NIS millions				
Reported financing income	4,830	1,293	1,331	1,091	1,115
Effect of adjustments to fair value of derivative financial instruments ALM	146	(74)	5	86	129
Effect of tax hedging in respect of IDB New York	(79)	(41)	(73)	57	(22)
Provision for impairment of held to maturity bonds	42	20	2	20	-
Gains on sale of available for sale bonds, net	(271)	(30)	(89)	(53)	(99)
Provision for impairment of available for sale bonds	8	6	1	1	-
Net realized and unrealized losses (income) on bonds in the trading portfolio	(1)	17	(2)	(8)	(8)
<b>Financing income after adjustments</b>	<b>4,675</b>	<b>1,191</b>	<b>1,175</b>	<b>1,194</b>	<b>1,115</b>

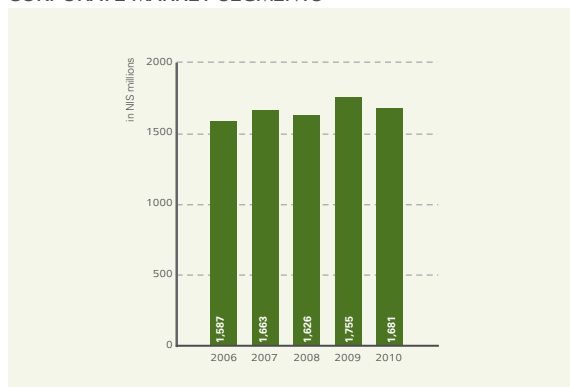
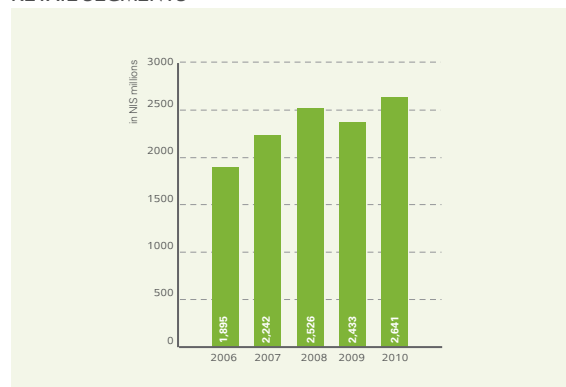
Following are details of the impact of certain components on financing income (continued):

	2009				
	Annual	Fourth quarter	Third quarter	Second quarter	First quarter
	In NIS millions				
Reported financing income	4,757	1,235	1,326	1,259	937
Effect of adjustments to fair value of derivative financial instruments ALM	247	(49)	14	4	278
Effect of tax hedging in respect of IDB New York	(9)	6	(56)	(94)	135
Gains on sale of available for sale bonds, net	(388)	(49)	(93)	(59)	(187)
Provision for impairment of available for sale bonds	119	1	17	50	51
Net realized and unrealized losses (income) on bonds in the trading portfolio	(13)	9	17	(4)	(35)
<b>Financing income after adjustments</b>	<b>4,713</b>	<b>1,153</b>	<b>1,225</b>	<b>1,156</b>	<b>1,179</b>

**The principle factors affecting profits from financing operations before provision for doubtful debts in 2010**, compared with 2009, were:

- a. An increase at the average rate of 2.7% in the income producing financial assets, from an amount of NIS 273,230 million to NIS 280,624 million.
- b. Adjustments to fair value of derivative financial instruments which created a positive gap of NIS 101 million, due to lack of matching between the methods of accounting for the value of base assets for these transactions, measured on an accrual basis, and of accounting for the value of the derivative financial instruments used as hedge for such base assets, measured on a fair value basis.
- c. Increased contribution of the active capital.
- d. A net decrease in other finance (as seen from the following Management Review) in the amount of NIS 74 million, mainly due to a decrease of NIS 60 million in gains on realization and adjustments of bonds.
- e. Hedge operations made by the Bank in order to eliminate the volatility in the provision for taxes, stemming from changes in the value of investment in consolidated subsidiaries abroad due to the devaluation or appreciation of currency exchange rates, resulted in an increase of NIS 79 million in profit from financing operations in 2010, compared to an increase of NIS 9 million in 2009. The effect of such hedge operation was offset in full against the taxes on income item.

**Income from financing activities before provision for doubtful debts in the fourth quarter of 2010** amounted to NIS 1,293 million, compared to NIS 1,235 million in 2009, an increase of 4.7%. Disregarding adjustments to fair value of derivative financial instruments, the effect of tax hedging, gains and provisions for impairment of bonds, profit from financing operations before provision for doubtful debts amounted to NIS 1,191 million, compared with NIS 1,153 million in 2009, an increase of 3.3%.

INCOME FROM FINANCING ACTIVITIES -  
CORPORATE MARKET SEGMENTSINCOME FROM FINANCING ACTIVITIES -  
RETAIL SEGMENTS

## INCOME FROM FINANCING ACTIVITY BY LINKAGE SEGMENTS

Below is the composition of income from financing activity by linkage segments (including the effect of derivative financial instruments which may be allocated to segments of activity - ALM):

For the year ended December 31							
2010				2009			Changes in contribution in NIS millions
Contribution to profit				Contribution to profit			
Volume of activity* in %	in NIS millions	In %	Volume of activity* in %	in NIS millions	In %		
Unlinked shekels	50.7	2,844	58.9	49.2	2,375	49.9	469
CPI-linked shekels	10.2	(48)	(1.0)	10.4	(47)	(1.0)	(1)
Foreign Currency	39.1	1,323	27.4	40.4	1,644	34.6	(321)
	100.0	4,119	85.3	100.0	3,972	83.5	147
Options		131	2.7		83	1.7	48
Other derivative financial instruments (not including hedged derivatives and ALM)		(3)	(0.1)		32	0.7	(35)
Financing commissions		177	3.7		171	3.6	6
Other financing income (expenses), net		406	8.4		499	10.5	(93)
<b>Total</b>		<b>4,830</b>	<b>100.0</b>		<b>4,757</b>	<b>100.0</b>	<b>73</b>

\* According to the average balance of the assets.

For further details of earnings from financing operations according to linkage terms, see "Financing income and expense ratios" in Schedule C in the Management Review hereunder.

## NET INTEREST INCOME ACCORDING TO LINKAGE SEGMENTS (INCLUDING ALM)

**In the non-linked shekel segment**, net interest income amounted to NIS 2,844 million in 2010, compared with NIS 2,375 million in 2009, an increase of 19.7%. Income from this segment constituted 58.9% of total net interest income in 2010, compared with 49.9% in 2009.

The average balance of assets in this segment increased in 2010 by 5.8% compared with the preceding year.

The interest margin of the segment increased from a rate of 1.70% in 2009 to a rate of 1.92% in 2010.

The increase in profit of this segment, stems from the increase in the interest spread, inter-alia in respect of an Income of NIS 35 million in respect of fair value adjustments of derivative financial instruments in 2010 compared to an expense of NIS 57 million in 2009 from an increase in the contribution of the active capital, as a result of the growth in the capital invested in this segment and the increased volume of activity in the segment.

The interest rate spread, after elimination of adjustments to fair value of derivative financial instruments ALM, reached a rate of 1.89% in 2010, compared to 1.75% in 2009.

**The CPI-linked Shekel segment** recorded in 2010 net interest expense of NIS 48 million, compared with expenses of NIS 47 million in 2009. Its proportion of total net interest income in 2009 was a negative rate of 1.0%, similar to 2009.

The average asset balance in this segment in 2010, rose by a negligible rate of 1.4% compared with the preceding year.

Adjustments to fair value of derivative financial instruments created a positive gap of NIS 152 million due to the inconsistency in accounting between the method for computing the value of the base assets for these transactions, measured on an accrual basis, and the method for computing the value of derivative instruments used to hedge the base assets, which are measured on the basis of fair value. If such adjustments were eliminated, the interest spread in the CPI linked segment would have reached a negative rate of 0.21% in 2010, compared to 0.35% in 2009. This compared to an actual negative spread of 0.46% in 2010 and compared to an actual negative spread of 0.45% in 2009.

The decrease in the interest rate spread, after elimination of adjustments to fair value of derivative financial instruments ALM, stems mostly from a relatively low rate of decline in the cost of resources, part of which were designed to improve the Bank's capital adequacy, compared with the decline at a higher rate in the returns on income producing applications.

The contribution of the active capital in this segment remained similar in the years 2009 and 2010.

**In the foreign currency segment**, which includes activities in the foreign currency-linked shekel segment, net interest income amounted to NIS 1,323 million in 2010, compared with NIS 1,644 million in 2009, a decrease of 19.5%. Its proportion of all net interest income was 27.4% in 2010, compared with 34.6% in 2009.

In 2010, the average balance of assets in this segment decreased by a negligible 0.8% compared with 2009.

The interest margin of the segment decreased from a rate of 1.51% in 2009 to a rate of 1.08% in 2010.

The decline in profits of the segment stems from a decrease in the interest spread, among other things, due to an expense of NIS 113 million in respect of adjustments to fair value of derivative financial instruments in 2010, in contrast to an income of NIS 31 million in 2009, which was offset due to the increase in the contribution of the active capital.

The interest rate spread, after elimination of adjustments to fair value of derivative financial instruments ALM, reached a rate of 1.18% in 2010, compared to 1.49% in 2009. In addition, a hedging operation performed by the Bank resulted in an increase of NIS 79 million in earnings from financing operations in 2010, compared to an increase of NIS 9 million in 2009.

The overall margin (excluding the effect of derivatives) reached a rate of 2.87% in 2010, compared with a rate of 2.40% in 2009.

**The interest margin, including the effect of other derivatives (in hedge transactions and ALM)**, reached a rate of 2.87% in 2010, compared with a rate of 1.40% in the preceding year.

The balance of the negative accumulated adjustment to the fair value of derivatives as of December 31, 2010, amounted to NIS 414 million, and stems mostly from the CPI linked segment. The said adjustment will be reduced in the following years until its elimination upon settlement of the present transactions, and is expected to increase the Bank's financing income accordingly.

**Total interest margin, disregarding the effect of adjustments to fair value of ALM derivative financial instruments and the effect of tax hedging in respect of IDB New York** reached a rate of 1.51% in 2010 compared with 1.49% in 2009.

The following is the composition of the income from financing activities, before provision for doubtful debts, by segments of operations:

	For the year ended December 31		
	2010	*2009	Rate of change
	In NIS millions		in %
Retail - household segment	1,386	1,253	10.6
Retail - small bussiness segment	920	818	12.4
Corporate marker segment	1,025	1,097	(6.6)
Middle market segment	656	658	(0.3)
Private banking segment	335	362	(7.5)
Financial management	508	569	(10.7)
<b>Total</b>	<b>4,830</b>	<b>4,757</b>	<b>1.5</b>

\* Reclassified.

The increase in the household sector stemmed mostly from the increase in interest spreads, due to the increase in market interest rate. The decrease in the business sector stemmed mostly from the decrease in volume of operations in this sector. The decrease in the financial sector stemmed mostly from decline in gains on sale of held to maturity of available-for-sale bonds and from realized and unrealized gains from adjustment to fair value of trading bonds and the provisions for impairment of and available-for-sale bonds, and from a decline in interest gain on bonds.

**Provision for doubtful debts in 2010** amounted to NIS 821 million, compared with a provision of NIS 998 million in the preceding year, a decrease of 17.7%. In 2010, the provision constituted 17.0% of the income from financing activities before provision for doubtful debts, compared with 21.0% of this income in the preceding year.

Following are details regarding the provision for doubtful debt expenses:

	For the year ended December 31		
	2010	2009	Rate of change
	In NIS millions		in %
Specific provision for current year	1,079	1,264	(14.6)
Reduction of specific provision and collection of debts written-off in previous years	(338)	(233)	
Change of specific provision	741	1,031	(28.1)
Change of supplemental provision	80	(33)	
<b>Provision charged to statement of Income</b>	<b>812</b>	<b>998</b>	<b>(17.7)</b>

The annual provision for doubtful debts, as a ratio of credit granted to the public, not including off-balance sheet credit risk, was 0.66% in 2010 (0.44% - including off-balance sheet credit risk), compared with 0.83% (0.55% - including off-balance sheet credit risk) in 2009.

The balance of the provision for doubtful debts, which includes the specific provision, the general provision and the supplemental provision, but not including provision for off-balance sheet credit risk, amounted to NIS 6,236 million in 2010 (NIS 6,384 million -

including provision for off-balance sheet credit risk). The balance of this provision constitutes 4.99% of the credit granted to the public (3.45% - including off-balance sheet credit risk), compared with a balance of the provision in the amount of NIS 6,394 million, not including provision for off-balance sheet credit risk (NIS 6,641 million - including provision off-balance sheet credit risk), constituting 5.29% of the credit granted to the public (3.64% - including off-balance sheet credit risk) at the end of the preceding year.

**The specific provision for doubtful debts** amounted to NIS 741 million in 2010, compared with NIS 1,031 million in the preceding year, a decrease of 28.1%.

The specific provision was made on a conservative basis, in accordance with management's assessment of expected losses in the credit portfolio, based on an examination and monitoring of the condition of debtors and their business activity, an assessment of the risks related to their financial condition and in relation to the type and value of the collateral.

Following are details of the quarterly development in the provision for doubtful debts (in NIS millions):

	2010				2009			
	Fourth quarter	Third quarter	Second quarter	First quarter	Fourth quarter	Third quarter	Second quarter	First quarter
Specific provision	241	164	222	114	277	253	242	259
Supplemental provision	33	5	39	3	(8)	(7)	(11)	(7)
<b>Total</b>	274	169	261	117	269	246	231	252
Rate of specific provision from credit granted to the public*	0.78%	0.52%	0.72%	0.38%	0.92%	0.83%	0.79%	0.82%

\* On an annual basis.

**Income from financing activities after provision for doubtful debts** amounted to NIS 4,009 million in 2010, compared with NIS 3,759 million in the preceding year, an increase of 6.7%.

**Non-financing income** in 2010 amounted to NIS 2,661 million, compared with NIS 3,091 million in the preceding year, a decrease of 13.9%.

The distribution of operating and other income item components are as follows:

	2010	2009	2008
	In NIS millions		
Account management	633	655	614
Credit cards	914	1,010	937
Revenue from the capital market	456	445	386
Gains on investment in shares, net	31	197	51
The handling of credit	254	221	223
Conversion differences	119	135	165
Foreign trade operations	58	57	67
Other	196	371	130
<b>Total</b>	2,661	3,091	2,573

**Operating Commissions** amounted to NIS 2,547 million in 2010, compared with NIS 2,633 million in the preceding year, an increase of 3.3%. The decrease results mainly from a decrease in commissions from credit cards.

Income from credit card operating activities amounted to NIS 914 million in 2010, compared with NIS 1,010 million in 2009, a decrease of 9.5%, as a result of a reduction in international trading activity.

**Income from capital market activity** in 2010 amounted to NIS 456 million, compared with NIS 445 million in 2009, an increase of 2.5%. The increase stems from the distribution of pension products.

Presented below are details regarding earnings from capital market operations in the years 2008-2010:

	Consolidated		
	2010	2009	2008
	In NIS millions		
Income from operations in securities and in certain derivative instruments	338	339	306
Distribution of financial products	81	55	37
Management, operating and trusteeship services to institutional entities	35	49	30
Other	2	2	13
<b>Total</b>	<b>456</b>	<b>445</b>	<b>386</b>

For details regarding "Capital market move" launched in the fourth half of 2010, see "Developments in the operations" in the section "Operations in the capital market" below.

**Gains on investment in shares, net**, amounted to NIS 31 million in 2010, compared to NIS 197 million in 2009. For details see Note 25 to the financial statements.

**Other income** in 2010 amounted to NIS 83 million, compared with NIS 261 million in the preceding year, a decline of 68.2% due mostly to the impact of the decline in profits of the severance pay fund.

**Non-financing expenses** amounted to NIS 5,631 million in 2010, compared with NIS 5,486 million in 2009, an increase of 2.6%.

**Salaries and related expenses** amounted to NIS 3,190 million in 2010, compared with NIS 3,175 million in the preceding year, an increase of 0.5%. (for details as to the components of this item, see Note 27 to the financial statements).

Following are details of the effects of certain components on salaries and related expenses:

	For the year ended December 31			Change in %	
	2010	2009	2008	2010	2009
	In NIS millions			compared to	
	2010	2009	2008	2009	2008
Salaries and Related Expenses - as reported	3,190	3,175	3,106	0.5	2.2
Awards	(91)	(179)	(103)		
Expense resulting from share based payment transactions	(7)	(2)	(15)		
The effect of changes in retirement rates on the provision for long-term service awards	-	(65)	-		
Waiver of wages in 2009	(16)	44	-		
Encouragement of early retirement expenses	(7)	(6)	-		
The influence of the severance pay fund	94	80	(81)		
<b>Salaries and Related Expenses - Disregarding certain components</b>	<b>3,163</b>	<b>3,047</b>	<b>2,907</b>	<b>3.8</b>	<b>4.8</b>

The increase in payroll expenses in 2010, disregarding certain components, compared to the preceding year, has been affected mostly by the wage agreements expected for 2010 at the Bank and at Mercantile Discount Bank.

In 2010, the severance pay funds recorded profits of NIS 158 million, which served to partially cover the increase in liabilities for severance pay in respect of prior years in the amount of NIS 94 million, resulting from the wage agreement for 2010 and the surplus profit in the amount of NIS 62 million being recorded in other income. The severance pay funds recorded in 2009 profits of NIS 340 million, used in part to cover the increase in severance pay liabilities in respect of prior years in the amount of NIS 80 million, the remaining profits in the amount of NIS 260 million recorded as "other income". For further details see "Human Resources" below. Salaries expenses, excluding related expenses, amounted in 2010 to NIS 2,169 million, compared with NIS 2,135 million in 2009, an increase of 1.6%.

**Depreciation and maintenance of building and equipment** amounted to NIS 1,148 million in 2010, compared with NIS 1,032 million in the previous year, an increase of 11.2%. The majority of the increase is due to the growth in the Bank's depreciation expenses, following the amortization of software costs for which in house development has been completed.

**Other expenses** amounted to NIS 1,293 million in 2010, compared with NIS 1,279 million in the previous year, an increase of 1.1%. The changes in other expenses were mainly off set by a decrease in computer, insurance and other expenses, which was offset by an increase in advertising and professional services expenses.

**The cover rate of non-financing income to non-financing expenses** reached 47.3% in 2010, compared with 56.3% in the preceding year.

**Total operating expenses in relation to total income** reached a rate of 75.2% in 2010 compared to 69.9% in the previous year.

**Operating income before taxes** amounted to NIS 1,039 million in 2010, compared with NIS 1,364 million in the preceding year, a decrease of 23.8%.

**Provision for taxes on operating income** amounted to NIS 467 million in 2010, compared with NIS 507 million in the preceding year. The ratio of the provision for taxes in relation to earnings from ordinary operations, before taxes, reached 44.9% in 2010, compared with 37.2% in 2009.

**Operating income after taxes** amounted to NIS 572 million in 2010, compared with NIS 857 million in 2009, a decrease of 33.3%.

**The Bank's share in operating income after taxes of affiliated companies** in 2010 amounted to income of NIS 186 million (including an amount of NIS 53 million in respect of the reversal of a part of the provision for taxes in respect of the investment in the First International Bank) - see note 29 L to the Financial Statements, compared with NIS 158 million in the preceding year (including an amount of NIS 10 million in respect of the reversal of a part of the provision for taxes regarding the investment in the First International Bank).

**Net operating income** amounted to NIS 688 million in 2010, compared with NIS 943 million in the preceding year, a decrease of 27%.

**The ratio of operating income before taxes to shareholders' equity, including minority interest**, was 11.4% in 2010, compared with a ratio of 17.0% in the preceding year.

**The ratio of operating income after taxes to shareholders' equity, including minority interest**, was 6.3% in 2010, compared with a ratio of 10.7% in the preceding year.

**Net income from extraordinary operations, after taxes**, amounted, in 2010, to NIS 36 million, compared to losses of NIS 20 million in 2009.

**Net income** in 2010 amounted to NIS 724 million, compared with of NIS 923 million in the preceding year, a decrease of 21.6%.

**Return on shareholders' equity** reached a rate of 6.9% in 2010, compared with a rate of 9.8% in 2009.

**Net earnings per one share of NIS 0.1 par value** amounted in 2010 to NIS 0.73 compared with NIS 0.93 in the preceding year. The net earnings of the Discount Group for the fourth quarter of 2010, amounted to NIS 135 million, compared with NIS 288 million for the third quarter of the year, a decline of 53.1%.

The return on equity for the fourth quarter of 2010, reached the rate of 5.1%, compared to 11.3% for the third quarter of the year.

Net earnings per share of NIS 0.1 par value, amounted in the fourth quarter of 2010 to NIS 0.13, compared to NIS 0.29 in the

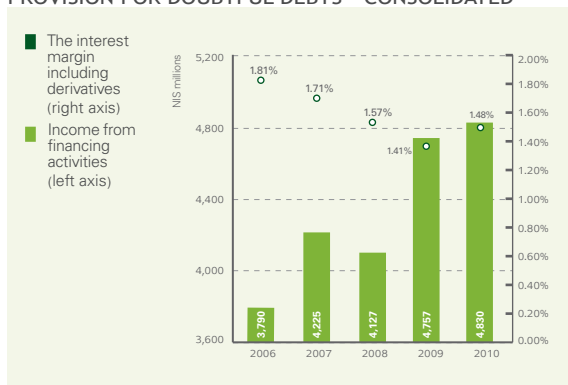
third quarter of the year.

The major factors affecting the business results of the Group in the fourth quarter of 2010, compared with the previous quarter, were:

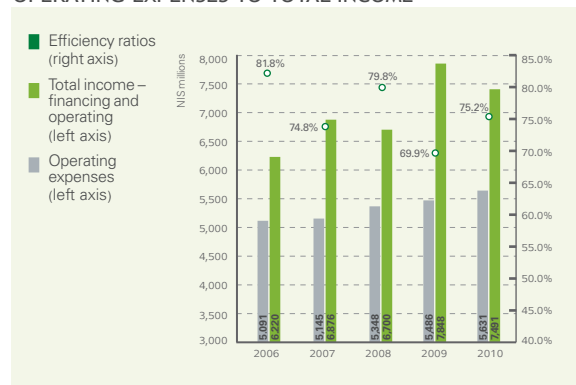
- A. A decline of 2.9% in income from financing operations before provision for doubtful debts.
- B. An increase of 62.1% in the provision for doubtful debts.
- C. An increase of 6.8% in operating and other income, effected by an increase of 1.7% in operating commissions, decrease of NIS 13 million in other income resulting mostly from a decline in gains recorded by the severance pay funds, and an increase of NIS 47 million in gains on investment in shares.
- D. An increase at the rate of 18.5% in operating and other expenses, effected by an increase of 15.0% in payroll and related benefits, mostly due to awards granted by a consolidated subsidiary, the updating of actuarial provisions and an increase in the provisions for vacation and severance pay, an increase of 13.3% in maintenance and depreciation expenses of buildings and equipment, mostly at the Bank and an increase of 32.5% in other expenses, mostly advertising, consulting and professional services as well as operating failures in credit not under the responsibility of the Bank.
- E. Provision for taxes on income from ordinary operations in the amount of NIS 107 million in the fourth quarter of 2010, compared with NIS 230 million in the previous quarter.
- F. The share of the Bank in earnings from ordinary operations of investee companies amounted in the fourth quarter of 2010 to NIS 87 million (including an amount of NIS 53 million in respect of the reversal of a part of the provision for taxes in respect of the investment in the First International Bank), compared with NIS 32 million in the previous quarter.
- G. Net earnings from extraordinary operations after taxes in the fourth quarter of 2010, amounted to NIS 5 million, compared with NIS 1 million in the previous quarter.

**An estimate of the effect of the Bank's and Mercantile Discount Bank's wage agreements on the business results for the first quarter of 2011.** The Bank will include in its financial statements for the first quarter of 2011, the full increase in the provisions for wage related liabilities in accordance with Management's evaluation of the cost of the wage agreement for 2011, in the estimated amount of NIS 140 million (first quarter 2010: NIS 115 million).

INCOME FROM FINANCING ACTIVITIES BEFORE PROVISION FOR DOUBTFUL DEBTS - CONSOLIDATED



OPERATING EXPENSES TO TOTAL INCOME



## DEVELOPMENT OF ASSETS AND LIABILITIES

**Total assets** as at December 31, 2010 amounted to NIS 185,814 million, compared with NIS 187,817 million at the end of the preceding year, a decrease of 1.1%.

Following are the developments in the principal balance sheet items:

	December 31		Rate of change in %
	2010	2009	
	In NIS millions		
<b>Assets</b>			
Cash and deposits with banks	18,187	24,583	(26.0)
Securities	37,176	36,338	2.3
Credit granted to the public	118,666	114,426	3.7
<b>Liabilities</b>			
Deposits from the public	138,011	141,825	(2.7)
Deposits from banks	3,387	3,724	(9.0)
Subordinated capital notes	12,294	11,529	6.6
Shareholders' equity	11,241	9,994	12.5

## CREDIT GRANTED TO THE PUBLIC

**General.** Credit granted to the public as at December 31, 2010, amounted to NIS 118,666 million, compared with NIS 114,426 million on December 31, 2009, an increase of 3.7%. The ratio of credit granted to the public to total assets reached 63.9% at the end of 2010, compared with 60.9% at the end of 2009.

For details regarding credit risk management, including strategy and policy relating to the credit risk management field, the structure and organization of credit risk management functions and more, see "Credit risk management" under "Exposure to risks and risk management" hereunder.

## COMPOSITION OF CREDIT GRANTED TO THE PUBLIC BY LINKAGE SEGMENTS

Following are data on the composition of credit granted to the public by linkage segments:

	December 31, 2010		December 31, 2009		Rate of changes in %
	In NIS millions	% of total credit to public	In NIS millions	% of total credit to public	
Non-linked shekels	65,359	55.1	59,498	52.0	9.9
CPH-linked shekels	19,160	16.1	19,021	16.6	0.7
Foreign currency and foreign currency-linked shekels	34,147	28.8	35,907	31.4	(4.9)
<b>Total</b>	<b>118,666</b>	<b>100.0</b>	<b>114,426</b>	<b>100.0</b>	<b>3.7</b>

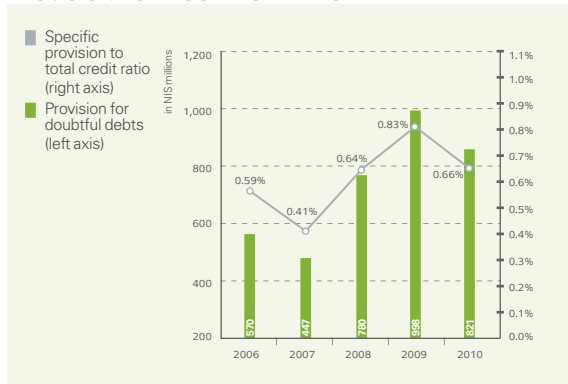
Credit granted to the public denominated in foreign currency and in Israeli currency linked thereto decreased by 4.9% compared with December 31, 2009. In U.S. Dollar terms, credit granted to the public in foreign currency and foreign currency linked Shekels increased by US\$110 million as compared to December 31, 2009, an increase of 1.2%.

The total credit granted to the public, which includes credit in foreign currency and Israeli currency linked to foreign currency, computed in dollar terms, increased by 5.6% as compared to December 31, 2009.

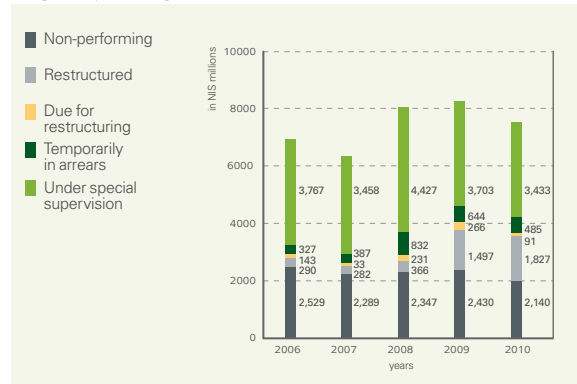
## DEVELOPMENTS IN THE PROVISIONS FOR DOUBTFUL DEBTS AND IN CREDIT TO PROBLEMATIC BORROWERS IN THE GROUP

The balance of the provision for doubtful debts to credit granted to the public (excluding off-balance sheet credit risk) reached 4.99% in 2010 compared to 5.29% in 2009.

### PROVISION FOR DOUBTFUL DEBTS



### PROBLEM DEBTS



Following are data as to the overall credit risk at the responsibility the of the Group as regards problematic debts net of provision for doubtful debts<sup>(1)</sup>:

	December 31	
	2010	*2009
	in NIS millions	
Non-performing debts	2,140	2,430
Reorganized debts <sup>(2)</sup>	1,827	1,497
Debts due for reorganization <sup>(3)</sup>	91	266
Debts temporarily in arrears	485	644
Debts under special supervision <sup>(4)</sup>	3,433	3,703
<b>Total balance sheet credit to problematic borrowers</b>	<b>7,976</b>	<b>8,540</b>
Off-balance sheet credit risk regarding problematic borrowers <sup>(5)</sup>	807	872
Debentures of problematic borrowers	172	12
Other assets in respect of derivative	2	24
<b>Total overall credit risk concerning problematic borrowers</b>	<b>8,957</b>	<b>9,448</b>
The overall credit risk in respect of problematic borrowers and banks	17	11
<b>The total credit risk in respect of problematic borrowers and banks</b>	<b>8,974</b>	<b>9,459</b>

\* Reclassified.

Notes:

- (1) Not including problem debts for which the collateral received is available for set-off with respect to the limitations on indebtedness of a single borrower and of a group of borrowers (Proper Banking Management Directive No. 313).
- (2) Credit reorganized during the current year as well as credit reorganized in prior years with waiver of income.
- (3) Credit to borrowers, which per Management decision is to be reorganized, but which reorganization has not yet been implemented.
- (4) Of which: debts of NIS 403 million, presented net of specific provision made thereof, and housing loans of NIS 133 million, in respect of which a provision according to the period of default exists (December 31, 2009: NIS 903 million and NIS 156 million, respectively).
- (5) As computed for the purpose of limitations on indebtedness of a single borrower or of a group of borrowers, except for guarantees granted by a borrower to secure a third party indebtedness.

The major part of the overall credit risk is in the construction and real-estate, financial services and industry sectors.

## A DIRECTIVE IN THE MATTER OF "MEASUREMENT AND DISCLOSURE OF IMPAIRED DEBTS, CREDIT RISK AND PROVISION FOR CREDIT LOSSES"

**General.** On December 31, 2007, the Supervisor of Banks issued a Directive in the matter of "Measurement and disclosure of impaired debts, credit risk and the provision for credit losses (hereinafter: "the Directive"). The Directive aligns the reporting principles applying to banking corporations in Israel with those applying to banks in the United States, and among other things, it is based on U.S. accounting principles and on the directives of the bank regulatory authorities in the U.S. as well as on the SEC. The principles on which the directive is based constitute a material change in the present directives regarding classification of problematic debts and measurement of provisions for credit losses in respect of these debts. On February 18, 2010, the Supervisor of Banks published an update of the original instruction, which, among other things, defers the implementation of the instruction to January 1, 2011 (instead of January 1, 2010, as stated in the original instruction). See Note 1AA (3) to the financial statements.

**Preparations by the Bank.** Implementation of the directive required significant changes in existing information systems in order to ensure the process of evaluation and creation of the provision for credit losses, including the establishment of internal control systems assuring the proper implementation of the directive and validation of the effectiveness of the method of computing the provision. The Bank's management has prepared for the implementation of the Directive within the framework of a project conducted by the Bank's Corporate Banking Division.

Development of the principal parts of the designated information system was completed only in December 2010. The first production of data was made in December 2010 with respect to data as of September 2010, within the framework of the preparation of an initial assessment of the impact of the implementation of the Directive on the Bank for the purpose of reporting to the Supervisor of Banks. Integration of the system was completed in January 2011. Various corrections and improvements in the system were made in February 2011, and it is possible that further improvements will have to be made also in the coming months.

**Manner of implementing the Directive.** Upon the initial implementation of the Directive, banking corporations are required to write off accounting wise, the balance of problematic debts that qualify the criteria specified in the Directive for an accounting write-off, to reverse all interest income accrued until January 1, 2011, if not actually collected by this date, in respect of impaired debts as defined in the Directive and to create provisions in accordance with the requirements of the directive.

The instruction is not to be applied retroactively in financial statements for prior periods. Adjustments of the balance of the provision for credit losses in respect of credit granted to the public and in respect of off-balance sheet credit instruments, according to the requirements of the instruction, will be reflected directly in the retained earnings item of shareholders' equity.

For details regarding the tax aspects of the implementation of the Directive, see "Taxation" below.

**Effect of the implementation of the Directive. (proforma)** Following are details clarifying the effect of the initial adoption of the Directive, on the main balance sheet items in the financial statement as of December 31, 2010, had it been applied on that date. As appears from the data presented below, implementation of the Directive (pro-forma) would have reduced shareholders' equity as of December 31, 2010, by NIS 817 million (including the effect of impaired debts at the First International Bank). It should be noted that the said reduction does not reflect a deterioration in the quality of the credit portfolio of the Discount Group. The reduction is made in accordance with an instruction of the Supervisor of Banks, requiring the banking industry in Israel to change into a new system of managing and measuring provisions for credit losses and to make a one off adjustment of the equity.

Among the main effects of the new system, the following might be mentioned:

- The group provision is computed in respect of all debts, including performing debts, while up to now no provision had been included in respect of performing debts;
- Computation of the rate of the group provision is being impacted by the cancellation of accrued interest income on nonperforming debts in the various sectors. Whereas in certain sectors, the relative weight of nonperforming debts at the Bank is higher than that of the banking industry, the rate of the group provision as computed by the Bank is relatively high (affecting, as stated, also the computation of the group provision in respect of the performing debts in those sectors);

- For the purpose of computing the specific provision, collateral that may be recognized have been reduced to material collateral and to documented future cash flows only.

It should be noted that in the Immediate Report issued by the Bank on March 3, 2011, the reduction in the shareholders equity in respect of the initial adoption of the Directive was assessed at NIS 850 million (excluding the effect of impaired debts of the First International Bank). The Bank diligently continues to improve and examine the data, and such efforts resulted in a lower assessment of the effect on the shareholders equity (including the effect of the impaired debts of the First International Bank) to an amount of NIS 817 million.

**(1) Non-performing assets, performing impaired debts, commercial criticized exposure and non-impaired debts that are in arrears for 90 days or over (pro-forma).** All balances presented below are stated according to the new Directive, had it been initially implemented on December 31, 2010 (consolidated).

	Balance as of December 31, 2010
	In NIS millions
<b>1. Non-performing assets:</b>	
Non-performing impaired credit granted to the public:	
Examined on a specific basis	4,220
Examined on a group basis	47
Non-performing impaired bonds	27
<b>Total non-performing assets</b>	<b>4,294</b>
<b>2. Performing impaired debts of restructured troubled debt</b>	<b>1,667</b>
<b>3. Commercial criticized exposure:<sup>(1)(2)</sup></b>	
Balance sheet credit risk in respect of the public	8,242
Off-balance sheet credit risk in respect of the public <sup>(3)</sup>	608
<b>Total commercial criticized exposure in respect of the public</b>	<b>8,850</b>
Commercial criticized exposure in respect of others	-
<b>Total commercial criticized exposure</b>	<b>8,850</b>
<b>4. Non-impaired debts in arrears for 90 days or over</b>	<b>483</b>
Of which: housing loans in respect of which provisions according to period of arrears exist	131
Housing loans in respect of which provisions according to period of arrears do not exist <sup>(4)</sup>	-
Non-impaired bonds in arrears for 90 days or over	-

Notes:

- (1) Balance sheet and off-balance sheet credit risk is stated before provision for credit losses and before the effect of collateral available for deduction for the purpose of computing indebtedness of a single borrower and of a group of borrowers.
- (2) Balance sheet credit risk (credit, bonds, other debts recognized in the balance sheet) and off-balance sheet credit risk that is impaired, substandard or under special mention, excluding balance sheet and off-balance sheet credit risk in respect of private individuals.
- (3) As computed for the purpose of restrictions of indebtedness of a single borrower and of a group of borrowers, excluding in respect of guarantees provided by a borrower which secure the debt of a third party, before the effect of collateral available for deduction.
- (4) Housing loans in respect of which the minimum provision is computed according to the period in arrears, which are in arrears over 3 months and up to 6 months and other non-impaired housing loans which are in arrears for 90 days or over and the minimum provision in respect thereof is not computed according to the period of arrears.

**(2) Effect on shareholders' equity (pro-forma).** Following are details of the effect on shareholders' equity had the new Directive been implemented on December 31, 2010. As stated, in accordance with the requirements of the new Directive, the adjustments of the outstanding balance of the provision for credit losses are recognized directly in shareholders' equity as of January 1, 2011.

	December 31, 2010
	In NIS millions
Balance of retained earnings as stated in the financial statements	7,037
Cumulative effect, net of taxes, of the initial implementation of the new Directives	(770)
Other changes in provision for credit losses	(1,367)
Related tax effect	593
The Share of minority interest in the changes in provision for credit losses	4
Cumulative effect, net of tax, of the initial implementation of the new Directives in an affiliated company	(47)
Balance of retained earnings in accordance with the new Directive	6,220

**(3) Effect on credit risk indices (pro-forma).** Following are several credit risk indices computed as of December 31, 2010, had the new Directive been applied on that day.

	December 31, 2010
	In %
Ratio of non-performing impaired credit granted to the public balance to total credit granted to the public	3.6
Ratio of non-impaired of credit granted to the public balance in arrears for 90 days or over to total credit granted to the public	0.4
The ratio of the balance of the provision for credit losses in respect of credit granted to the public, to the balance of credit granted to the public	1.7
Ratio of the outstanding balance of provision for credit losses in respect of credit granted to the public to the outstanding non-performing balance of impaired credit granted to the public	48.9
The ratio of commercial criticized exposure in respect of the public, to the total credit risk in respect of the public	5.0

Notes:

(1) For the purpose of computing the above mentioned ratios, the balance of credit granted to the public has been computed according to the recorded amount of credit granted to the public.

## THE RISK CHARACTERIZATION OF THE CREDIT GRANTED TO THE PUBLIC PORTFOLIO

The improvement in the quality of the portfolio was expressed by the decline in the ratio of the balance sheet problematic debt to the total balance sheet credit granted to the public of the Group, from 7.3% at the end of 2009 to 6.7% at the end of 2010. Starting with the second half of 2009, improvement was experienced in the activity and repayment ability of most of the borrowers in most economic sectors, where during 2010, the growth in activity of borrowers continued as a result of the recovery in levels of demand both in Israel and abroad.

The provision for doubtful debts of the Group amounted in 2010 to NIS 821 million, compared to a provision of NIS 998 million in 2009, a decrease of 17.7%.

The Group's specific provision for doubtful debts amounted in 2010 to NIS 741 million, compared to a provision of NIS 1,031 million in 2009, a decrease of 28.1%.

As a result, the rate of the specific provision has declined in relation to the balance sheet credit. from 0.9% in 2009 to 0.6% in 2010.

Restructured troubled debts or intended for restructuring increased by an amount of NIS 155 million (from NIS 1,763 million in 2009 to

1,918 million in 2010) this, due to the classification of restructured troubled debts amounting to NIS 1.0 billion, regarding a number of borrowers belonging to a certain group of borrowers, operating mostly abroad. Disregarding this exceptional classification, the debt in this classification group would have been smaller by 50% compared with 2009, a fact that indicates the improvement that has taken place in the quality of the credit portfolio due to improved operating profit margins and cash flows of most of the borrowers.

The non-performing debt decreased to an amount of NIS 2.14 billion, compared with NIS 2.43 billion in 2009, a decrease at the rate of 11.9%, as a result of the stricter collection arrangements and/or debt repayment arrangements with customers and from the increase in the value of collateral securing the debt to the Bank.

The improvement in the financial condition of borrowers in the various economic sectors stemmed from the following developments:

- Commercial sectors – growth was recorded in revenues and in operating profit margins in most sectors due to growing demand in the domestic market;
- Construction and real estate sector – the domestic market recorded a steep rise in revenues from residential construction due to a growth in the number of new residential units sold as part of private enterprise and due to sharp price increases in the housing market. Occupancy rates and rental prices of income generating commercial properties remained stable. Occupancy rates for office premises in preferred areas in the center of the country increased slightly, excluding in Tel Aviv, where slight reductions were recorded in occupancy rates and rental prices. The slowdown in activity of entrepreneurial and income generating property companies operating abroad continued, mostly as a result of shortage in resources of finance, though selectivity exists and in some of the markets that had recovered from the economic crisis, new investments have been recorded;
- Industrial sectors – the volume of industrial production grew as a result of increases in domestic and foreign demand, on the background of the growth in volume of global trading and acceleration in the domestic activity;
- The communications sector – recorded a moderate growth in activity with an improvement in operating profit margin on the background of mergers, acquisitions and increased competition;
- Other business services sector – moderate improvement was recorded in the financial condition of private and small and medium business borrowers who provide services in various fields, compared to large suppliers of services in other economic sectors.

Following are the rates of the specific provisions for doubtful debts recorded for certain sectors, in relation to the outstanding balance of problematic debts (both balance sheet and off-balance sheet) in such sectors:

Sector	Proportion of provision	
	2010	2009
Construction and real-estate	5.5%	7.8%
Hotels, hotel services and food	*(2.7)%	3.6%
Commerce	11.7%	19.9%
Industry	8.6%	11.6%
Communications and computer services	0.3%	10.3%
Financial services	2.7%	25.0%
Other business services	31.7%	19.2%

\* Decrease in provision.

The data presented above shows that, with the exception of the other business services sector, all other principal economic sectors recorded a decline in the rates of the provision for doubtful debts in relation to the balance of problematic debts. The significant increase in the other business services sector stemmed from the relatively moderate improvement in the operations of small and medium suppliers of services, which has not yet been reflected in the operations of a large part of the customers.

Following are the rates of the specific provision for doubtful debts in certain sectors in relation to the consolidated balance sheet credit granted to the public in these sectors:

Sector	2010	2009
Construction and real-estate	0.9%	1.3%
Hotels, hotel services and food	*(0.6)%	1.3%
Commerce	0.5%	0.9%
Industry	0.6%	0.9%
Communications and computer services	0.0%	1.7%
Financial services	0.1%	0.8%
Other business services	1.4%	1.1%

\* Decrease in provision.

The data presented above shows that, with the exception of the other business services sector, in all other main economic sectors the rates of the specific provisions for doubtful debts have declined in relation to the credit granted to the public at the Bank. The decline in the real estate sector stemmed, mostly, from the decline in provisions in respect of borrowers activity in Israel, from NIS 162 million in 2009 to NIS 91 million in 2010, while the provision in respect of the overseas activity of borrowers amounted to NIS 117 million compared with NIS 123 last year. The decrease in the provision for doubtful debts in the hotel and tourist services sector stemmed from an improvement in borrowers financial condition as a result of growth in the number of bed/nights and the number of tourist in 2010, compared with 2009. The decrease in the provision for doubtful debts in the communications sector reflects mostly the consequence of the exceptional provision recorded last year, stemming from the Bank's exposure to one specific borrower.

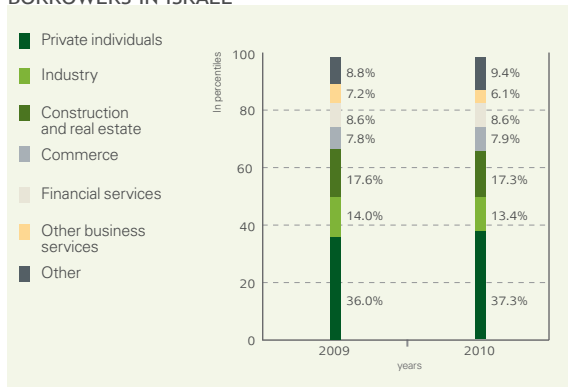
Following are the proportionate share of certain economic sectors in the total specific provision compared to 2009:

Sector	Proportion of provision	
	2010	2009
Construction and real-estate	28.1%	27.6%
Hotels, hotel services and food	*	3.7%
Commerce	9.0%	9.6%
Industry	13.6%	13.4%
Communications and computer services	0.1%	4.8%
Financial services	2.0%	9.5%
Other business services	16.9%	10.0%

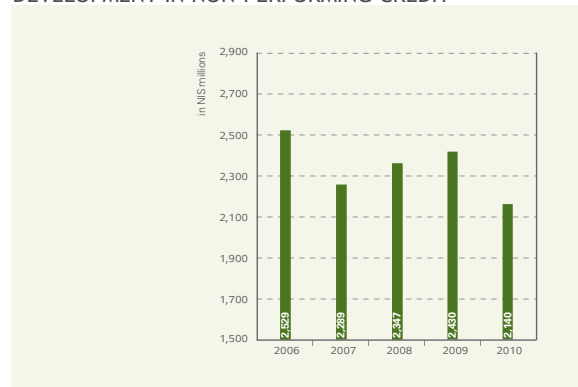
\* The reduction of the provision in the hotel sector was expressed in the reduction of the total provision, which in relation thereto, the weight of the provisions in the remaining sectors is being measured.

The data presented above indicates an increase in the weight of the construction and real estate sector, industry sector and the other business services sector in the total provision, compared to 2009.

CLASSIFIED BY ECONOMIC SECTORS CONSOLIDATED - BORROWERS IN ISRAEL



DEVELOPMENT IN NON-PERFORMING CREDIT



**Development of credit granted to the public by economic sectors.** Balance sheet credit risk for the construction and real estate sector amounted to NIS 22.4 billion as at December 31, 2010, compared with NIS 22.8 billion on December 31, 2009, a decrease of 1.9%, which constituted about 18.3% of the total balance sheet credit risk to the public, compared with 19.4% on December 31, 2009. Off-balance sheet credit risk for the construction and real estate sector (mostly sales guarantees and non-utilized credit lines) amounted to NIS 12.6 billion as at December 31, 2010, compared with NIS 11.3 billion on December 31, 2009, and it constituted 21.1% of the off-balance sheet credit risk, compared with 18.3% as at December 31, 2009.

Total credit risk for the construction and real estate sector constituted 19.2% of the total credit risk to the public as at December 31, 2010, compared with 19.0% on December 31, 2009.

**Total credit risk for the industrial sectors** amounted to NIS 27.6 billion as at December 31, 2010, compared with NIS 27.3 billion at December 31, 2009, an increase of 1.3%, and it constituted 15.1% of the total credit risk to the public under the Group's responsibility, compared with 15.2% as at December 31, 2009. Credit to industry is extended to a large number of customers in various industrial sectors.

Included within the framework of credit to industry is credit to the diamond industry with a small spread. The Bank's total credit risk to the diamond industry as at December 31, 2010 amounted to NIS 2.5 billion, compared to NIS 2.9 billion on December 31, 2009, a decrease of 13.8%.

Total credit risk for the commercial sector amounted to NIS 17.8 billion as at December 31, 2010, compared with NIS 17.4 billion as at December 31, 2009, an increase of 2.2%, and it constituted 9.8% of the total credit risk to the public, compared with 9.7% as of December 31, 2009.

Total credit risk to individuals was NIS 54.4 billion as at December 31, 2010, compared with NIS 51.6 billion as at December 31, 2009, an increase of 5.6%, and it constituted 29.9% of the total credit risk to the public, as compared with 28.8% as at December 31, 2009.

The following is a review of developments in the balance of credit granted to the public, by segments of operations:

	December 31				
	2010		2009		Rate of change in %
	In NIS millions	% of total credit to public	In NIS millions	% of total credit to public	
Retail - household segment	36,268	30.5	*33,323	29.1	8.8
Retail - small bussiness segmemt	14,820	12.5	13,653	11.9	8.5
Corporate marker segment	44,461	37.5	44,725	39.1	(0.6)
Middle market segment	19,455	16.4	19,815	17.3	(1.8)
Private banking segment	3,662	3.1	*2,910	2.6	25.8
<b>Total</b>	<b>118,666</b>	<b>100.0</b>	<b>114,426</b>	<b>100.0</b>	<b>3.7</b>

\* Reclassified.

**Developments in credit granted to the public, including off-balance sheet credit risk by borrower size.** Approximately 99.5% of borrowers were granted credit of less than NIS 1.2 million. Credit to this group constituted 32.0% of total credit granted to the public as at December 31, 2010, compared with 31.5% as at December 31, 2009.

The credit bracket between NIS 1.2 million and NIS 200 million constitutes about 50.6% of all credit as at December 31, 2010, compared with 51.8% as at December 31, 2009.

The 73 largest borrowers, in the credit brackets between NIS 200 million and NIS 2,000 million, were granted credit constituting 17.42% of total credit as at December 31, 2010, compared with 64 borrowers that were granted credit constituting 16.7% of the total credit as at December 31, 2009.

**Credit levels in excess of NIS 800 million - additional details.** The financial statements as of December 31, 2010, present details regarding composition of credit granted to the public and off-balance-sheet credit risk, by size of credit to individual borrower (Note 4 D), in accordance with public reporting instructions published by the Supervisor of Banks.

Following are general details regarding the largest borrowers included in the upper levels (over NIS 800 millions) of the said Note<sup>(1)</sup> As at December 31 2010 and December 31 2009 (Consolidated):

Field of activity:	As at December 31	
	2010	2009
	in NIS thousands	
Finance	1,830,645	1,217,540
Sea freight	1,192,041	965,185
Infrastructure	1,021,000	914,000
Real estate	982,447	929,384
Security	968,163	1,135,741
Real estate	951,963	945,620
Energy	897,744	1,082,979
Finance	(2)	984,081
Food stuff	(2)	910,496
Finance	(2)	968,970

Footnotes:

(1) The above data represent "indebtedness" data (also including unutilized credit facilities).

(2) The indebtedness of these borrowers was not included in the upper levels as of December 31, 2010.

## CREDIT GRANTED TO GOVERNMENTS

Credit granted to the Governments amounted to NIS 1,556 million as at December 31, 2010, compared with 1,820 million as at end of 2009, a decrease at a rate of 14.5%.

The balance as at December 31, 2010 includes NIS 1,551 million deposited with the Accountant General's deposit as part of the Bank's success in the teachers tender and the state employees tender (compared to NIS 1,517 million as at December 31, 2009; see "Retail banking segment - Household segment" under "Activities of the Group according to principal segments of operations" hereunder).

## SECURITIES

**General.** Securities amounted to NIS 37,176 million as at December 31, 2010, compared with NIS 36,338 million at the end of 2009, an increase of 2.3%. It is clarified that the "nostro" portfolio to the Discount Group as of December 31, 2010, did not include any security the investment in which comprised 5% or over of the value of the total portfolio.

**Nostro portfolio management policy.** The Bank's "nostro" investment portfolios and of its subsidiaries are used primarily as a central tool in the management of linkage base and interest rate risks, as well as in the management of excess liquid funds. The portfolios are managed with a general overview, aiming at maximizing interest income, under risk limitations determined by the Board of Directors and the Boards of Directors of the subsidiaries. The asset and liability management committee is the factor which actually determines the composition of the portfolio in each of the companies.

As seen from the data detailed hereunder, some 65% of the portfolio is invested in Government bonds, and 23% of the portfolio is invested in bonds of U.S. Government Supported Enterprises (GSE).

Within the framework of the steps taken by the Bank In 2009 for the improvement in its capital adequacy and for the preparations towards the implementation of the Basel II guidelines, the Bank realized a large part of the corporate bonds portfolio held by it in Israel. Likewise, IDB New York has exchanged part of its asset backed securities (ABS) of the Fannie Mae and Freddie Mac agencies for collateralized mortgage obligations (CMO) of the Ginnie Mae agency, which are fully guaranteed by the government.

During 2010, the Bank increased the volume of bonds in the held to maturity portfolio, in order to reduce the sensitivity of the capital reserve to changes in the market value of the bonds.

## COMPOSITION OF THE SECURITIES PORTFOLIO BY LINKAGE SEGMENTS

Following is the composition of the securities portfolio by linkage segments:

	December 31		Rate of change in %
	2010	2009	
	In NIS millions		
Non-linked shekels	12,603	8,594	46.6
CPI-linked shekels	6,292	6,897	(8.8)
Foreign currency and foreign currency-linked shekels	17,588	20,134	(12.6)
Shares - non-monetary items	693	713	(2.8)
<b>Total</b>	<b>37,176</b>	<b>36,338</b>	<b>2.3</b>

Securities in foreign currency and in Israeli currency linked foreign currency decreased by 12.6% compared with December 31, 2009. In U.S. Dollar terms, the securities in Israeli currency and in foreign currency linked Israeli currency decreased by US\$378 million, a decrease of 7.1% as compared with December 31, 2009.

Total securities, including securities in foreign currency and in Israeli currency linked to foreign currency expressed in U.S. Dollar terms, increased by 5.4% as compared with December 31, 2009.

## COMPOSITION OF THE SECURITIES PORTFOLIO ACCORDING TO PORTFOLIO CLASSIFICATION

In accordance with directives of the Supervisor of Banks, securities have been classified into three categories: held-to-maturity bonds portfolio, available-for-sale securities portfolio, and trading securities portfolio.

Following is the composition of investments in securities according to the above categories

	December 31, 2010			December 31, 2009		
	Net adjusted cost	Fair value	Book value	Net adjusted cost	Fair value	Book value
In NIS millions						
<b>Bonds</b>						
Held to maturity	6,752	6,785	6,752	1,989	2,014	1,989
Available for sale	27,440	27,550	27,550	31,451	31,491	31,491
Trading	2,187	2,181	2,181	2,110	2,145	2,145
<b>Shares</b>						
Available for sale	665	681	681	700	703	703
Trading	12	12	12	16	10	10
<b>Total Securities</b>	<b>37,056</b>	<b>37,209</b>	<b>37,176</b>	<b>36,266</b>	<b>36,363</b>	<b>36,338</b>

The net difference (after tax effect) between the fair value of the available-for-sale portfolio and its written-down cost in the amount of NIS 128 million as of December 31, 2010, is included in equity under "adjustments to fair value of available-for-sale securities" as a positive capital reserve (December 31, 2009: NIS 39 million as a positive capital reserve). In addition, included in equity is the difference, as stated, relating to the Bank's share in equity of the First International Bank amounting to NIS 1 million as a positive capital reserve (December 31, 2009: NIS 17 million as a positive capital reserve).

**Transfer of bonds from the available-for-sale portfolio to the held-to-maturity portfolio.** Due to the significant change in the treatment of available-for-sale bonds when computing the ratio of capital to risk assets (in Basel II terms), the Supervisor of Banks allowed banking corporations the one off transfer on March 31, 2010, of bonds from the available-for-sale portfolio to the held-to-maturity portfolio, subject to the terms determined by him. In accordance with that stated above, the Bank and IDB New York transferred on March 31, 2010, bonds from the available-for-sale portfolio to the held to maturity portfolio, the fair value and the stated value of which amounted on date of transfer to NIS 3.57 billion. For further details see Note 3 C to the financial statements.

**Corporate bonds.** Discount Group's available for sale securities portfolio as of December 31, 2010, includes investments in corporate bonds in the amount of NIS 3,369 million (an amount of NIS 1,638 million is held by IDB New York and an amount of NIS 723 million, directly by the Bank), compared with NIS 3,350 million as of December 31, 2009 (an amount of NIS 1,381 million is held at IDB New York and an amount of NIS 1,573 million is held directly by the Bank). For details as to the balance of unrealized losses included in the balance of the said bonds, see Note 3 to the financial statements.

**Available for sale bonds - data according to economic sectors.** Following are details regarding to the distribution of bonds in the available for sale portfolio according to economic sectors:

December 31, 2010				
	Net adjusted cost	Fair value	Cumulative other comprehensive income	
			profits	losses
In NIS millions				
<b>Non governmental bonds and bills</b>				
Industry	103	106	4	1
Construction and real estate	99	103	5	1
Electricity and water	111	124	13	-
Commerce	27	27	-	-
Transportation and storage	15	21	6	-
Financial services <sup>(1)</sup>	3,197	2,988	27	236
<b>Total non governmental bonds and bills</b>	<b>3,552</b>	<b>3,369</b>	<b>55</b>	<b>238</b>
<b>Government bonds and bills</b>				
US government*	3,187	3,208	35	14
Israel Government	13,677	13,822	169	24
Other Governments	401	400	2	3
<b>Total government bonds and bills</b>	<b>17,265</b>	<b>17,430</b>	<b>206</b>	<b>41</b>
<b>Government Sponsored Enterprises (GSE) Agencies</b>				
Freddie Mac	2,107	2,157	55	5
Fannie Mae	4,451	4,529	85	7
Other	65	65	-	-
<b>Total government Sponsored Enterprises (GSE) Agencies</b>	<b>6,623</b>	<b>6,751</b>	<b>140</b>	<b>12</b>
<b>Total available-for-sale bonds</b>	<b>27,440</b>	<b>27,550</b>	<b>401</b>	<b>291</b>
December 31, 2009				
<b>Total non governmental bonds and bills</b>	<b>3,698</b>	<b>3,350</b>	<b>33</b>	<b>381</b>
<b>Total government bonds and bills</b>	<b>18,768</b>	<b>18,937</b>	<b>213</b>	<b>44</b>
<b>Total government Sponsored Enterprises (GSE) Agencies</b>	<b>8,985</b>	<b>9,204</b>	<b>238</b>	<b>19</b>
<b>Total available-for-sale bonds</b>	<b>31,451</b>	<b>31,491</b>	<b>484</b>	<b>444</b>

\* Including Ginnie Mae bonds in a fair value of NIS 2,423 million.  
For further details see next page.

(1) Following are details regarding available for sale securities in financial services sector:

Rating	December 31, 2010			
	Net adjusted cost	Fair value	Cumulative other comprehensive income	
			profits	losses
	In NIS millions			
Banks and banking holding companies <sup>(2)</sup>	2,980	2,770	25	235
Insurance	35	36	1	-
Other	182	182	1	1
<b>Total financial services</b>	<b>3,197</b>	<b>2,988</b>	<b>27</b>	<b>236</b>

(2) Following are details according to geographical areas of investments in available for sale securities of banking and banking holding companies:

North America <sup>(3)</sup>	1,687	1,488	15	214
West europe <sup>(4)</sup>	500	481	-	19
Israel	721	728	9	2
Asia	25	25	-	-
Other	47	48	1	-
<b>Total bank and other banking holding companies</b>	<b>2,980</b>	<b>2,770</b>	<b>25</b>	<b>235</b>

(3) Following are details by rating of investments in available-for-sale bonds of banks and bank holding companies in the available-for-sale portfolio in North America:

AAA	86	87	1	-
AA-	66	65	-	1
A+ to A-	942	867	3	78
BBB+ to BBB-	520	420	3	103
BB- to B+	18	12	-	6
Not rated	55	37	8	26
<b>Total</b>	<b>1,687</b>	<b>1,488</b>	<b>15</b>	<b>214</b>

(4) Following are details by country of investments in available-for-sale bonds of banks and bank holding companies in the available-for-sale portfolio in Western Europe:

England	276	263	-	13
Other*	224	218	-	6
<b>Total</b>	<b>500</b>	<b>481</b>	<b>-</b>	<b>19</b>

\* Fair value amounts lower than NIS 100 million per country.

**Held-to-maturity bonds - data according to economic sectors.** Following are details regarding the distribution of bonds in the held-to-maturity securities portfolio according to economic sectors:

December 31, 2010				
	Amortized cost	Fair value	Unrecognized gains from adjustment to fair value	Unrecognized losses from adjustment to fair value
In NIS millions				
<b>Non governmental bonds and bills</b>				
Industry	16	16	-	-
Electricity and water	10	10	-	-
Commerce	10	10	-	-
Transportation and storage	4	4	-	-
Financial services	273	283	10	-
<b>Total non governmental bonds and bills</b>	<b>313</b>	<b>323</b>	<b>10</b>	<b>-</b>
<b>Total Government bonds and bills</b>				
	4,785	4,845	76	16
<b>Government Sponsored Enterprises (GSE) Agencies</b>				
Freddie Mac	546	538	3	11
Fannie Mae	380	376	5	9
Other government agencies	728	703	-	25
<b>Total government Sponsored Enterprises (GSE) Agencies</b>	<b>1,654</b>	<b>1,617</b>	<b>8</b>	<b>45</b>
<b>Total held-to-maturity bonds</b>	<b>6,752</b>	<b>6,785</b>	<b>94</b>	<b>61</b>
December 31, 2009				
<b>Total non governmental bonds and bills</b>	408	384	2	26
<b>Total government bonds and bills</b>	1,561	1,609	49	1
<b>Total government Sponsored Enterprises (GSE) Agencies</b>	20	21	1	-
<b>Total held-to-maturity bonds</b>	<b>1,989</b>	<b>2,014</b>	<b>52</b>	<b>27</b>

**Trading bonds - data according to economic sectors.** Following are details regarding the distribution of bonds in the available-for-sale securities portfolio according to economic sectors:

December 31, 2010				
	Amortized cost	Fair value	Unrealized gains from adjustment to fair value	Unrealized losses from adjustment to fair value
In NIS millions				
<b>Non governmental bonds and bills</b>				
Industry	19	20	1	-
Construction and real estate	7	7	-	-
Electricity and water	2	2	-	-
Commerce	1	1	-	-
Transportation and storage	3	2	-	1
Communication	3	3	-	-
Financial services	50	47	-	3
Other business services	20	18	-	2
<b>Total non governmental bonds and bills</b>	<b>105</b>	<b>100</b>	<b>1</b>	<b>6</b>
Total government bonds and bills	2,064	2,063	3	4
Total government Sponsored Enterprises (GSE) Agencies	18	18	-	-
<b>Total trading bonds</b>	<b>2,187</b>	<b>2,181</b>	<b>4</b>	<b>10</b>
December 31, 2009				
<b>Total non governmental bonds and bills</b>	<b>111</b>	<b>107</b>	<b>2</b>	<b>6</b>
<b>Total government bonds and bills</b>	<b>1,994</b>	<b>2,033</b>	<b>41</b>	<b>2</b>
<b>Total government Sponsored Enterprises (GSE) Agencies</b>	<b>5</b>	<b>5</b>	<b>-</b>	<b>-</b>
<b>Total trading bonds</b>	<b>2,110</b>	<b>2,145</b>	<b>43</b>	<b>8</b>

For further details regarding exposure to foreign financial institutions, see hereunder in the Chapter "Exposure to risks and risk management".

## INVESTMENTS IN ASSET BACKED SECURITIES

**General.** Discount Group's securities portfolio as of December 31, 2010 includes investment in asset backed securities in the amount of US\$3,071 million, which are held by IDB New York, compared to an amount of US\$3,641 million as at December 31, 2009, a decrease of 15.6%. In 2010, IDBNY acquired Ginnie Mae CMOs, which are a direct obligation of the U.S. Government, amounting in total to US\$532 million. About 98% of the mortgage backed securities portfolio is comprised of debentures of various federal agencies (Ginnie Mae, Fannie Mae, Freddie Mac) with an AAA rating in the U.S. The investment in the said bonds does not include exposure to the subprime market, except for exposure in a negligible amount, as detailed below.

As of December 31, 2010, the portfolio of mortgage backed securities (MBS) included unrealized net gains of US\$52 million.

**U.S. Government Sponsored Enterprises.** Fannie Mae and Freddie Mac are Government Sponsored Enterprises (GSE) chartered by the U.S. Congress with mission to provide liquidity and stability to the U.S. housing and mortgage markets. To accomplish their mission, the

GSE operate in the secondary mortgage market. Rather than granting home loans directly to the consumers, the GSE work with mortgage banks, brokers, and other primary mortgage market partnerships ensuring they have the funds to lend to home buyers at affordable rates. The GSE fund their mortgage investments primarily by issuing debt securities in the domestic and international markets.

The market for GSE Mortgage Backed Securities (MBS) has always operated under the assumption that these securities had the implicit guarantee of the U.S. Government, as such the actions taken by the Federal Government, placing the GSE into conservatorship were welcomed by the market.

This measure adds to market stability by providing additional security to GSE debt holders - senior and subordinated and adds to mortgages affordability by providing additional confidence to investors in GSE mortgage-backed securities. This commitment also eliminates any mandatory triggering of receivership.

All of IDB New York's GSE-MBS are performing up to their conditions. As at December 31, 2010 their market value increased by US\$46 million over their value in the books.

In addition to Fannie Mae and Freddie Mac, a third GSE is the Federal Home Loan banks whose mission is to provide liquidity and stability to its U.S. member banks.

**Direct investments in Federal Agencies' bonds.** The securities portfolio of the Discount Group as at December 31, 2010, includes a direct investment in Federal Home Loan Bank (FHLB), Fannie Mae and Freddie Mac bonds (hereinafter: "the Federal Agencies"), that are held by IDB New York, in an amount of US\$420 million, compared to US\$161 million on December 31, 2009.

#### Exposure to ALT-A loans and to sub-prime loans

IDB New York holds a portfolio of held to maturity bonds, bonds of the RMBS ALT-A type, with a total balance sheet exposure of NIS 148 million. This investment was made in the first half of 2008, and was backed by mortgage backed loans of private home owners.

The legal maturity periods of these bonds vary between 25 years and 37 years. The average maturity of bonds of this type is generally much lower, due to current repayments of the mortgages backing the loans.

Additional exposure exists to sub-prime RMBS in the available-for-sale portfolio in respect of a single investment amounting at December 31, 2010, to NIS 2 million, which is rated at a level below investment grade rating, and is due on June 25, 2037.

The valuation of the RMBS type instruments is particularly sensitive to assumptions regarding the rate of repayment of the mortgage loans and the expected level of default pertaining to these loans. The higher the rate of repayment of the loans the higher would be the value of the bonds, while the higher the volume of losses on these loans the lower would be the value of the bonds.

The rating of all mortgage backed securities of the ALT-A type has been decreased during the past year to below the investment rating. IDB New York recorded in 2010 a provision for impairment of an other than temporary nature in the amount of NIS 42 million in respect of these securities. All securities of the RMBS type were sold in the first quarter of 2011 (for further details see Note 3 D to the financial statements).

Following are details regarding RMBS Alt-A and RMBS Subprime Exposure:

	As at December 31, 2010				As at December 31, 2009		
	Maturity Date	Adjusted cost	Fair Value	Book Value	Adjusted cost	Fair Value	Book Value
In NIS millions							
RMBS Alt-A	2035	58	58	58	92	82	92
	2036	41	41	41	62	55	62
	2037	37	38	37	72	64	72
	2047	12	12	12	25	24	25
<b>Total RMBS Alt-A</b>		148	149	148	251	225	251
<b>Total RMBS Subprime</b>	2037	2	2	2	4	3	3

As reflected in the table, the amount of exposure was reduced during 2010 this as a result of current repayments and provisions for impairment.

**Exposure to commercial mortgage backed securities (CMBS).**

IDB New York holds a portfolio of commercial mortgage backed bonds (CMBS) with a total balance sheet exposure of NIS 68 million. These securities are classified under the financial services segment. The collateral pertaining to these securities is all located in the United States.

During the first quarter of 2010, IDB New York transferred all its marketable mortgage backed securities from the available-for-sale portfolio to the held-to-maturity portfolio (see Note 3 C to the financial statements).

As regards the remaining balance of such securities, managements of IDB New York and of the Bank are of the opinion that the impairment in value of these securities is not of an other than temporary nature.

Following are details regarding CMBS Exposure:

Maturity Date	As at December 31, 2010			As at December 31, 2009		
	Adjusted cost	Fair Value	Book Value	Adjusted cost	Fair Value	Book Value
In NIS millions						
2039-2040	17	18	17	19	18	18
2045-2047	12	14	12	14	13	13
2049-2051	39	44	39	48	41	41
<b>Total CMBS</b>	<b>68</b>	<b>76</b>	<b>68</b>	<b>81</b>	<b>72</b>	<b>72</b>

**DETAILS REGARDING IMPAIRMENT IN VALUE OF AVAILABLE FOR SALE SECURITIES**

**General.** The point in time for determining the length of the period in which the investment was in a continuous unrealized loss position, is the date of the financial statements for the reporting period during which a continuous impairment first occurred. The rate of the decline in the fair value below cost is computed as of the reporting date. This is so even if during the period in which the investment was in a continuous unrealized loss position, the rate of decline in fair value below cost was significantly different from the rate applying on the reporting date.

**Unrealized losses - shares available for sale.** At December 31, 2010, and at December 31, 2009, there were no unrealized accumulated losses in respect of available-for-sale shares.

**Unrealized losses - asset backed securities available for sale.** Following are details regarding the distribution of unrealized accumulated losses on asset backed securities available for sale, according to the ratio of unrealized loss to the cost of the investment and the period of time in which this loss accrued:

Ratio of unrealized loss to amortized cost	December 31, 2010					Total
	Period of decline in fair value below amortized cost					
	In NIS millions					
	Up to 6 months	From 6 to 9 months	From 9 to 12 months	Over 12 months		
Up to 20%	16	1	-	-		17
<b>Total</b>	<b>16</b>	<b>1</b>	<b>-</b>	<b>-</b>		<b>17</b>

December 31, 2009					
Period of decline in fair value below amortized cost					
In NIS millions					
Ratio of unrealized loss to amortized cost	Up to 6 months	From 6 to 9 months	From 9 to 12 months	Over 12 months	Total
Up to 20%	31	6	-	7	44
From 20% to 40%	-	-	-	5	5
<b>Total</b>	31	6	-	12	49

**Unrealized losses - bonds available for sale.** Following are details regarding the distribution of unrealized accumulated losses on the said bonds, according to the ratio of unrealized loss to the cost of the investment and the period of time in which this loss accrued:

December 31, 2010					
Period of decline in fair value below amortized cost					
In NIS millions					
Ratio of unrealized loss to amortized cost	Up to 6 months	From 6 to 9 months	From 9 to 12 months	Over 12 months	Total
Up to 20%	37	14	-	31	82
From 20% to 40%	-	-	-	166	166
Over 40%	-	-	-	26	26
<b>Total</b>	37	14	-	223	274
Of which: Government bonds	24	14	-	3	41

December 31, 2009					
Up to 20%	31	2	6	52	91
From 20% to 40%	-	-	-	253	253
Over 40%	-	-	-	51	51
<b>Total</b>	31	2	6	356	395
Of which: Government bonds	18	-	-	-	18

Presented below are details as of December 31, 2010 and December 31, 2009, of certain debentures with unrealized losses, which are considered temporary, held by IDB New York in their available for sale portfolio, with a ratio of unrealized loss to amortized cost in excess of 20%, and where the period in which the fair value has been lower than the amortized cost exceeds 12 months:

December 31, 2010							
Issuer's / Group's Name	Net adjusted Cost	Market Value	Unrealized Loss	Final Maturity	Securities Ratings		
					Moody's	S&P	Fitch
In NIS thousands							
<b>Securities with ratio of unrealized loss over 40%</b>							
Community trust bancorp	16,567	7,450	(9,117)	2037	NR	NR	NR
United bancshares inc	16,102	7,453	(8,649)	2037	NR	NR	NR
International bancshares corp.	16,439	7,808	(8,631)	2037	NR	NR	NR
Boden - Argentina	25	7	(18)	2012	B3	B	B
<b>Total securities with ratio of unrealized loss over 40%</b>							
	49,133	22,718	(26,415)				
<b>Securities with ratio of unrealized loss from 20% to 40%</b>							
Bank of America	183,828	134,316	(49,512)	2028	Baa3	BB+	BBB-
Wells Fargo	196,948	154,044	(42,904)	2027	Baa1	A-	A
J.P. Morgan Chase	178,383	139,894	(38,489)	2037	A2	BBB+	A
Suntrust Capital	73,131	53,672	(19,459)	2027	NR	BB	BBB-
Huntington bank	17,745	12,084	(5,661)	2027	Ba1	BB-	BBB-
Barclays Bank	17,745	12,084	(5,661)	2026	Aa3	NR	AA-
Firsf Maryland	17,195	13,476	(3,719)	2027	Baa2	BBB-	NR
Other	3,524	2,474	(1,050)	2037			
<b>Total securities with ratio of unrealized loss from 20% to 40%</b>							
	688,499	522,044	(166,455)				

Notes:  
NR - Non Rated.  
The data in the table was aggregated by issuer's group.

December 31, 2009							
Issuer's / Group's Name	Net adjusted Cost	Market Value	Unrealized Loss	Final Maturity	Securities Ratings		
					Moody's	S&P	Fitch
In NIS thousands							
Securities with ratio of unrealized loss over 40%							
Huntington bank	18,875	7,799	(11,076)	2027	Baa3	B	BB+
Community trust bancorp	17,610	6,606	(11,004)	2037	NR	NR	NR
International bancshares corp.	17,437	6,607	(10,830)	2037	NR	NR	NR
United bancshares inc	17,059	6,606	(10,453)	2037	NR	NR	NR
Barclays Bank	18,875	11,314	(7,561)	2026	Aa3	AA-	AA-
Boden - Argentina	42	15	(27)	2012	B3	B-	B-
<b>Total securities with ratio of unrealized loss over 40%</b>	<b>89,898</b>	<b>38,947</b>	<b>(50,951)</b>				
Securities with ratio of unrealized loss from 20% to 40%							
Wells Fargo	209,437	137,795	(71,642)	2027	Baa2	A-	A
J.P. Morgan Chase	243,271	173,981	(69,290)	2037	A2	BBB+	A+
Bank of America	195,210	139,785	(55,425)	2028	Baa3	BB	BB+
Suntrust Capital	77,754	48,677	(29,077)	2027	NR	BB+	BBB
PNC Bank	23,730	16,437	(7,293)	2028	Baa1	BBB	A
Firsf Maryland	18,252	11,406	(6,846)	2027	Baa1	BBB-	NR
Other	5,710	4,158	(1,552)	2049			
<b>Total securities with ratio of unrealized loss from 20% to 40%</b>	<b>773,364</b>	<b>532,239</b>	<b>(241,125)</b>				

Notes:

NR - Non Rated.

The data in the table was aggregated by issuer's group.

65% of the unrealized loss in the IDBNY securities portfolio at December 31, 2010 relate to Trust Preferred Securities (hereinafter: "TRUPS"), issued by financial institutions. Unrealized loss in the amount of NIS 75 million is in respect of securities rated below investment grade by one or more rating agencies.

TRUPS Characteristics:

- Background - Formal guidelines for the issuance of TRUPS were published by the Federal Reserve Board in 1996, which allowed Bank Holding Companies ("BHCs") to raise capital cost-efficiently through the issuance of TRUPS. While TRUPS are treated as debt securities for U.S. financial statement and income tax purposes, the FRB ruled that a BHC's TRUPS can be treated as part of the company's regulatory tier I capital (up to a limit of 25%) if it meets certain criteria as described under structure below.
- Issue structure - TRUPS are limited-life, cumulative preferred stocks, for the most part issued with contractual maturities up to 35 years. Although TRUPS may be issued by corporations and bank holding companies, when issued by a bank holding company and adhering to certain criteria, TRUPS may be treated as regulatory capital rather than debt. It is for this reason that the vast majority of TRUP issuances have been by banks. Dividend payments on the TRUPS are more like interest payments, since the issuer usually pays them quarterly or semi-annually and as previously noted are tax-deductible as interest for the issuers. For a BHC, the revenue source for the servicing of its TRUPS obligations are dividends upstreamed from its bank subsidiary (ies), as the primary asset of the typical BHC is the equity ownership in its bank subsidiary (ies).

In order to qualify as regulatory capital the debt must meet the following criteria:

- A five-year cumulative deferral of interest at the option of the issuer. If interest is deferred, all prior interest deferred is contractually due to the holder of the instrument after the deferral period ends.
- The debenture issued must also have a minimum stated maturity of 30 years (not to exceed 50 years for tax-deductibility) and be subordinate to all other forms of debt issued by the BHC.
- The issuer may not announce of an early redemption until the end of the first five years.
- TRUPS may not have voting rights.
- Restrictions - the FRB has restricted the maximum amount of cumulative preferred stock (TRUPS or regular perpetual preferred stocks) that will be eligible for inclusion as tier I (core) capital up to 25% of total capital. Any excess over 25% is treated as tier II (supplementary) capital.
- Deferral Provision - Dividend payments on a security may be deferred by the issuer for up to five years accumulated. If an issuer elects to defer interest payments on TRUPS it must also cease dividend/interest payments on preferred and common stock-Parent Guarantee - TRUPS have a parent holding company guarantee that only provides for payment of dividends or distributions, if the SPTV has sufficient funds to pay investors. If the BHC has defaulted on its junior subordinated note payment to the SPTV and as a consequence the latter does not have funds on hand to pay investors, then the BHC is not obligated to pay any amount owed on the TRUPS.

The Company reviews its Available-for-sale and Held-to-maturity investment securities quarterly to determine whether an impairment that is considered to be other-than-temporary (OTTI) has occurred. If a decline in fair value is judged by the Company to be other-than-temporary, and if there are significant credit concerns regarding a particular security and it is expected that the Company will not recover its amortized cost, the security is written down from its original cost basis to reflect the adjusted fair value and a new cost basis is established. Management's assessment also addresses the impact of the length of time an investment has been in an unrealized loss position. In general, the longer the length of time that a security has been in an unrealized loss position and the greater the magnitude of the unrealized loss, the more likely it is that the security is OTTI. Factors that management considers in its reviews for OTTI are the financial condition and near-term prospects of the issuer, recent events specific to the issuer or the issuer's industry, adverse or positive changes in fair value and ratings announced by one or more rating agencies, trends and volatility in earnings, whether the issuer of the debt security has remained current on principal and interest payments, whether the decline in fair value appears to be issuer specific or, alternatively, a reflection of general market conditions, and current analyst evaluations and other key measures, and if relevant, cash flow models based on the specific structure of the security to determine if there are adverse changes in cash flows.

The Company has the ability and intent to hold securities with unrealized losses until a market price recovery (which for debt securities may not be until maturity) and currently intends to hold all temporarily impaired securities to full recovery. Future reviews for OTTI will consider the particular facts and circumstances during the respective reporting period. There remain significant market and economic uncertainties that could result in further declines in the fair value of securities in our portfolio in the future. There continues to be considerable challenges facing the U.S. and global economies and a prolonged economic downturn could have implications and impact any recovery in security valuations. In spite of numerous market interventions and programs implemented by U.S. and global governments and regulators there continues to be a lack of liquidity and capital market flows to facilitate an improvement in many securities markets. Therefore, there is still a risk that there may be additional other than temporary impairment write-downs in the future.

All the securities presented in the table are current in principal and interest and management has stated that it has the intent and ability to hold the security to maturity or recovery

Review of fluctuations in prices of the aforementioned securities subsequent to the balance sheet date (through February 28, 2011) did not reveal any significant change compared to market prices as of December 31, 2010.

Below are further details in reference to certain groups for which an unrealized loss of NIS 10 million or more exists:

**Bank of America Corporation (BOA).** BOA reported a net loss of US\$1.24 billion for the fourth quarter of 2010, compared to a net loss of US\$7.3 billion in the previous quarter, and a net loss of US\$194 million in the corresponding quarter last year. The loss for the quarter was effected from an impairment charge in goodwill of US\$2 billion. Excluding this charge, the net income for the fourth quarter of 2010 was US\$756 million. The provision for credit losses decreased to US\$5.1 billion, compared with US\$5.2 billion in the previous quarter. Per share loss in the fourth quarter amounted to US\$0.16, compared with a per share loss of US\$0.72 in the previous quarter. Total assets amounted to US\$2.26 trillion, a decline compared to US\$2.34 trillion at the end of the previous quarter and US\$2.22 trillion at the end of the corresponding quarter last year.

The ratio of non-performing loans to the total gross loans was 7.18% at the end of the fourth quarter of 2010, a decrease compared to 7.34% in the previous quarter.

BOA is a well capitalized institution with a total capital ratio of 15.77% as of December 31, 2010, compared to 15.65% at the end of the previous quarter.

**JP Morgan Chase (JPM).** JPM reported net income of US\$4.8 billion for the fourth quarter of 2010, compared to US\$4.4 billion in the previous quarter and compared to US\$3.3 billion for the corresponding quarter last year. The provision for credit losses decreased to US\$3.2 billion, compared with US\$3.24 billion in the previous quarter. Per share earnings amounted to US\$1.12, compared with US\$1.01 in the previous quarter. Total assets amounted to US\$2.11 trillion, a decline compared to US\$2.14 trillion at the end of the previous quarter. The ratio of non-performing loans to the total gross loans was 6.4% at the end of the fourth quarter of 2010, a decrease compared to 6.6% at the end of the previous quarter.

JPM is a well capitalized institution with a total capital ratio of 15.51% as of December 31, 2010, compared to 15.45% at the end of the previous quarter.

**Wells Fargo & Co. (WFC).** WFC reported net income of US\$3.4 billion for the fourth quarter of 2010, compared to US\$3.3 billion in the previous quarter, and to US\$2.8 billion for the corresponding quarter last year. The provision for credit losses decreased to US\$3 billion, compared with US\$3.5 billion in the previous quarter. Per share earnings for the fourth quarter of 2010 amounted to US\$0.61, compared with US\$0.63 in the previous quarter. Total assets amounted to US\$1.25 trillion, an increase compared to US\$1.22 trillion at the end of the previous quarter. The ratio of non-performing loans to the total gross loans was 6.9% at the end of the fourth quarter of 2010, a decrease compared to 7.5% at the end of the previous quarter.

WFC is a well capitalized institution with a total capital ratio of 15.01% as of December 31, 2010, compared to 14.88% at the end of the previous quarter.

**Sun Trust Banks, Inc. (STI).** STI reported net income of US\$184 million for the fourth quarter of 2010, compared to US\$153 million in the previous quarter, and to a net loss of US\$248 million in the corresponding quarter last year. The provision for credit losses decreased to US\$509.4 million, compared with US\$619.8 million in the previous quarter. STI reported per share earnings for the fourth quarter of 2010 of US\$0.23, compared with US\$0.17 in the previous quarter. Total assets amounted to US\$172.9 billion, a decrease compared to US\$174.7 billion at the end of the previous quarter.

The ratio of non-performing loans to the total gross loans was 4.75% at the end of the fourth quarter of 2010, a decrease compared to 4.98% at the end of the previous quarter.

STI is a well capitalized institution with a total capital ratio of 16.54% as of December 31, 2010, compared to 16.42% at the end of the previous quarter.

**Impairment provisions.** In 2010, IDBNY recorded provisions in respect of impairment of an other-than-temporary nature amounting to US\$12.7 million, \$11.3 million in respect of held-to-maturity securities and \$1.4 million in respect of available for sale securities. The Bank has recorded a provision of NIS \_\_\_ million for impairment not of a temporary nature in the value of a fund of hedge funds.

**Review of impairment of securities.** According to directives and guidelines issued by the Supervisor of Banks and accepted accounting principles applying to banking corporations, available for sale securities are stated in the balance sheet at fair value, except for shares in respect of which fair value is not available, which are stated at cost less a provision for impairment that is

not of a temporary nature, which is reflected in the statement of income. Gains or losses not yet realized from adjustment to fair value, less the tax effect, are stated directly as a separate item of shareholders' equity and are taken to the statement of income in certain cases, including when realized. Unrealized losses reflected as a capital reserve are losses of a temporary nature only. Losses which are of other than temporary nature are stated directly in the statement of income.

For details regarding the considerations involved in the decision as to the type of losses accumulated in respect of securities as stated see below in the item "Critical accounting policy" and Note 1 I 7 to the financial statements. Based on a review of the impairment of the said securities, and where relevant, basing itself also on the review made by the relevant subsidiary, the Bank's Management believes that the impairment is of a temporary nature.

For further details see Note 3 to the financial statements.

## DEPOSITS FROM THE PUBLIC

Deposits from the public as at December 31, 2010, amounted to NIS 138,011 million, compared with NIS 141,825 million at the end of the preceding year, a decrease of 2.7%.

Following is data on the composition of deposits from the public by linkage segments:

	December 31, 2010		December 31, 2009		change in %
	In NIS millions	% of deposits from the public	In NIS millions	% of deposits from the public	
Non-linked shekels	71,592	51.9	68,048	48.0	5.2
CPI-linked shekels	11,609	8.4	12,982	9.1	(10.6)
Foreign currency and foreign currency-linked shekels	54,810	39.7	60,795	42.9	(9.8)
<b>Total</b>	<b>138,011</b>	<b>100.0</b>	<b>141,825</b>	<b>100.0</b>	<b>(2.7)</b>

Deposits from the public in foreign currency and in Israeli currency linked to foreign currency decreased at the rate of 9.8%, compared with December 31, 2009. In dollar terms the deposits from the public in foreign currency and in Israeli currency linked to foreign currency decreased by US\$650 million, a decrease of 4.0% compared with December 31, 2009.

Total deposits of the public, including deposits in foreign currency and in Israeli currency linked to foreign currency, expressed in U.S. Dollar terms, decreased by 0.2% as compared with December 31, 2009.

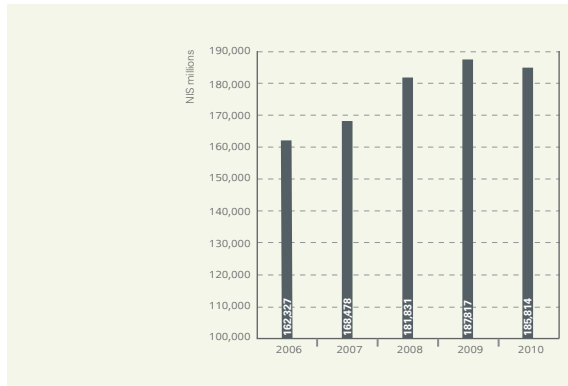
The following is a review of developments in the balance of deposits from the public, by segments of operations:

	December 31				
	2010		2009		Rate of change in %
	In NIS Millions	% of total credit to public	In NIS Millions	% of total credit to public	
Retail - household segment	57,534	41.7	*58,311	41.1	(1.3)
Retail - small business segment	13,988	10.1	*12,877	9.1	8.6
Corporate market segment	21,112	15.3	22,375	15.8	(5.6)
Middle market segment	7,982	5.8	9,261	6.5	(13.8)
Private banking segment	37,395	27.1	*39,001	27.5	(4.1)
<b>Total</b>	<b>138,011</b>	<b>100.0</b>	<b>141,825</b>	<b>100.0</b>	<b>(2.7)</b>

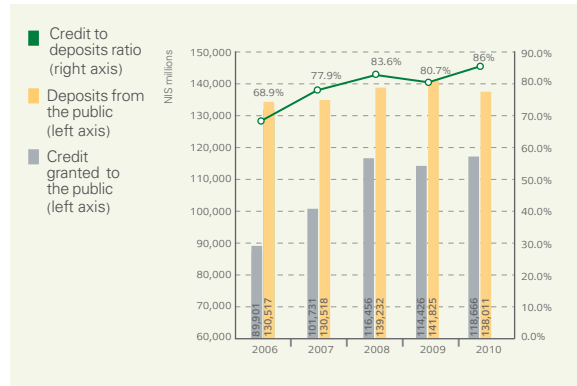
\* Reclassified.

The ratio of total credit granted to the public to deposits from the public was 86.0% at the end of 2010, compared with 80.7% at the end of the previous year.

DEVELOPMENT OF TOTAL ASSETS - CONSOLIDATED



DEVELOPMENT OF CREDIT GRANTED TO THE PUBLIC AND DEPOSITS FROM THE PUBLIC - CONSOLIDATED



## FIXED ASSETS AND INSTALLATIONS

### BUILDINGS AND EQUIPMENT

At the end of 2010, the investment in buildings and equipment amounted to NIS 3,138 million, compared with NIS 3,178 million at the end of 2009, a decrease of 1.3%.

Most of the premises on which the Bank's business is conducted in Israel are owned directly by the Bank or by its auxiliary corporations.

The total office space at the Bank's disposal at December 31, 2010, was 161 thousand square meters, compared with 172 thousand square meters at the end of 2009. Of this area, 104 thousand square meters were freehold property and 57 thousand square meters leasehold property (2009: 111 thousand square meters were freehold property and 61 thousand square meters leasehold property). At the end of 2010, some 78 thousand square meters served the Bank's branches and the balance served the head office, similar to 2009.

For details as to the Bank's investments in buildings and equipment, see Note 7 to the financial statements.

**Concentration of the offices of Mercantile Discount Bank's management.** Management of Mercantile Discount Bank and its central Head Office units operated until the beginning of 2011 in five different locations. In order to improve the efficiency of management's and head office work, Mercantile Discount Bank signed an agreement on September 22, 2009, for the purchase of a part of an office building in central Tel Aviv, in consideration for NIS 110 million. During 2010 the office space in the building had been modified to the needs of Mercantile Discount Bank, and upon completion of the work at the beginning of 2011, relocation of the various Head Office units to the new building began.

## INFORMATION AND COMPUTER SYSTEMS

### GENERAL

The information and control systems stand at the core of the Bank's operations and comprise the backbone on which the Bank's operations are based. The Bank's data processing system is a central computerized system composed of main frame computers located at the Bank's computer centers and work stations at the branches and at the head office units. The central system is

currently based on IBM computers.

Some 9,000 work stations (PC's) and 400 servers are installed at the branches and at head office units, providing service to both internal and external customers.

Direct banking services are provided by the Bank through a variety of channels: Internet, information stations, automatic teller machines, computerized vocal response and more. These services are interfaced with the central computer in order to receive and update data, by way of designated servers using advanced data security technology.

Over 400 information stations are available to customers providing also self service operations and a wide variety of services - "Discount Information Station".

Most of the various computer systems serve both the Bank and Mercantile Discount Bank.

Over the years the Bank has developed efficient, stable and effective computer solutions with respect to all business areas in which the Bank operates. The solutions developed are among the most advanced existing in banks in Israel. These systems are capable of serving the Bank for many years to come, subject to maintenance services being provided at an appropriate level.

For details as to the cost of in-house development of computer programs, see Note 7 F to the financial statements. For details regarding the engagement for providing computer services to Discount Mortgage Bank, see "Main future projects" below.

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## LOCATIONS OF THE OPERATION

The Bank's mainframe systems are located at two different locals, in various cities in the Greater Tel Aviv area. The fact that the two systems are located at a distance from one another adds to the survivability of the Bank's information systems. The Bank's two computer sites are connected by optical fibers in two different routes. These sites also house the disc systems of EMC and IBM, cassette robots, central printers and additional peripheral equipment required for the Bank's operation. Needless to say that this equipment is also backed-up at the two sites.

The branches and the head office units are connected to the computer center by two communication lines. Both lines are active at the same time and provide a band width of 3MB. In the event of failure, one line provides back-up for the active applications on the other line, and vice versa.

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## BACK-UP AND DISASTER RECOVERY

The Bank operates by the "hot backup" method. This means that the computers in both locations are updated concurrently as to the transactions conducted at the Bank's branches, so that in case of failure at the central computer, the secondary location begins operations without losing any entry.

The Bank is acting to upgrade the capabilities of the direct banking operations at times of disaster. The upgrade will enable direct banking to operate even when the Bank's telephone service center is out of service.

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## DATA PROTECTION

The Bank's information technology layout constitutes a central component of the Bank's current and proper operation and management, and as such dominates all areas of the Bank's operation. The importance of this layout increases in view of the technological developments in recent years and its consequences on the Bank. Therefore, the Bank views the protection of data as a primary interest and invests vast resources in order to protect the data on hand.

The principal risks involving data protection are: improper use of the information by system users and unauthorized changes in the data maintained therein; harming the system environment, the operation of the system and its impact upon the Bank's business; sensitivity of the information and violation of privacy and confidentiality of the data and its owners (Bank customers).

The protection of data at the Bank is conducted mostly in accordance with provisions of the Law including the Computer Law, the

Protection of Privacy Law, and the Supervisor of Bank's Proper Banking Management Directives. The principal procedure as regards the management of information systems at banking corporations is Proper Banking Management Directive No. 357, and the Bank's activity with respect to data protection is conducted in compliance with the guidelines of this Instruction.

As regards the Bank's links to the Internet, in view of the importance of the information and in order to minimize risks, the system providing information to customers via the Internet is managed separately from the central banking system providing information to Bank employees, who conducts banking business on an ongoing basis. Thus, the exposure to the risk of changing the real data at the Bank is minimized.

The Bank operates a data protection center the purpose of which is to identify risks and breaches in the data protection system. Furthermore, as part of the internal audit operates a unit which specializes in the field of information systems, which conduct a current audit of these matters.

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## MAIN FUTURE PROJECTS

1. The capital market move – a project, the objective of which is the cutting down of the reaction to market time, the adjustment to a competitive market and increasing the volume of operations. The project began in 2010.
2. E-Banking - a project for the upgrading the Bank's Internet site as well as modifying it for small and medium business customers as well as to additional projects, such as cellular. This project began in 2007.
3. Projects intended to conform to regulatory instructions regarding credit and risk management (Basel II) matters and in the matters of securities and the capital market.

The Bank's budget for 2011 in respect of projects for the development of information systems, including for information system development projects, amounts to NIS 309 million. This, compared with NIS 320 million in 2010.

The contents of the above section constitutes a forward-looking information based on past experience in everything related to system development and technological abilities, the investment required for the development of new systems and adaptation of existing systems in order for them to comply with regulatory demands and the Bank's business requirements. The above is also based on regulatory provisions existing at date of publication of the Annual Report (even though they have not as yet become effective) and provisions expected by the Bank to apply, based, inter alia, on drafts published by the various Regulators. The above is also based on the Bank's development programs existing at date of publication of the Annual Report, and on business intentions, the realization of which would require the development of supportive computer systems.

Legislative and regulatory changes unknown at the above date, including changes in the details of existing initiatives and drafts, technological developments and/or activities of competitors bringing about changes in customer demands and expectations, as well as macro developments in Israel and in the world, may bring about changes in the assessments or in the ability to carryout the Bank's plans at date of the Annual Report.

**Engagement for provision of computer services to Discount Mortgage Bank.** In December 2008, the Bank and BDL Computer and Administration Services, a subsidiary of the Bank (hereinafter together in this paragraph: "the Bank") entered into an agreement with Discount Mortgage Bank for the provision of computer services, which includes all the computer systems as well as the "Shamayim" project (Discount Mortgage Bank being in the midst of its development).

At the first stage, services will be provided relying on Discount Mortgage Bank's present systems. At the second stage, the service will be provided on the basis of the Bank's computer systems. Completion of the transition to the use in full of the Discount Bank systems had been initially planned for the beginning of March 2011, but was postponed to May, 2012. The agreement relates also to the use of the backup site.

The Bank has acquired in full from Discount Mortgage Bank the ownership rights in the "Shamayim" project, purchased and/or developed by Discount Mortgage Bank, in consideration for the accumulated as of the end of 2008.

The development of the system supporting the granting of loans had been completed and so was the integration of the system in all branches of Discount Mortgage Bank and in its relevant Head Office units.

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## MAJOR SUPPLIERS

The Bank has a large number of major suppliers in the field of information systems and their development. The Bank has no significant dependence on any supplier, with the exception of IBM. IBM is engaged with the Bank through IBM (Israel) Ltd.

## INTANGIBLE ASSETS

**Trade marks and brand names.** The Bank has exclusive intellectual property rights in the following trademarks that are duly registered with the Registrar of Trademarks, and in the label accompanying each of them: "Israel Discount Bank Ltd.", "Discount Bank", and "Discount". In addition, the Bank registers from time to time, for the purpose of its business and marketing operations, names of services and products such as: "Drive, you have the drive to live" and slogans such as "In Discount we take you personally", "Discount Banking from the heart", etc. In 2010, the Bank registered the "Key" and "Discount key" trademarks as well as the trademark of the key chart. In February 2011, the Bank registered the following trademarks: "Discount", "Discount taking you personally" and "Israel Discount Bank", which include the new logo.

Following the commencement of competition in the VISA credit card field, ICC started to develop a distinct symbol in order to differentiate it from the other VISA issuers, using the brand name "ICC" or "Cal".

Furthermore, ICC owns many registered trade marks in Israel, including "ICC", "Cal" "Active" and "WWW.Card". In addition, ICC is in the process of registering a number of additional trademarks.

ICC is also in the process of registering several additional trade marks. Furthermore, the Bank's subsidiary companies own trade marks, related brand names and slogans registered for the purpose of their business and marketing operations.

**Licenses and franchises.** The Bank and ICC have the status of a "principal member" in the International VISA Organization, which grants them the license to use the trade marks of VISA as well as the right to issue and clear credit cards under this brand name in Israel.

The International Diners Organization has granted Diners in Israel the exclusive franchise for the use of the "Diners" trade mark and for operating issuance and clearing services for Diners credit cards in Israel. Diners and Diners International signed agreements in March 2007 granting Diners the license to make use of trade marks and to issue credit cards, to open accounts and the exclusivity to provide services to customers in Israel until the year 2017. The said agreements are renewable for periods of five years each at the discretion of Diners International.

The bank and ICC have the status of a "principal member" in the MasterCard Worldwide organization, which has granted them licenses to use the "MasterCard", "EuroCard", "Cirrus" and "Maestro" trade marks in Israel.

**Software.** The Bank also has intellectual property rights in designated software systems and various modules used in its business, which the Bank develops and/or acquires in the course of its ongoing operations for its own use and/or the use of subsidiaries and affiliates.

**Data bases.** The Bank and its subsidiaries have data bases regarding their various fields of operations relating mostly to their customers and employees. Thus, among other things, ICC holds three data bases of registered customers holding VISA, Diners (through Diners) and MasterCard credit cards, as well as of traders accepting these cards.

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## TAXATION

### GENERAL

The Bank and most of its subsidiaries in Israel are considered a financial institution under the Value Added Tax Law, 1975, and as such are chargeable to payroll tax and to profit tax at the rate of 16.0% of the payroll expense and of the profit, respectively. Final tax assessments have been issued to the Bank for the years up to and including the tax year 2005 (For details regarding an

assessment under appeal for the 2006 tax year, see Note 29 C to the financial statements).

For details regarding reduction in company tax rates and changes in the rate of "payroll tax" and "profit tax", see Note 29 G and H to the financial statements.

#### **Taxation of the foreign banking subsidiaries**

In accordance with an agreement reached with the Israeli Tax Authorities, the earnings of the foreign banking subsidiaries are added to the Bank's chargeable income, so that the Bank complements the taxes paid abroad on the pre-tax accounting profits of the foreign subsidiaries to the amount of taxes that would have been paid in Israel based on the tax rate applicable to the Bank in Israel.

#### **Tax aspects of the Directive regarding impaired debts**

The Givoli Committee, appointed by the Commissioner of Income Tax to examine the tax aspects relating to doubtful debts of banks, submitted its conclusions in 1992. Though the recommendations of the Givoli Committee have not been reflected in legislation amendments, in practice, the banks with the acquiescence of the Commissioner of Income Tax acted in accordance with the principles laid out by the committee.

Implementation of the Directive regarding "measurement and disclosure of impaired debts, credit risk and provisions for credit losses" requires preparations for the treatment of the tax aspects relating to such implementation. Accordingly, in recent months, the banks, by means of the Union of Banks, are negotiating with the Tax Authorities as to the timing of recognition for tax purposes of the credit loss expense to be recorded in the books in accordance with the Directive.

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### **A QUALIFIED INTERMEDIARY (QI) STATUS**

The Bank has been granted the status of Qualified Intermediary (QI), as defined by the US Tax Authorities. The significance of this is that the Bank has entered into an agreement with the U.S. Tax Authorities, whereby it is entitled to withhold tax with regards to its customers' securities transactions.

For further details regarding the Bank's provision for taxes, final assessments and reconciliation of the Bank's applicable statutory tax rate to the effective tax rate, see Note 29 to the financial statements.

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## **CAPITAL RESOURCES**

### **TRANSITION TO MEASUREMENT OF CAPITAL RATIO ACCORDING TO BASEL II GUIDELINES**

From December 31, 2009, capital adequacy has been computed in accordance with the provisional instruction issued by the Supervisor of Banks regarding "framework for the measurement of capital adequacy" dated December 31, 2008. The provisional instruction was instituted in June 2010 as part of Proper Banking Management Directives (hereinafter: "Basel II guidelines"). Until December 31, 2009, capital adequacy has been computed in accordance with Proper Banking Management Directives Nos. 311 and 341 regarding "minimum capital ratio" and "allocation of capital in respect of exposure to market risk", respectively (hereinafter: "Basel I guidelines").

For details regarding clarifications by the Supervisor of Banks in the matter of the continued recognition of hybrid capital instruments issued prior to the coming into effect of the Basel II guidelines, see Note 14 6 a to the financial statements.

**Additional issues of hybrid capital instruments.** For details regarding the clarification of the Supervisor of Banks, according to which banking corporations must take into consideration the high probability that new issues of such instruments will not be recognized in the future for capital adequacy purposes, see note 14 6b to the financial statements.

In view of the above, the Bank has suspended plans for the issue of additional hybrid capital instruments included in the work plan for 2010.

**Policy regarding capital for the interim period.** The Basel Committee published in December 2009 draft recommendations in the matter of "Strengthening the resilience of the banking sector", and informed that it is its intention to publish a material part of the proposed changes as final recommendations as early as at the beginning of 2011, with effect as from December 31, 2012 (the recommendations were published in December 2010).

In his letter of June 30, 2010, the Supervisor of Banks informed that he is following developments in this respect and intends to examine the new recommendations in their final form with a view of modifying the existing directives applying in Israel, as the case may be.

In the interim period until the modification of the directives, the said letter requires banking corporations to take the following actions:

- To adopt until December 31, 2010, a target for the core capital ratio; this ratio is to relate to the core capital, less all deductions required by tier I, in accordance with Proper Banking Management Directive No. 202, "Measurement and capital adequacy - components of capital". The target has to be determined at a rate not lower than 7.5%;
- To submit to the Supervisor of Banks by the end of August 2010, a work plan designed to attain the said target;
- A banking corporation encountering difficulties, regarding the stated above, shall apply to the Supervisor of Banks in order to arrive at an agreed layout for reaching the target.
- To avoid the distribution of dividend, without prior approval from the Supervisor of Banks, if a bank has not attained the said target or if the distribution of the dividend will create such a situation.

In view of the above, the Bank's Board of Directors held a discussion regarding a proposed plan, which includes a target for the core capital ratio for the end of 2010, as well as a rising outline for the years 2011-2012. The plan submitted for approval of the Board of Directors was based on the examinations of several scenarios, the result of a number of which is that as of December 31, 2010, the Bank might not attain the required target. On August 31, 2010, the plan was submitted to the Supervisor of Banks and the Bank acted in order to form an outline agreed with the Supervisor of Banks for attaining the target.

The Supervisor of Banks informed on January 24, 2011, that the Bank may determine a core capital target of not less than 7.5% in effect until December 31, 2011 instead of December 31, 2010, on condition that certain terms determined by the Supervisor of Banks are fulfilled, including approval of a capital adequacy outline for maintaining a core capital target of not less than 7.5% until December 31, 2011, even if significantly different developments than those assumed at the base of the work plan occur. Furthermore, the Board of Directors shall receive a monthly report regarding compliance with the capital outline that had been determined, and that such report will also be submitted to the Supervisor of Banks. The Bank is required to form the said plan and submit it to the Supervisor of Banks.

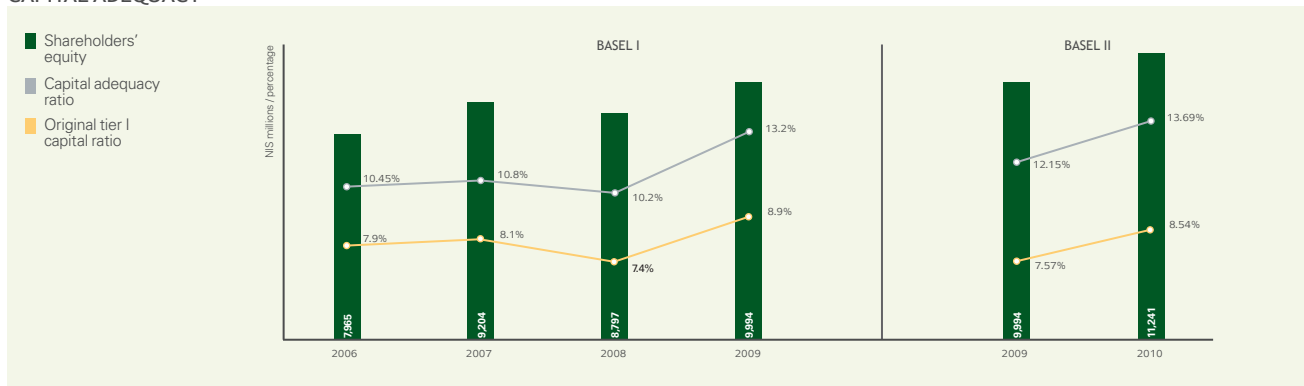
The meeting of the Board of Directors held on March 2, 2011, approved a detailed outline for attaining a core capital target at the rate of between 7.5% and 8%, and in any case, a target that shall not fall below 7.5%, as well as a total capital adequacy ratio of not less than 13%, and this until December 31, 2011.

The layout is based on strict management of the Bank's capital and includes a series of measures to assure the said capital targets even under conservative scenarios.

It should be noted that in view of the agreement signed between FIBI and the Bank and in view of the approvals granted in respect thereof (see Note 6 D to the financial statements), in which a layout has been determined for the sale of the Bank's holdings in FIBI, the Supervisor of Banks has permitted the Bank to exclude from the core capital the deduction in respect of the Bank's investment in FIBI.

**The core capital ratio** as of December 31, 2010, computed in accordance with the above stated, reached a ratio of 7.9%.

## CAPITAL ADEQUACY



## COMPONENTS OF CAPITAL

**The Bank's capital resources** as at December 31, 2010, including minority interest, amounted to NIS 11,569 million, compared with NIS 10,292 million at December 31, 2009, an increase of 12.4%.

**Shareholders' equity** as at December 31, 2010, amounted to NIS 11,241 million, compared with NIS 9,994 million at December 31, 2009, an increase of 12.5%.

The change in shareholders' equity in 2010 was affected, among other things, by earnings in that period, by an increase of NIS 79 million in the "net adjustments for the presentation of available for sale securities at fair value, net of tax" item, and from the share and rights issues of NIS 450 million completed in December 2010 (see below).

**The ratio of shareholders' equity, including minority interest, to total assets** as at December 31, 2010, stood at 5.5%, compared with 5.0% at the end of the preceding year.

**Ratio of tier I capital to risk assets** as of December 31, 2010, reached a rate of 8.54%, compared with 7.57% at the end of 2009.

**Ratio of original tier I capital to risk assets ("original tier I capital to risk assets ratio" in Basel I terms)**, reached a rate of 7.96% as of December 31, 2010, compared with 7.08% at the end of 2009.

It should be noted that the Bank's Board of Directors resolved with respect to the issuance of subordinated capital notes, to adopt a capital adequacy policy according to which the Bank will maintain, at all times, an original tier I adequacy ratio of at least 6.5%.

**The ratio of total capital to risk assets**, as at December 31, 2010, reached a rate of 13.69%, compared to a rate of 12.15% on December 31, 2009.

**Innovative complex capital instruments** constitute capital notes recognized as part of tier I capital (see Note 14 to the financial statements, item 7). The Bank's innovative complex capital instruments as of December 31, 2010 amounted to NIS 1,680 million, compared with NIS 1,636 million as of December 31, 2009. The innovative complex capital instruments are limited to 15% of the overall tier I capital. As of December 31, 2010, the innovative complex capital instruments amounted to 12.97% of the overall tier I capital (December 31, 2009: 14.05%). See above regarding the suspension of plans to raise funds by means of additional hybrid capital instruments.

**Lower tier II capital.** The Bank's lower tier II capital totalled NIS 6,475 million as at December 31, 2010, compared with NIS 5,826 million as of December 31, 2009. The extent of subordinated capital notes is limited to 50% of the tier I capital that was not allocated against market risks. At December 31, 2010, the said ratio was 50% (December 31, 2009: 50%). In view of the said restriction, capital notes in the amount of NIS 531 million were not included in the Bank's Lower tier II capital as of December 31, 2010.

**Upper tier II capital.** The Bank's upper tier II capital amounted to NIS 1,668 million as of December 31, 2010, including NIS 254 million of general provision for doubtful debts, compared with NIS 1,595 million as of December 31, 2009. The volume of the upper tier II capital is limited to 100% of the tier I capital. The balance of the upper tier II capital that the Bank is permitted to raise as of December 31, 2010, amounted to 4,807 NIS million. See above regarding the suspension of plans to raise funds by means of additional hybrid capital instruments.

**Issuances of lower tier II capital in 2010.** In 2010, the Bank and its subsidiary companies raised lower Tier II capital in the amount of NIS 600 million.

**Effect of the agreement with FIBI.** If the Bank were to sell 6% of its equity holdings in the First International Bank according to the value of the shares in the Bank's books, the deductions from the Bank's tier I capital and the tier II capital will be reduced by an amount of NIS 337 million. This will, among other things, increase the ratio of total capital to risk assets to 13.93% in terms of December 31, 2010. For further details see note 6 D to the Financial Statements.

**The effect of the initial implementation of the Directive regarding "measurement and disclosure of impaired debts, credit risk and provisions for credit losses".** As stated, upon the initial implementation of the Directive, the Bank is required to post to the retained earnings item of shareholders' equity as of January 1, 2011, the adjustments of the outstanding provision for credit losses in respect of credit granted to the public and the provision in respect of off-balance sheet credit instruments. According to the pro-forma computation (see Note 1A to the financial statements), the said charge, had it been applied on December 31, 2010, would have reduced the core capital of the Bank by an amount of NIS 817 million, and respectively increased the volume of debt notes not included in the lower Tier II capital of the Bank as of December 31, 2010 in the amount of NIS 410 million. The above would have reduced the total ratio of capital to risk assets to a rate of 12.90%, and the ratio of the core capital to a rate of 7.35%, all in terms of December 31, 2010.

**Issuance of Capital Notes in 2011.** An amount of NIS 925 million of capital notes issued in the past will be deducted in the course of 2011 from the tier II capital of the Group, used in calculating the ratio of capital to risk assets.

## RIGHTS ISSUE AND PUBLIC OFFERING

Within the framework of measures for the improvement of capital adequacy, the Bank has examined in cooperation with the controlling shareholders the possibility of raising tier I capital in a move for the offer of shares to the public together with a rights issue to shareholders. The process of public offering and rights issue was for a long period at the stage of obtaining approval by the various regulatory authorities in Israel and primarily abroad. The required permit from the Federal Reserve Bank of New York was given on October 15, 2010.

In December 2010, the Bank raised a gross amount of NIS 462 million, through the public issue of shares as well as a rights issue. Expenses of issue amounted to NIS 12.9 million (excluding commission paid to a subsidiary in the amount of NIS 2 million). For additional details, see Note 13 D to the financial statements.

The controlling shareholders of the Bank have exercised in full the rights offered to them within the framework of the rights issue.

## CAPITAL STRUCTURE

### Capital Adequacy Data

	December 31	
	2010	2009
	In NIS millions	
<b>1. Capital for Calculating ratio of capital</b>		
Tier 1 capital less deductions	12,101	*10,700
Tier 2 capital less deductions	7,293	*6,469
<b>Total capital</b>	<b>19,394</b>	<b>17,169</b>
<b>2. Weighted credit risk balance</b>		
Credit risk	125,514	*125,641
Market risk	2,907	2,752
Operational risk	13,233	12,969
<b>Total weighted credit risk assets balance</b>	<b>141,654</b>	<b>141,362</b>
<b>3. Ratio of capital to risk assets<sup>(1)</sup></b>		
Ratio of original tier 1 capital to risk assets	8.0	*7.1
Ratio of tier 1 capital to risk assets	8.5	*7.6
Ratio of total capital to risk assets	13.7	*12.1
<b>Ratio of total minimum capital required by the Supervisor of Banks</b>	<b>9.0</b>	<b>9.0</b>

\* Reclassified.

Footnote:

(1) For details regarding the capital ratio of significant banking subsidiaries see Note 14 to the financial statements.

Capital Structure

	December 31	
	2010	2009
	In NIS millions	
<b>a. Capital elements</b>		
<b>Tier 1 capital</b>		
Share capital	4,075	*3,600
Retained earnings	7,037	6,313
Other capital reserves	-	*25
Minority interests in the equity of consolidated subsidiaries	328	298
<b>Total core capital</b>	<b>11,440</b>	<b>10,236</b>
Innovative hybrid capital instruments	1,680	1,636
Amounts deducted from tier 1 capital:		
Goodwill	(149)	*(176)
Intangible assets	(20)	*(44)
Tier 1 capital less deductions from this tier's capital only	12,951	11,652
50% deductions from tier 1(B) capital	(850)	(952)
<b>Total tier 1 capital</b>	<b>12,101</b>	<b>10,700</b>
<b>Tier 2 capital</b>		
45% of net gains of adjustment for presentation of available for sale securities at fair value	90	42
General provision for doubtful debts	254	254
Preferred shares	2	2
Innovative hybrid capital instruments	1,322	*1,297
Subordinated capital notes	6,475	5,826
50% deductions from tier 2 capital	(850)	(952)
<b>Total tier 2 capital</b>	<b>7,293</b>	<b>6,469</b>
<b>Total qualified capital</b>	<b>19,394</b>	<b>17,169</b>
<b>b. 50% deductions from tier 1 capital and from tier 2 capital</b>		
Investments in non-realistic companies with significant influence <sup>(1)</sup>	1,548	1,650
Other deductions from tier 1 and 2 capital	152	254
<b>Total deductions</b>	<b>1,700</b>	<b>1,904</b>
* Reclassified.		
Footnote:		
(1) Of which: in respect of the First International Bank of Israel Ltd.	1,532	1,632

## Risk assets

	December 31, 2009			
	Risk assets	Capital requirements	Risk assets	Capital requirements
	9% <sup>(1)</sup>		9% <sup>(1)</sup>	
In NIS millions				
Risk assets and capital requirements in respect of credit risk caused by exposures of:				
Sovereigns	583	52	872	78
Public sector entities	991	89	*1,438	*129
Banks	3,925	353	*4,634	*417
Corporates	87,444	7,862	*86,845	*7,819
Secured by commercial real estate	660	59	-	-
Single retailer exposures	11,865	1,068	*12,397	*1,116
Small business loans	6,534	588	*6,204	*558
Secured by residential real estate	7,801	702	*7,371	*664
Securitization	37	3	37	3
Other assets	5,674	511	5,843	526
<b>Total risk assets and capital requirements in respect of credit risk</b>	<b>125,514</b>	<b>11,294</b>	<b>125,641</b>	<b>11,310</b>
<b>Risk assets and capital requirements in respect of market risk according to the standard approach</b>	<b>2,907</b>	<b>263</b>	<b>2,752</b>	<b>248</b>
<b>Risk assets and capital requirements in respect of operational risk according to the basic indicator approach</b>	<b>13,233</b>	<b>1,191</b>	<b>12,969</b>	<b>1,167</b>
<b>Total risk assets and capital requirements</b>	<b>141,654</b>	<b>12,748</b>	<b>141,362</b>	<b>12,725</b>

\* Reclassified.

Footnote:

(1) The minimum capital requirement in respect of the first pillar instructions with the addition of 1% in respect of the second pillar instructions.

## RATING THE BANK'S LIABILITIES

Details regarding the rating determined for the Bank and some of its subsidiaries by different rating agencies are presented hereunder.

Rating given by	Subject of rating	Rating	Rating horizon	Date of rating/ratification of rating	Additional details
<b>Discount Bank</b>					
<b>Standard &amp; Poor's, Ma'alot</b>	Issuer rating (including deposits)	il AA-	Negative	January 24, 2010	
	Subordinate capital notes	il A+	Stable	December 15, 2010	The rating horizon has been updated from "negative" to "stable". The rating also relates to subordinate capital notes issued by Manpikim.
	Upper tier II capital (Series 1)	il A-	Negative	July 5, 2010	
	Hybrid tier I capital (Series "A")	il BBB-	Negative	January 24, 2010	

Details regarding the rating determined for the Bank and some of its subsidiaries by different rating agencies are presented hereunder (continued).

Rating given by	Subject of rating	Rating	Rating horizon	Date of rating/ ratification of rating	Additional details
<b>Discount Bank (continued)</b>					
<b>Midroog</b>	Long-term deposits	Aa2	Stable	May 17, 2010	
	Short-term deposits	P-1	Stable	May 17, 2010	
	Junior Subordinate Debt	A2	Stable	May 17, 2010	
	Subordinate capital notes	Aa3	Stable	May 17, 2010	The rating also relates to subordinate capital notes issued by Manpikim.
<b>The international rating agency S&amp;P</b>	Issuer rating Short-term	A-3	Stable	December 15, 2010	
	Issuer rating Long-term	BBB-	Stable	December 15, 2010	
<b>The international rating agency Moody's</b>	Issuer rating	C-	Negative	April 28, 2010	On March 2, 2010, Moody's published a review of the Israeli banking industry, which noted, among other things, that in the event that economic growth will continue for several more months, and that as a result the quality of the credit portfolio will continue to improve, they would be willing to consider a change in the rating horizon to "stable".
	Long-term foreign currency deposits	A-2		April 28, 2010	
<b>Discount Mortgage Bank</b>					
<b>Midroog</b>	Long-term deposits	Aa2	Stable	November 4, 2009	
	Short-term deposits	P-1	Stable	November 4, 2009	
	Subordinate capital notes	Aa3	Stable	November 4, 2009	
<b>Mercantile Discount Bank</b>					
<b>Standard &amp; Poor's, Ma'alot</b>	Issuer rating (including deposits)	iAA-	Stable	December 15, 2010	The rating horizon has been updated from "negative" to "stable".
	Subordinate capital notes	iIA+	Stable	January 24, 2010	
<b>Discount Bank Latin America</b>					
<b>The international rating agency S&amp;P</b>	Issuer rating (including deposits)	BB	Stable	September 7, 2010	DBLA rating is identical to the Country's rating of Uruguay. The rating was raised from "BB-", following Uruguay rating's raise.

As part of the rating of the subordinate capital notes (Series A), which comprise hybrid tier I capital, Ma'alot and Midroog emphasized that this rating was based, inter-alia, on the decision of the Bank's Board of Directors regarding the subordinate capital notes, in accordance with which the Board adopted a capital adequacy policy according to which the Bank will maintain, at all times, an original tier I capital adequacy ratio (excluding hybrid tier I capital) of at least 6.5%. Midroog also noted that the determined ranking is based on the Bank's total capital adequacy ration.

## DIVIDENDS

The Bank has not distributed dividends to its shareholders since 1996, excluding the distribution of dividend in October 2008, and except on the Bank's cumulative preference shares, in an annual amount of £24 thousand (see Note 13 B and F (4) to the financial statements), which the Bank distributes regularly.

The main limitation affecting the Bank's ability to distribute a dividend in the recent years was the capital base limitation. For details regarding a limitation set by the Governor of the Bank of Israel, in the permit issued to the Bronfman-Schron Group for the acquisition and holding of means of control in the Bank, see "The Governor of the Bank of Israel's permit for the control and holding of means of control in the Bank" under "Control of the Bank" hereunder and Note 13 F (2) to the financial statements.

**Distribution of dividend.** The Bank's Management believes that it would not be possible to distribute a dividend in 2011.

## LIQUIDITY AND THE RAISING OF RESOURCES IN THE BANK

### GENERAL

The year 2010 was characterized by the continued expansionary monetary policy, through the rather moderate increase of the Bank of Israel interest rate (1%) alongside a significant moderation in the combined money supply in the market:

- Following an exceptional increase in the liquid money supply M1 (cash held by the public and Shekel bank current accounts deposits) in 2009, at the rate of approx. 52%, the growth rate was slowed down significantly in 2010 standing at 5%. The material change occurred in current account deposits – from an increase of 76% in 2009 to only 3% in 2010. Concurrently, the growth in the amount of cash held by the public has also slowed down from 20% to 8%.
- Moderation has also been recorded in the wider liquid money supply M2 (M1 with the addition of unlinked deposits of up to one year), from 14% in 2009 to 4% in 2010. In this respect, it should be noted that while time deposits from one to seven days recorded a decline of 5% (compared with an increase of 40% in 2009), time deposits from seven days to one year an upward trend is being recorded (from a decline of 4% to a growth of 6%). These contrasting directions match the increase in the Bank of Israel interest rate and the interest rate on bank deposits.
- The trend of moderation regarding the monetary components typified the whole year, and in fact had begun already in September 2009, together with the beginning of the monetary reduction, with a gradual increase in the interest rate (a record was registered in August 2009 in the annual growth rate of M1 and M2, 64% and 20%, respectively).

In contrast to the said moderation in the liquid money supply M1 and M2, the monetary base continued to expand in 2010, even over and above the growth recorded in 2009, some NIS 12 billion compared to NIS 5 billion, respectively. The increase in the monetary base stems from the inflow by the Bank of Israel while Government activity had only a minimized effect:

- A sharp decline occurred in 2010 in the purchases of foreign currency by the Bank of Israel (from NIS 77 billion in 2009 to NIS 44 billion in 2010) as well as a transition from inflow of cash by means of open market operations (NIS 5 billion) to absorption of cash by means of the issue of short-term loans (MAKAM) (NIS 49 billion). At the same time, Government activity led to an inflow of NIS 1 billion, compared with an absorption in the amount of NIS 14 billion in 2009.
- In view of the operations by the Bank of Israel in the foreign currency and the MAKAM markets and the fact that Government activity hardly affected liquidity in the market, the Bank of Israel was not required to absorb surplus liquidity by a massive expansion of Shekel deposits, as was the case in 2009 (by NIS 63 billion). Instead, the Bank of Israel provided liquidity by means of these deposits in an amount of NIS 13 billion.
- The last quarter of 2010, stands out in the purchase of foreign currency by the Bank of Israel in a very large volume of NIS 19 billion, some 43% of the annual amount. Absorption of the surplus liquidity was achieved by extending the Shekel deposits tenders by NIS 13 billion (in contrast to reducing the tenders during the first three quarters of the year), while the volume of absorption by open market operations dropped significantly compared to the previous three quarters.

## THE BANK

During the entire year, the Bank maintained liquid assets in a volume higher than its liquid liabilities. Following are the changes in the composition of the Bank's deposits in 2010:

**The non-linked segment.** The volume of non-linked deposits of the public with the Bank reached at the end of 2010 an amount of NIS 61.3 billion, compared with NIS 58.3 billion at the end of 2009, an increase of 5.1%.

**The CPI linked segment.** The total of CPI linked financial resources amounted to NIS 12.4 billion at the end of 2010, compared with NIS 13.6 billion at the end of 2009, a decrease of 8.4%.

**The foreign currency and foreign currency linked segment.** The volume of non-linked deposits of the public with the Bank reached US\$8.5 billion at the end of 2010, compared to US\$9.0 billion at the end of 2009, a decrease of 5.6%. After eliminating exchange differences, the change between the currencies amounted to a decline of US\$321 million, a drop of 3.6%.

**Raising of capital.** For details regarding raising capital in 2010, by means of various capital instruments, see "Capital resources" above.

## EXPOSURE TO RISKS AND RISK MANAGEMENT

### RISK MANAGEMENT POLICY AND OBJECTIVES

The Bank's activity as a financial broker involves risk taking, the principal of which are: credit risks, market risks and liquidity risks. Additional risks relate to these risks, such as operational and legal risks.

The risk management policy is intended to increase the profit expectancy as part of the means to attain the Bank's business targets. This, within the framework of the approved risk appetite, in accordance with the Bank's ability to bear such risk.

In order to address all risks, the Bank adopted a risk management policy that defines the kind of risk exposure to the Bank, the units responsible for the risk exposure or for hedging against exposure, and their authorization. In addition, tools and mechanisms were defined for the management, measurement, monitoring, control and reporting of risk exposure. The policy was modified in 2010, within the framework of the preparations for the implementation of the Basel II guidelines, with a view of upgrading the quality of risk management according to the best accepted practice. A model for risk management has been defined, as detailed below.

### THE STRUCTURE AND ORGANIZATION OF THE RISK MANAGEMENT FUNCTION FACTORS INVOLVED IN RISK MANAGEMENT

**Risk management model.** The Enterprise Risk Management Model, which has been adopted by the Bank and the Group, is intended to create a balance between the separate circles related to risk management and to define the relations and affinities between them. The factors involved in risk management include: the Board of Directors, the Board's Risk Management Committee, the Bank's Management as well as the three circles related to risk management: the creators of risk, the factors responsible for the independent management of risk and the internal audit. The risk management model is included within the framework of a basic document dealing with Group risk management, which was approved by the Board of Directors in May 2010. The document determines the vision, principles guiding risk management, the functions participating in the core processes of risk management, and the work interface with subsidiaries in the field of risk management. In addition, in May 2010, the Board of Directors approved the policy document on the matters of risk appetite and capital planning.

The guideline document for the formation of risk management policy documents (Meta policy) has been approved by Management and presented to the Board's risk management committee and the Board of Directors. These guidelines are designed to create a uniform infrastructure for the development and consistent implementation of policy documents and risk management processes. The chart on the next page describes the Corporate Governance framework tasked with risk management at the Bank.



**The Bank's Board of Directors.** The Board bears the ultimate responsibility for determining the risk management model and policy of the Bank and of the Group and for supervising their implementation, subject to the provisions of the law. This includes: capital adequacy of the Bank; determination of the Bank's capital targets; determination of the risk propensity as part of planning the use of capital and approval of the limitations on risk derived from the propensity; determination of a policy for risk management; the determination of strategy and of business policy assuring compliance with the limits of risk appetite; establishment of the organizational structure and core processes for risk management (as defined by the policy); supervision and control of exposure to risks and the manner of its management.

The Board of Directors is assisted by its Risk Management Committee, and by various factors within the Bank's Management (risk management, legal counseling, internal audit and more).

**The Risk Management Committee of the Board.** The Committee discusses and submits recommendations to the Board of Directors with respect to any issue related to the risk management field at the Bank, including procedures of the Board in this field.

The Committee supervises the implementation of the risk management policy both in the Bank and in the Group, including the examination of various issues which arise from time to time, such as: the implementation of new proper banking management directives published by the Bank of Israel, the determination of new limitations, management policy documents of the various risk and suchlike. Generally, the committee convenes once a month.

The risk management issues, which among other things include the policy, exposure and authorizations determined for their management and the nature of their monitoring and control, are tabled once every quarter for discussion by the Board of Directors within the framework of the exposure document. This document includes a report on the Bank's overall exposures to various types of risks in the past quarter. This document also relates to risks at the banking subsidiaries.

**The Bank's Management.** The Management is responsible for the realization of the risk management model and policy, the existence of control and supervision over the quality of risk management and the appropriateness of risk measurement and evaluation. Management acts through the Chief Risk Manager and the risk management layout and by a committee of risk managers of the Bank and of the Bank Group.

**Risk Managers Committee.** The Bank's Management acts through the committee of risk managers headed by the Bank's Chief Risk Manager. The committee's members are:

Mr. Yair Avidan, Executive Vice President	-	Chief Risk Manager and Chairman of the Committee;
Ms. Dorit Ben-Simon, Senior Executive Vice President	-	Market and Liquidity Risk;
Ms. Orit Alster, Executive Vice President	-	Credit Risk Manager (replacing Mr. Ehud Arnon, who retired from the Bank at the end of 2010);
Ms. Esther Deutsch, Senior Executive Vice President	-	Legal risk manager;
Mr. Shai Vardi, Senior Executive Vice President	-	IT Risk Manager;
Mr. Amir Rozin	-	Deputy Manager of the Risk Management Layout

Each risk manager is responsible for risk management in his own sphere of activity.

The committee is engaged in forming the Bank's risk management policy in the various areas, in identifying new risk areas and risk centers and in initiating changes required in the risk management policy. The committee also serves as the Bank's steering committee in the matter of the Bank's preparations for the implementation of the Basel II directives.

**The Supervisor of Banks' guideline regarding a chief risk manager and the risk management function.** In December 2009, the Supervisor of Banks issued a guideline on this subject, which is based on the principles of the second pillar of Basel II and specifies guidelines regarding the position, duties and responsibilities of the risk management function and the officer heading it. The guideline determines that the risk management function shall have a significant position in the organization and that it shall be headed by a chief risk manager, who is to be independent and shall not be involved in business decisions creating risks. The chief risk manager shall be a member of management and shall be directly responsible to the President & CEO.

Within the framework of the preparation for implementation of the guideline, the Bank's Board of Directors decided on March 28,

2010, to establish a risk management layout. On May 24, 2010, the Board appointed Mr. Yair Avidan as the Bank's Chief Risk Manager (CRO) and member of Management with the title of Executive Vice President. The Board of Directors approved on October 3, the structure of the risk management layout. The risk management department, the foreign extensions and subsidiaries department, market and liquidity risk controller, credit control unit and the compliance officer and the prohibition of money laundering and finance of terror unit have been transferred to the risk management layout.

On June 9, 2010, after obtaining the consent of the Supervisor of Banks, Mr. Avidan commenced his tenure as the Bank's chief risk manager. Ms. Ben-Simon, who until that date acted as chief risk manager, continues to act as the Bank's market and liquidity risks manager.

**The Risk Management Layout.** The layout, headed by the Chief Risk Manager, is responsible for managing the overall risks at the Bank and the Group within the framework of the second control circle (see below), including the implementation of the Basel guidelines, excluding legal risks and regulation risks, which are managed by the Legal Services Layout and financial reporting risks, which are handled by the Accounting Layout. In addition, the Layout is responsible for managing and coordinating projects in the area of risk management at the Discount Group as a whole.

**Creators of risk (the first control circle).** The Bank's units that take on risks for the Bank and are responsible for the current management of such risks. These units are responsible both for forming the "strategy and business policy" and its execution, and for the implementation of the "risk management policy" with respect to the risks taken as part of their operation. The first control circle includes the middle office and back office units, which act under the creators of risk (in divisions where such units exist) and assist them in the realization of the risk management policy.

**Independent management and control (second control circle)**

- Chief Risk Manager - has the overall responsibility for risk management at the Bank and Group levels;
- Risk management layout - the layout through which the Chief Risk Manager operates is responsible for assuring the understanding of risks facing the Group; the development of methodologies and of quantitative and qualitative tools for identifying and measuring exposure to risk; support of creators of risk in everything relating to managing the risks for which they are responsible; analysis and reporting exposure of the Bank and the Bank Group to the various risks, including supervision and control over overseas extensions and a subsidiary in Israel. Furthermore, the Layout is responsible for the evaluation of capital adequacy, for verifying the effectiveness of risk management processes, and for the formation of recommendations relating to risk management, including the risk management policy, definition and updating of the risk appetite, the capital adequacy target, etc.;
- Independent risk controllers – The credit controller and the market and liquidity risk controller form part of the risk management layout and assist the Chief Risk Manager in supervising risks, including the efficiency and effectiveness of their management;
- The compliance officer-monitors the Bank's preparations towards the fulfillment of the duties imposed on it under the legislation and regulation in the field of consumer instructions, including verification of the Bank's compliance with consumer instructions relevant to new operations of the Bank. The compliance officer also verifies the correction of deficiencies identified in this field.
- Officer in charge of money laundering prohibition – is responsible for complying with the duties imposed on the Bank with respect to prohibition of money laundering and prohibition of financing of terror activities.

**Audit factors (third control circle).** The internal audit layout, which is subject to the Board of Directors, serves the Board and Management as the third control circle in the audit of risk management, including efficiency and effectiveness of controls. It should be noted that whereas the audit of the risk controllers is the authority and responsibility of the internal audit, it belongs to a control circle that is separate from them.

## CREDIT RISK MANAGEMENT

### GENERAL

Credit risk is the risk of damage to the Bank's value and profitability following deterioration in the ability of borrowers to honor their obligations or due to a decline in the quality of borrowers and in the value of the collateral provided by them to the Bank.

The credit risk management concept at the Bank and at the Discount Group is designed to secure a proper balance between the business factors that directly create and manage exposure to credit risk, and the factors engaged in supervision, control and risk evaluation, including the formation of the policy and methodology for credit risk management, analysis, evaluation and reporting procedures regarding exposure to credit risk and independent risk control, and the factors engaged in the independent audit.

The Bank is working towards adapting the risk management policy to the required format according to Basel II guidelines, the object of which is to assure the understanding of the risk management concept, the existence of effective processes of credit risk management, including compliance with determined exposure limits.

In this context, a risk management unit has been established in the Corporate Banking Division.

A department is established within the framework of the unit, which will be integrated into the credit approval process and will prepare an independent review of credit applications, prior to their approval. In addition, the unit will include the economic department, which, among other things, is engaged in forming the Bank's credit strategy and policy, as well as the business and operations control department, that among other things, will engage in the development of a uniform methodology for business control at the Bank. The application of the credit risk management policy at the Bank is reflected in the credit strategy and policy documents.

The credit strategy document outlines the mode of the Bank's operation as regards the granting of credit, within the framework for the implementation of the Bank's strategic plan, by detailing target markets and business targets, improving the management of the credit portfolio and its quality and the pricing of credit with a view of reflecting and expressing credit risks.

The credit policy includes principles and guidelines supporting the management of credit risk, including the policy regarding collateral, credit authority, the credit underwriting process and exposure limits. Risk indicators have been determined within the framework of the credit policy, the existence of which requires validation and updating of the documents. Furthermore, a policy and specific limitations have been determined with respect to exposure defined as significant.

The Bank is acting towards the integration of group credit risk management, that shall bind all subsidiaries. Each subsidiary in the Group will be required to approve a credit risk management policy, which in all material respects, is compatible with the guidelines of Discount Bank. In this framework, the risk appetite of the Group and its concept of credit risk management will, among other things, be integrated. As a first step in the move for the implementation of a Group credit strategy and policy, the principal items in the strategy and policy documents of the Bank and of Mercantile Discount Bank have been coordinated this year. The credit strategy of IDB New York has been reviewed by the Bank's Management.

Credit risk management is conducted by means of procedures and work processes that define the underwriting principles at the Bank, the management and control of the existing credit portfolio, credit granting authority and the ranking of the credit committees, work methodology approval and control procedures, required collateral, the monitoring of credit portfolios and reporting by means of information systems. The role of all of these is to secure an appropriate management of the Bank's credit portfolio, reducing to the extent possible of the credit risk.

The procedures for the treatment of credit, collateral and the relevant information systems are being updated on a current basis, with a view of improving the credit management.

In addition, the Bank makes ongoing use of analysis and control tools, with the objective of locating, as early as possible, borrowers who might become problematic.

Hereunder is included reference, as the case may be, to the principal subsidiaries - IDB New York, Israel Credit Cards and Discount Mortgage Bank. In view of the fact that Mercantile Discount Bank is similar to the Bank in its general characteristics, from the general lines of operation and related regulatory aspects, no separate reference is generally included with respect to this bank.

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## STRATEGY AND POLICY OF THE BANK WITH RESPECT TO CREDIT RISK MANAGEMENT

The strategy and policy of the Bank and of its subsidiaries with respect to the granting of credit to the public are, among other things, intended to improve the quality of the credit portfolio, to diversify the portfolio, to limit its concentration and to spread out the risks inherent therein.

The documents are discussed once a year, while determining strategy and credit policy for the following year. The policy is approved by the Bank's Management and Board of Directors. Due to the crisis in 2008, it has been decided to examine the credit policy on a current basis, and where necessary, to submit to the Board of Directors a proposal for amendment of the policy.

In addition, a detailed credit strategy is determined with respect to various areas and activities that include: economic sectors, large borrowers and borrower groups. Special emphasis is put on economic activities having a material and unique credit risk, such as: the acquisition of means of control, the diamond industry, real estate and construction projects, the London branch, large capital market operators.

A policy has been determined also for environmental issues in view of the increased awareness of ecological and social damage caused as a by-product of the activities of corporations and due to increased legislation in the matter and in accordance with the guidelines of the Supervisor of Banks in this respect. A strategy has also been determined with respect to complex foreign trade transactions and to banks and financial institutions as well as borrowers in less developed countries (LDC).

The strategy document has been broadened to include the items detailed in the letter of the Supervisor of Banks dated December 10, 2009, regarding "Lessons learnt from the financial crisis regarding credit risk management". Among other things, a detailed credit strategy has been determined for holding companies, including guidelines for manner of financing.

At the beginning of 2011, the Bank modified the credit strategy and policy documents to the principles determined in the new Proper Banking Management Directive No. 301 in the matter of "the Board of Directors". Among other things, the modification related to the following issues: determination of business targets and target markets for the granting of credit, determination of new limits to the level of exposure to risks inherent in the credit portfolio, addition of principles regarding the granting of credit to employees and to related parties and reference to compliance with supervisory and regulatory requirements.

The regulatory limitations imposed on banking corporations within the framework of directives of the Supervisor of Banks as to industry concentration, single borrower, group of borrowers and the six largest borrower groups, impose an effective limitation on the group regarding the granting of credit to certain borrowers. The Discount Group complies with these limits. In addition, the credit policy of the Bank and of its subsidiaries include internal restrictions and lines of operation in addition to those promulgated by the Supervisor of Banks.

The distribution of risk among economic sectors is based on the evaluation of forecasted developments through current reviews of the situation in the economic sectors and surveys of various industries.

The Bank conducts ongoing monitoring of large borrowers/the six largest borrower groups and of compliance with the limitations set by the Supervisor of Banks and with the internal limitations determined by the Bank in their respect. Each large borrower group is discussed by the Bank at periodic intervals.

According to the Supervisor of Banks' instructions, the Bank prepares in each quarter an exposure document that describes, among other things, the overall credit risks in the different areas to which the Bank and the Group are exposed, compliance with regulatory limitations as well as the Bank's and the Group's internal restriction for monitoring and control purposes. The exposure document is presented to the Bank's Board of Directors.

The credit exposure document relates to the following exposures: linkage segments base exposure, exposure to segments of operation, exposure to economic sectors, and exposure to large borrowers/large borrower groups.

In addition, the quality of the credit portfolio is examined in accordance with the distribution of the indebtedness rating of borrowers, the volume of problematic debt and the expense for doubtful debt provision.

**Foreign extensions - IDB New York.** The credit portfolio of the subsidiary IDB New York, is monitored according to the following concentration categories: type of industry, geographical distribution, exposure to large borrower groups, risk rating and the real estate portfolio, with the aim of distributing the risks inherent in the credit portfolio. Management of IDB New York is responsible for determining limitations and/or targets within the framework of such concentration risks. Credit exposure and compliance with limitations are reported to the Board of Directors on a quarterly basis.

**ICC.** The credit policy of ICC, which is approved by the Board of Directors of ICC at least once a year, determines limitations to

the different lines of operation. Within the framework of the credit risk exposure report, the Board of Directors and the Bank's Management examine in each quarter, among other things, compliance with the limitations set by the board, deviations from such limitations and plans of action for correction of these deviations.

**The mortgage loans field.** The activity of the Group in granting mortgage loans is mainly conducted through the subsidiary Discount Mortgage Bank Ltd. (hereinafter: "DMB"). This activity is typified by a highly spread out credit portfolio, due to the focus of loans to households. DMB's policy in recent years dictated the focus on mortgage loan activity, both in financing the acquisition of residential units, including the construction of private houses, and in loans for other purposes secured by a residential unit owned by the borrower. This policy contributes to the distribution of the existing credit portfolio over a large number of borrowers, at a significant geographic distribution. In addition DMB also finances the acquisition of property for commercial, office or light industry purposes in demand areas, both for owner use and for investment in income producing property. DMB does not provide new financing for hotels, event halls, heavy industry real estate or large commercial centers. DMB also finances groups of borrowers organized as "acquisition groups", mostly for residential purposes.

DMB has determined limitations on exposure to the following segments of activity: (a) the ratio of credit to the commercial segment to the total credit portfolio; (b) the ratio of credit to foreign residents to the total mix of DMB's operations; (c) the combined volume of credit facilities allocated to acquisition groups. Furthermore, DMB has defined internal limitations on exposure to a single borrower and to groups of borrowers.

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## STRUCTURE AND ORGANIZATION OF THE CREDIT RISK MANAGEMENT FUNCTIONS

The organizational structure designed for the management of credit risk is composed, as above said, of three control circles.

### The first control circle

- Various processes for the reduction of credit risk are performed within the framework of the **business units** through the economic and business analysis of applications for credit in order to evaluate the credit risk involved in the operations of the borrower, credit rating and the ongoing monitoring and control over the credit granted as well as the quality of the borrower. Within the framework of such processes, the collateral provided is being assessed and revalued in accordance with the collateral policy and procedures derived there from. The current survey of credit files includes a review of implementation of decisions taken by the credit committees, including documents related to credit transactions (loan agreements, pledge documents, compliance with terms and conditions, availability of current reporting by the customer, etc.)

The control procedures are performed using irregularity reports and outstanding debt reports at various profiles. The aim of the control is to identify as early as possible defaults in customer accounts and to draw the attention of the business factors to the urgent need to correct any irregularities in their indebtedness;

- **The credit committees** discuss and take decisions on matters of credit, both as regards new applications for credit and as regards existing indebtedness. Discussions of the committees include a review of borrowers including compliance with the credit terms, changes in credit profitability, developments in the financial condition of the borrower, evaluation of the level of exposure to changes in exchange rates, rating of the borrower, etc;
- **Credit risk management unit** at the Corporate Banking Division, which includes the following units:
  - **"Second opinion" unit** – a new department to engage in providing an independent opinion as part of the credit underwriting process;
- **Business control units** monitor deviations from credit terms and signs of deterioration in the financial condition of customers. This is achieved through periodic irregularity reports and ongoing follow-up of customers in respect of whom "red flags" have been identified and the monitoring thereof by way of conducting a "follow-up list".
- **The Economic department** at the corporate banking division, among its duties are: preparing strategy and credit policy documents, and analysis of credit exposure at the Bank's level;

Participation in the development of models for credit rating and designing the methodology for the analysis of credit risk; Preparation of surveys for credit risk evaluation of the different economic sectors and of certain borrower groups; The analysis of credit risk applying to complex applications for credit.

- **Credit management and operation unit** is engaged in the preparation and updating of follow-up files for the credit committees. The unit is also responsible for relating groups of borrowers, in accordance with directives of the Bank of Israel in the matter, and for the current monitoring for the prevention of deviations from the limitations on a single borrower/group of borrowers; The unit is also responsible for the writing of a part of the credit and collateral procedures at the Bank. The Bank has two units engaged in the management of problematic debts with a view of arriving at collection arrangements and repayment of the debt: the **special credit department** that operates teams of business managers and deals with large credit files. The **collection department**, responsible for customers of the Banking Division, managing small credit files.

### The second control circle

- Duties of the credit risk management unit, which operates within the framework of the risk management department, include:
  - Formation and implementation of policy and methodology documents for the management of credit risks, all this in order to monitor and verify that the credit portfolio is managed in accordance with exposure limitations approved by the Board of Directors;
  - Development and application of internal models for internal credit rating of Bank customers, in order to quantify credit risk and support decisions;
  - Development of a statistical model for the computation of a group provision, according to the directive of the Supervisor of Banks concerning defective debts;
  - Follow-up of trend and developments in the field of risk management and their communication to all of the Bank's units.
  - Development of models for stress tests and the examination of their impact on the portfolio of the Bank and of the Group.
- **The credit control unit** evaluates, independently of factors approving the credit, the quality of the specific borrower and of the Bank's credit portfolio. The unit also renders an opinion on the quality of borrowers rating. The sample test includes the Bank's principal borrowers, according to that required under Proper Banking Management Directive No. 319. The unit reports to the Bank's Chief Risk Manager.

Mercantile Discount Bank has decided on the formation of credit control units, planned to begin in 2011.

### The third control circle

**The internal audit** performs sample test checks of credit files. It examines the procedures for approval of the credit granted, the management of credit, examines borrowers' files and tests whether work procedures are in line with the Bank's procedures. In addition, the internal audit performs across the board audits in respect of credit issues.

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## CREDIT UNDERWRITING AND MANAGEMENT PROCESSES

**The credit underwriting process at the Bank** is defined by procedures, credit authority and work processes. The underwriting process is structured and begins with the customer's application for credit, analysis of the application, stages of approval of the application in accordance with the credit authority, the actual granting of credit, following which the current control of the borrower's file.

The Bank has determined a scale of credit authority for managers and the various credit committees, reaching up to the Board of Directors. The credit authority at the Bank is determined by the Board of Directors and is defined by the procedures of the Board. According to procedures, credit applications by customers are directed to the different credit committees in accordance with the scope of credit facility of the borrower or of the group of borrowers to which he belongs, in accordance with the following scale:

- The Bank's Board of Directors;
- The credit committee of the Board;

- The central credit committee headed by the Bank's CEO;
- Division level credit committees (corporate and Banking Divisions) and at the level of the commercial department;
- Local credit committees (in accordance with the business unit to which the customer belongs).

In 2011 the Bank will prepare for the change in the process of approval of credit, so that the involvement of the Board of Directors with the approval of credit will be limited and will mainly focus on approval of transactions that are inconsistent with the Bank's credit policy, as required by the new Proper Banking Management Directive No. 301.

Specific credit committees exist for customers belonging to the diamond industry. These are rated according to the scope of the customer's credit facility, starting with the credit committee of the Diamond Exchange branch and reaching the Board of Directors. The considerations for the granting of credit to a business customer are mostly based on purpose of credit and repayment ability, financial soundness, business position and quality of collateral provided by the customer. An additional important parameter is the quality of the customer and past experience with him.

An economic and business analysis of the customer is performed as part of the approval of the credit designed to locate and evaluate credit risks inherent in his business. Furthermore, as part of the discussions held by the credit committee, it is being considered whether the approval of the credit reflects acceptance of a reasonable risk on the part of the Bank concurrently with profitability and an appropriate return.

The consumer credit at the Bank is characterized by small amounts and a high distribution. The methodology and procedures regarding the examination of credit applications submitted by private customers, is intended to focus more on acquaintance with the customer, on socio-economic parameters and on his financial soundness in addition to the examination of the collateral. Furthermore, a private customer credit scoring system is also used, in order to determine the rating and credit recommendations for existing customers. Decisions on the granting of consumer credit are taken under personal authority or by the relevant credit committee, in accordance with the scope of credit.

The Bank emphasizes the qualitative examination process of the credit application and the response to the customer. The Bank also offers a comprehensive financing package and endeavors to modify it to the customer's needs.

Within the framework of the **credit management process at the Bank**, current discussions are conducted at the credit committees at frequencies of about twice a year in respect of every customer having a credit facility in excess of NIS 400 thousand. Preparation and updating of follow-up files are made prior to each discussion. Developments and principal changes in the business condition of the borrower are reviewed within the framework of the discussion, including compliance of the borrower with the credit terms, changes in the credit profitability, the financial condition of the customer and his indebtedness rating.

The Bank acts according to procedures that define criteria for identifying credits having a problematic potential, in order to ensure the ongoing monitoring of the quality of the credit portfolio, and where required, the classification of problematic debts and/or creation of provisions at the appropriate time. The process of classifying debts as problematic and determination of provisions is made once a quarter by the Bank's Management, and in a manner that would reflect the risk level of the credit portfolio.

The monitoring process of the credit portfolio includes two stages:

- Identifying and locating borrowers having negative indications, by means of the "red light" system and follow-up lists.
- Identification of customers whose financial condition and/or their ability to honor their obligations towards the Bank have deteriorated, and classifying them, in consequence, as "problematic debts".
- The creation of provisions that reflect the expected loss to the Bank in respect of the "problematic debts". In determining the provisions, the Bank's Management relies on information at hand regarding the borrower, such as: his credit rating, financial soundness and/or owner guarantees, scope and quality of the collateral held, the risk level of the industry in which he operates, etc.

The Bank has prepared for the management of the credit portfolio and of the provisions for credit losses in accordance with the requirement of the new Directive in respect of impaired debts.

**Credit underwriting process at IDB New York.** The credit underwriting process at IDB New York begins with the submission of a credit application by the business unit. The credit risk management unit prepares an "opinion" with respect to each credit

application, which, among other things, relates to cases where the credit exposure exceeds the various limitations determined by the credit policy. The opinion may voice consent, consent under certain terms or a recommendation for rejection.

**Credit underwriting and management processes at ICC.** ICC operates according to procedures and work processes which define the underwriting principles, management and monitoring of the credit portfolio. Procedures for the handling of credit and collateral and the relevant information systems are updated on a regular basis with a view of improving credit management.

Evaluation of credit risk at ICC is based on the following statistical models:

- Credit scoring model - a statistical model used for determining customer scores, according to which the level of credit/type of card is determined.
- Behavior scoring model - a statistical model used for determining customer scores based on their behavior during the period of their relationship with the company.

Every new of evaluation and re-approval of credit facilities is made in accordance with criteria and authority scale defined in the policy document.

**Credit underwriting and management processes at DMB.** The documentation and criteria required for the examination of applications for credit are defined in the procedures of this bank and include, among other things, a "getting to know the customer" policy, evaluation of the repayment ability of the customer in accordance with his characteristics (private and corporate), purpose of the transaction and the type of collateral offered in respect thereof.

DMB does not operate the grading model prior to the approval of credit, and is acting towards the formation of principles for the development of such a system.

However, DMB operates credit quality control from the moment of granting the credit through a back office that includes an underwriting unit and an examination unit, which serve as control units over the operation of the branches prior to the granting of the credit.

The underwriting unit performs control over both the appropriateness of documents submitted by the customer and his economic condition, both as to the rights offered as collateral and the statements made by him in connection with the granting of the credit, as well as the possibility of registering the property as an adequate collateral for the loan. Following the validation of the file, the underwriting unit issues an approval, which includes reference to the collateral documents required for the granting of the credit.

DMB reviews periodically the large credit files in accordance with the authority scale approved by the Board of Directors of this bank. In addition, DMB grades its customers, excluding housing loans, in accordance with requirements and definitions of the Supervisor of Banks. The grading system includes behavioral scoring received once a month. DMB makes efforts for the continued improvement of the grading model.

The review of the credit portfolio is performed by the collection unit in order to examine the need for the classification of debts and the creation of provisions. Furthermore, the unit deals with loan arrears both by forming repayment arrangements and by taking legal action, as the case may be.

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## CREDIT RISK MEASUREMENT AND REPORTING SYSTEMS

The Bank uses several measurement and reporting systems supporting credit risk management, as follows:

- Computerized system for the management of credit facilities and for the management of borrower debt, which also enables following up on the volume of the credit file. The system covers all Bank customers whose indebtedness exceeds NIS 400 thousand. The system is in the integration stage also with respect to customers of the Banking Division having a smaller indebtedness. The system provides information regarding the status of credit and collateral of the borrower, credit facility, guarantees and financial covenants. The system supports the work of the various credit committees and summarizes customer data in a comprehensive report presented to the various credit committees. In addition, the system supports the process of analyzing financial statements and evaluation of floating pledges.

Furthermore, the system supports the customer credit risk management on the basis of a model for customer indebtedness

rating. This rating model is composed of a questionnaire and includes a scoring of a financial statistical model for credit rating, based on an analysis of the borrower's financial statements;

- A computerized system for credit scoring and providing credit recommendations for private customers;
- A computerized system for the management of material collateral. The system documents pledges on real estate assets, fixed assets, securities and floating pledges. The system manages the value of the material collateral securing the debt;
- A computerized system for guarantee management;
- An information system used for assessing the profitability of a single portfolio and of a business unit (under development is the enlargement of the system in respect of assessment of yield from an individual customer);
- The Bank has integrated a computerized system for the computation of risk assets on a Group level, in accordance with Basel II guidelines.

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## REDUCING THE RISK IN RESPECT OF CONCENTRATION OF CREDIT

Concentration risk is the risk emanating from the lack of diversification of the credit portfolio. This risk is made up of two main categories: (1) Risk emanating from a large volume of credit granted to a specific borrower and/or several borrowers who belong to the same group of borrowers; (2) Risk emanating from a large volume of credit granted to borrowers belonging to a certain economic sector or to a certain geographical area.

Spreading of the credit risk is reached, among other things, by the spreading of the credit portfolio over a large number of borrowers/groups of borrowers in various economic sectors and industries.

**Reducing the credit risk in respect of the concentration of borrowers/groups of borrowers.** The Bank performs an ongoing follow-up of the situation of large borrowers/the six large borrower groups and compliance with the Bank of Israel limitations and within internal limitations determined by the Bank. In addition, the Bank conducts surveys and holds periodic discussions with respect to each borrower group, with a view of evaluating the credit risk at Group level.

The Bank complies with the Bank of Israel limitations and with internal limitations in respect of a single borrower and in respect of the six large borrower groups.

**Reduction in credit risk in respect of concentration according to economic sectors.** The Bank performs industry surveys of various economic sectors as well as current surveys of the situation of the economic sectors in Israel in order to evaluate the credit risk at the industry level. Within the framework of the individual application for credit, an analysis of the economic sector of the borrower is performed and it is examined whether the application is in line with the credit policy according to economic sectors.

The Bank complies with the Bank of Israel limitations and with internal limitations in respect of economic sectors, including the specific limitations regarding the real-estate industry.

**Reduction in exposure to exchange rate risks.** The Bank is monitoring the minimization of exposure to possible changes in the exchange rate of the Shekel as against foreign currencies, among other things, by way of testing the sensitivity of borrowers that took out loans in foreign currency to changes in the exchange rate. Regarding borrowers defined as being highly exposed, the Bank is taking steps to reduce the exposure by way of increasing the collateral and demanding hedging transactions.

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## METHODOLOGY AND TRAINING IN CREDIT MANAGEMENT

- Methodology and procedures exist with respect to the manner of preparation of credit applications and for financial analysis of the condition of the borrower. A current analysis is performed on most recent financial statements of the Bank's business customers and a current follow-up of their business and financial condition is conducted. Furthermore, an economic and business analysis of credit applications is made, which focuses on the identification and evaluation of credit risk inherent in the customer's operations;
- Several methods developed by the Bank for the evaluation of the repayment ability of the borrower, of his needs for working

capital and for evaluating the reasonableness of the credit exist. These methods are modified to the type of customer and structure of the transaction;

- Credit officers at all levels undergo training and study sessions with a view of preserving and updating the existing knowledge and their professional standards;
- A process of drawing conclusions is conducted at the Bank by committees from the various divisions, discussing various issues including credit issues. The committees meet periodically in order to discuss failure events, to analyze failure data and to form means for the prevention of similar failure events in the future.

## DEFINITION OF PROBLEMATIC DEBTS

The identification and classification of debts as "problematic debts" is performed according to classifications determined by Proper Banking Management Directive No. 314 and according to criteria specified in this Directive: "doubtful debts", "non-performing debts", "rescheduled debts", "debts in temporary arrears" and "debts under special supervision". See Note 1 to the financial statements for details regarding expected changes in the above definitions, following the instruction regarding "Measurement and disclosure of impaired debts, credit risk and provisions for credit losses" taking effect.

For details regarding credit risk and its components relating to problematic debts, see above "Credit granted to the public" under "Developments of assets and liabilities".

## DESCRIPTION OF THE APPROACH AND STATISTICAL METHODS FOR THE CREATION OF SPECIFIC AND GENERAL PROVISIONS

As part of the Bank's preparation for the implementation of the instruction in the matter of "Measurement and disclosure of impaired debts, credit risk and provisions for credit losses", the Bank acted towards the development of methodology and statistical tools for the determination of provisions for credit losses. See Note 1 A to the financial statements for details regarding this instruction.

## QUANTITATIVE DISCLOSURE REGARDING CREDIT RISK

Segmentation of credit risk according to main credit exposure types

### 1. Gross credit risk exposure

	December 31, 2010	Average in 2010 <sup>(1)</sup>	December 31, 2009	Average in 2009 <sup>(1)</sup>
In NIS millions				
Credit	146,493	146,177	*148,894	*143,609
Bonds	25,972	25,462	*24,703	*30,455
Others <sup>(2)</sup>	7,558	8,505	8,521	8,717
Guarantees and other liabilities on account of clients <sup>(3)</sup>	62,435	63,389	*63,521	*65,439
Transactions in derivative financial instruments <sup>(4)</sup>	1,913	2,312	2,316	2,743
<b>Total</b>	<b>244,371</b>	<b>246,845</b>	<b>247,955</b>	<b>250,963</b>

\* Reclassified.

Footnotes:

(1) The average for 2009 and onwards is computed on a quarterly basis as from 31, 2008. The data in respect of quarters prior to December 31, 2009 are based on data reported to the Supervisor of Banks during the period of integration of the Basel II guidelines and are not audited.

(2) Primarily: cash, shares, fixed assets.

(3) Off balance sheet credit risk is stated prior to conversion to credit equivalent (before multiplication by the CCF coefficient).

(4) Credit risk in respect of transactions in derivative financial instruments is presented in terms of credit equivalent (after netting effect and after multiplication by the "add-on" coefficient).

Counterparty type distribution of exposures

December 31, 2010						
	Credit	Bonds	Other <sup>(1)</sup>	Guarantees and other liabilities on account of clients <sup>(2)</sup>	Transactions in derivative financial instruments <sup>(3)</sup>	Total
In NIS millions						
Sovereigns	14,212	19,288	-	-	-	33,500
Public sector entities	797	2,898	-	281	39	4,015
Banks	13,039	1,849	-	44	870	15,802
Corporates	73,448	1,731	-	38,592	923	114,694
Secured by commercial real estate	653	-	-	14	-	667
Single retailer exposures	16,543	-	-	17,913	9	34,465
Small business loans	10,026	-	-	3,484	3	13,513
Secured by residential real estate	17,775	-	-	2,107	69	19,951
Securitization	-	206	-	-	-	206
Other assets	-	-	7,558	-	-	7,558
<b>Total</b>	<b>146,493</b>	<b>25,972</b>	<b>7,558</b>	<b>62,435</b>	<b>1,913</b>	<b>244,371</b>
December 31, 2009						
Sovereigns	19,213	*16,864	-	-	-	36,077
Public sector entities	1,047	*4,093	-	327	3	5,470
Banks	*14,686	*1,519	-	*45	856	17,106
Corporates	*72,313	*1,886	-	*40,260	*1,277	115,736
Single retailer exposures	*16,864	-	-	*16,880	93	33,837
Small business loans	*9,096	-	-	*3,542	*4	12,642
Secured by residential real estate	*15,675	-	-	*2,467	*83	18,225
Securitization	-	341	-	-	-	341
Other assets	-	-	8,521	-	-	8,521
<b>Total</b>	<b>148,894</b>	<b>24,703</b>	<b>8,521</b>	<b>63,521</b>	<b>2,316</b>	<b>247,955</b>

\* Reclassified.

Footnotes:

(1) Primarily: cash, shares, fixed assets.

(2) Off balance sheet credit risk is stated prior to conversion to credit equivalent (before multiplication by the CCF coefficient).

(3) Credit risk in respect of transactions in derivative financial instruments is presented in terms of credit equivalent (after netting effect and after multiplication by the "add-on" coefficient).

Division of the file according to remaining contractual maturity periods<sup>(1)</sup>

December 31, 2010					
	Up to 1 year	Over 1 year and up to 5 years	Over 5 years	No fixed maturity date <sup>(2)</sup>	Total Cash Flow
in NIS millions					
Credit	80,856	42,543	25,914	3,019	152,332
Bonds	8,051	11,192	30,839	-	50,082
Others <sup>(3)</sup>	2,431	274	208	4,645	7,558
Guarantees and other liabilities on account of clients <sup>(4)</sup>	42,987	13,330	4,238	1,880	62,435
Transactions in derivative financial instruments <sup>(5)</sup>	14,892	2,767	2,576	-	20,235
<b>Total</b>	<b>149,217</b>	<b>70,106</b>	<b>63,775</b>	<b>9,544</b>	<b>292,642</b>

Footnotes:

- (1) This note presents the anticipated future contractual cash flows in respect of the exposures, according to the remaining period to the contractual maturity date of each cash flow.  
The data is shown net of the provision for doubtful debts, the allocation of which over periods is made in accordance with an estimate based on the credit periods in respect of which they were made.
- (2) Includes past-due receivables totaling NIS 1,653 million.
- (3) Primarily: cash, shares, fixed assets.
- (4) Off balance sheet credit risk is pre conversion to credit risk (pre multiplying by CCF coefficient).
- (5) Presented as calculated for the purpose of limitation on borrowewr indebtedness.

December 31, 2009					
Credit	*90,355	35,211	24,097	*3,802	153,465
Bonds	6,578	13,217	30,565	20	50,380
Others <sup>(3)</sup>	3,183	295	178	4,865	8,521
Guarantees and other liabilities on account of clients <sup>(4)</sup>	*45,002	*12,928	3,762	1,829	63,521
Transactions in derivative financial instruments <sup>(5)</sup>	*12,957	*2,163	*2,460	-	17,580
<b>Total</b>	<b>158,075</b>	<b>63,814</b>	<b>61,062</b>	<b>10,516</b>	<b>293,467</b>

\* Reclassified.

Footnotes:

- (1) This note presents the anticipated future contractual cash flows in respect of the exposures, according to the remaining period to the contractual maturity date of each cash flow.  
The data is shown net of the provision for doubtful debts, the allocation of which over periods is made in accordance with an estimate based on the credit periods in respect of which they were made.
- (2) Includes past-due receivables totaling NIS 1,821 million.
- (3) Primarily: cash, shares, fixed assets.
- (4) Off balance sheet credit risk is pre conversion to credit risk (pre multiplying by CCF coefficient).
- (5) Presented as calculated for the purpose of limitation on borrowewr indebtedness.

## DISCLOSURE AS TO CREDIT FILES MANAGED ACCORDING TO THE STANDARD APPROACH

For the purpose of averaging out exposure risk, the Bank and its banking subsidiaries in Israel use international rating data issued by Moody's - the international rating agency. IDB New York uses rating data issued by the international rating agencies - Moody's, Fitch and S&P.

The Group uses independent rating for all types of relevant exposures, including: sovereign entities, public sector entities, multi-purpose development banks, banking corporations, securities companies, corporations and securitization.

The Group acts according to the standard mapping published by the Supervisor of Banks.

The process, which is used for the application of public issue rating to similar assets existing in the banking book, is in accordance with the framework published by the Supervisor of Banks. When the Bank invests in a particular issues that has a specific issues

rating the weight attributed to the risk is based on such rating. Where the debt to the Bank does not comprise a particular rated issues, the Bank applies the principles determined in the framework.

Exposure amounts according to risk weights

December 31, 2010									
	0%	20%	35%	50%	75%	100%	150%	Deduction from capital	Total
In NIS millions									
Exposure before credit risk mitigation <sup>(1)(2)</sup>	34,804	17,165	16,596	3,833	49,569	119,099	3,153	152	244,371
Exposure after credit risk mitigation <sup>(1)(2)</sup>	35,109	11,633	16,566	8,903	39,101	114,231	3,121	-	228,664
December 31, 2009									
Exposure before credit risk mitigation <sup>(1)(2)</sup>	*36,809	*20,721	*14,467	*4,122	*48,480	*119,788	3,314	254	247,955
Exposure after credit risk mitigation <sup>(1)(2)</sup>	*37,020	*14,443	*14,430	9,175	39,369	*114,213	3,270	-	231,920

\* Reclassified.

Footnotes:

(1) Off balance sheet credit risk is pre conversion to credit risk (pre multiplying by CCF coefficient).

(2) Credit risk in respect of transactions in derivative financial instruments is presented in terms of credit equivalent (after netting effect and after multiplication by the "add-on" coefficient).

## REDUCTION OF CREDIT RISK

**General qualitative disclosure regarding the reduction of credit risk.** The Bank operates according to a policy, procedures and work processes regarding the acceptance of collateral and its management that includes guidelines as to revaluation of the asset, the rate of reliance on the collateral, pledges registered on the collateral and their registration with the relevant Registrars, etc. According to the Basel II guidelines, banking corporations may obtain relief from capital requirements with respect to usage of methods of reducing credit risks (CRM), subject to legal certainty. Legal certainty requires, among other things, that all documents securing a transaction, setoff documents, guarantees, etc. shall be binding on all parties involved and may be legally enforceable in all relevant judiciary fields.

In computing the capital requirements as of December 31, 2010, the Bank has only recognized a part of the collateral potential eligible for mitigation in accordance with the Basel II guidelines. The Bank continues to act towards the improvement of processes and procedures in order to achieve the legal certainty required for the recognition of additional collateral.

**Collateral management and control processes.** Collateral received with respect to credit of various types is managed and controlled by the different units, as follows:

- The business units evaluate and value the collateral in accordance with the collateral policy and procedures derived there from. In addition, current control is performed over customer files, which includes a review of the collateral documents and updating of their value;
- The business control unit (within the first control circle) engaged in a sample testing of the value of collateral, compliance with procedures and is responsible for the development of control and warning reports with respect to the value of the collateral, validity of valuation, etc.;

- The valuation unit performs a periodic review of the value of real estate and closed finance projects accepted as collateral, in accordance with the type of asset and at frequency determined in the Bank's procedures;
- The credit control unit (within the second control circle) performs a sample check of customer files, which includes an examination of documents evidencing the collateral and whether they are in compliance with the Bank's policy and procedures;
- The internal audit department performs each year current audits of the business divisions. Such audits include an examination of collateral from the registration and reporting aspects, evaluation of the value of collateral, existence of insurance policies etc. The audit monitors the correction of deficiencies and the implementation of recommendations by the business factors until completion of the process;
- The legal department is involved in the management of collateral, in accordance with its type, as regards one or more of the following three aspects: preliminary legal advice, preparation of the collateral documents, examination and approval of the collateral.

The Bank is acting towards improving the said management and control processes.

**Policy and procedures regarding balance sheet and off-balance sheet netting.** The Bank does not make use of balance sheet netting (in terms of Section 188 of the Instruction, and not in accounting terms of balance sheet setoff).

**The reduction of credit risk relating to banking corporations.** The Bank's policy, as approved by the Board of Directors in February 2010, is to enter into transactions in financial derivatives only with banking corporations with which an ISDA agreement had been signed. This agreement leads to a reduction in credit risk by permitting the netting of liabilities and mutual demands stemming from over the counter derivative transactions in cases of insolvency of the counterparty.

The agreements are signed separately with each legal entity; with certain of the said banking corporations a credit support annex (CSA) to the agreement is signed, which regularizes with the counterparty the issue of collateral in respect of derivative transactions. The CSA includes a threshold amount that reflects the maximum exposure that each of the counterparties is ready to accept without receiving collateral.

IDB New York transacts business only with banking corporations with which ISDA agreements had been signed.

Mercantile Discount Bank applies off-balance sheet netting with respect to transactions in derivative instruments with banks with which netting agreements had been signed that comply with ISDA rules.

**The reduction of clearing risks.** The clearing of derivative transactions with foreign banks and financial institutions constitutes the main source for the Bank's exposure to clearing risks. In order to hedge the clearing risk inherent in these transactions, the Bank uses the services of the CLS - Continuous Linked Settlement system where the clearing process is executed net in the various currencies, simultaneously.

In order to reduce clearing risks, the Bank, where possible, performs the clearing of dual transactions in the principal currencies with banks, using CLS.

**Policy and processes regarding the valuation and management of collateral.** The Bank has a detailed policy as regards collateral referring to the acceptance of the collateral, management of the various collateral accepted and the rate of reliance thereon. In general, the Bank's practice is to grant credit to customers against collateral of various types, including liquid assets, fixed assets, pledges and guarantees of various kinds.

The scope and quality of the collateral are derived from the level of credit risk that the Bank is ready to accept at the time of the granting of credit, putting a special emphasis on borrowers' repayment ability. Thus, in certain cases, such as: a borrower having a high indebtedness rating, a reliable borrower, credit might be granted without collateral and/or special terms imposed on the borrower. To the extent possible, the collateral is adjusted to the credit it secures from the stand point of the period of credit, currency in which the loan is granted, paid-up or renewable credit.

The collateral management policy and determination of their value for security purposes are based on principles and rules determined within the framework of the Bank's procedures for the granting of credit, in accordance with the type of assets. The rate of coverage of the debt by collateral is adjusted to the characteristics of the customer, his financial condition and the industry and economic sector in which he operates.

As a condition for reliance on material collateral (pledge on fixed assets, such as: motor vehicles, residential real estate, commercial real estate, machinery and equipment), the Bank requires an insurance policy for the asset pledged.

Determination of the value for security purposes of the different collateral is derived from their type, their quality and how quickly they may be realized, including changes in their value due to situations of slowdown or growth in the economic environment of the borrower.

Furthermore, Bank procedures include determined maximum rates of reliance on collateral in accordance with the type of asset, for the purpose of reducing the risk upon realization of the asset.

Valuation of the collateral is performed periodically, determining the value of the asset and the appropriate rate of reliance thereon, which should not exceed the maximum rate determined by the procedure. In certain cases, financial covenants are imposed on the borrower. Compliance with such covenants is examined periodically, the violation of which constituting a cause for the immediate repayment of the loan or a demand for additional collateral.

**Main types of collateral accepted by the Bank.** The Bank accepts the following main types of collateral:

- "Eligible collateral" and guarantees available for netting - collateral used by the Bank for the reduction of risk assets in the credit field in accordance with Basel II instructions, which include:
- Deposits pledged in favor of the Bank;
- Bank guarantees provided to the Bank as security for credit granted;
- Securities deposit and securities pledged in favor of the Bank (only securities defined as qualified under the rules of Basel II);
- "Other collateral" – all other collateral that are not defined as qualified (available for setoff). Other collateral serving the Bank for the purpose of hedging credit risks, include the pledge on fixed assets, such as: motor vehicles, residential property, commercial property, machinery and equipment, floating pledge, negotiable instruments that include credit card vouchers and documentary credit and including securities not defined as qualified.

The principles for the valuation of the various types of collateral are as follows:

- Liquid collateral - The Bank procedures determine the rate of reliance on liquid collateral in accordance with their type;
- Pledge on property - the valuation of real estate used as collateral for credit is made by the Bank's valuation department and/or on the basis of assessments by qualified appraisers. An updated valuation is required in accordance with the period of reliance thereon as specified in the Bank's procedures.

Bank procedures regarding pledges on real estate determine, among other things, the method of computing their value, the security spreads, the frequency of updating of the value and the authority for examination and approval of valuations in respect of the granting of credit. Furthermore, the Bank's procedures determine the rates of reliance applying to the different assets, such as: income producing property, stores, residential property, industrial buildings, land of various types, etc.;

- Fixed pledge - Bank procedures include guidelines for the evaluation of a pledge on fixed assets of various kinds. The procedures detail the frequency of updating the value of the pledge and the rates of reliance on the different assets in accordance with the type of the asset, its age, the level of marketability and possibility of realization. This includes: the value of motor vehicles is based on a suitable independent price list that is regularly updated, while the value of machinery and equipment is based on their purchase price or on an assessment by an appraiser;
- Floating pledge - Bank procedure determine guidelines for the valuation of a floating pledge, frequency of updating the valuation, rates of reliance on the various assets included in the pledge and computation of the Bank's share in the pledge. A floating pledge is formed based on updated information, knowledge of the borrower's business, type of active assets and the possibility of their realization. In cases where the information at hand for the purpose of determining the floating pledge is insufficient, the rates for reliance are reduced accordingly.
- Marketable securities - the value of marketable securities, at a holding rate lower than 5%, is based on market price, the rate of reliance for the security being determined by the securities research department. The value of securities held at a higher rate is assessed by the business factor at the Bank dealing with the customer.

- Within the framework of the Bank's policy regarding the financing of acquisitions of means of control, rules have been determined for the valuation of the acquired shares for the purpose of securing such credit. A valuation of the acquired company is performed in accordance with the value of the transaction, market price, or according to a valuation assessment, as well as an examination as to the ability of the acquired company to pay dividends, being generally the source of funds for the repayment of the loan.

## Redaction of credit risk

December 31, 2010					
	Total credit exposure <sup>(1)(2)</sup>	Credit exposure covered by eligible financial collateral <sup>(3)(4)</sup>	Total outflows <sup>(5)</sup>	Total Inflows <sup>(5)</sup>	Net credit exposure
In NIS millions					
Sovereigns debts	33,500	-	-	305	33,805
Public sector entities debts	4,015	-	(168)	-	3,847
Banks debts	15,802	(6,775)	-	6,616	15,643
Corporates debts	114,694	(4,242)	(766)	-	109,686
Debts with commercial real estate securities	667	-	-	-	667
Single retailer exposures	34,465	(1,851)	(5,961)	-	26,653
Small business loans	13,513	(2,657)	(26)	-	10,830
Secured by residential real estate	19,951	(30)	-	-	19,921
Securitization	206	-	-	-	206
Other assets	7,558	-	-	-	7,553
<b>Total</b>	<b>244,371</b>	<b>(15,555)</b>	<b>(6,921)</b>	<b>6,921</b>	<b>228,816</b>

December 31, 2009					
	Total credit exposure <sup>(1)(2)</sup>	Credit exposure covered by eligible financial collateral <sup>(3)(4)</sup>	Total outflows <sup>(5)</sup>	Total Inflows <sup>(5)</sup>	Net credit exposure
Sovereigns debts	*36,077	-	-	211	36,288
Public sector entities debts	*5,470	(2)	(211)	-	5,257
Banks debts	*17,106	*(7,241)	-	*5,866	15,731
Corporates debts	*115,736	*(4,482)	(743)	-	110,511
Single retailer exposures	*33,837	*(1,770)	*(5,109)	-	26,958
Small business loans	*12,642	*(2,249)	(14)	-	10,379
Secured by residential real estate	*18,225	(37)	-	-	18,188
Securitization	341	-	-	-	341
Other assets	8,521	-	-	-	8,521
<b>Total</b>	<b>247,955</b>	<b>(15,781)</b>	<b>(6,077)</b>	<b>6,077</b>	<b>232,174</b>

\* Reclassified.

Footnotes:

- (1) Off balance sheet credit risk is pre conversion to credit risk (pre multiplying by CCF coefficient).
- (2) Credit risk in respect of transactions in derivative financial instruments is presented in terms of credit equivalent (after netting effect and after multiplication by the "add-on" coefficient).
- (3) After balance sheet or off-balance sheet netting, when relevant, and after application of haircuts.
- (4) Including gold.
- (5) The amount of exposure covered by guarantees and transferred to the counterparty debts who gave the guarantee.

## GENERAL DISCLOSURE REGARDING EXPOSURE RELATED TO CREDIT RISK OF A COUNTERPARTY

**Over the counter derivatives.** Counterparty credit risk is the risk that the counterparty to the transaction will be in default before the final settlement of the cash flows in respect of the transaction. The main source for the Group's exposure to counterparty credit risk is over the counter (OTC) derivative transactions.

The Bank's policy regarding the management of counterparty credit risk is established in the policy document approved by the Board of Directors every year. The policy document includes, among other things, principles for the identification, measurement and evaluation of the risk, requirements for the determination of combined limitations and for exposure reporting as well as definition of responsibilities and authorizations.

Exposure of the Group to counterparty credit risk is created mostly with respect to international banks and financial institutions.

The framework of exposure to international financial institutions is approved at Group level on the basis of an internal model. The approved framework is allocated by the Bank among the subsidiaries in the Group.

Activity in derivatives is conditional on the prior approval of the credit facility that determines limitations on counterparty exposure.

The framework of exposure to customers is approved in accordance with credit approval authorizations based on obtaining financial collateral only (government bonds, rated corporate bonds, shares and deposits), to the volume of the exposure framework. The credit committee is authorized to approve the acceptance of collateral in accordance with actual exposure only. Furthermore, the granting of a framework to a customer without collateral is possible in accordance with the facts of the case.

The monitoring of counterparty credit risk exposure is performed as follows:

- Exposure to foreign banks and financial institutions - the back office unit at the finance division performs, a comparison of actual exposure to the approved framework on a daily basis;
- Exposure to large customers and/or those having complex activities - The middle office unit at the finance division performs a comparison of actual exposure to the approved framework, on a daily basis, including application of extreme scenarios. As part of management and control over the utilization of the exposure framework, the information system produces a daily irregularity report, which, among other things, includes a list of customers whose actual utilization of the exposure framework is equal or exceeds 85%. The purpose of this report is to give warning to the responsible business factor as to the high utilization rate.

In addition, the Bank determined a set of internal limitations imposed on combined credit exposure of counterparties, such as: combined limitations according to currencies and types of products.

The methods used by the Bank for counterparty credit risk reduction, include:

- Daily monitoring of the customer's collateral situation, and where needed, a demand for additional collateral;
- A contractual "stop loss" clause - enabling the Bank to enforce the closing of a customer position, in cases where a deviation in loss terms from the "stop loss" amount determined for the customer exists;
- The signing of ISDA agreements and CSA annexes (for explanations regarding "ISDA agreement" and "CSA annex", see "Reduction of credit risk" above).

**The method for determining counterparty credit exposure limitations.** For regulatory reporting purposes the Group uses the "present exposure method", according to which the present cost of replacement is computed by the revaluation of agreements to market prices together with an "add-on" coefficient, in order to reflect the future potential exposure over the remaining life time of the agreement. The future potential exposure, computed on the basis of the notional principal sum of the total counterparty file, is in accordance with the type of product and the remaining period to redemption, according to a coefficient table included in the Basel II guidelines

For counterparty credit risk exposure management purposes, the Group uses the "customer exposure model", based on the computation of exposure in equal value credit terms that includes a mark to market valuation of transactions together with the future potential exposure.

In the years 2008-2009, the Bank made changes to the future exposure coefficients use by it for assessing credit exposure involving derivative financial instruments (CCR), this following financial developments in these years. During 2008 exposure coefficients were raised and through 2009 they were reduced.

**Policy for the protection of collateral, its valuation and management.** According to the Bank's policy, the financial collateral is valued on a daily basis. The rate of reliance on such collateral is determined according to the risk volatility of its market price over time, and are secured in the policy document approved by the Board of Directors.

**The effect of the amount of collateral that would have to be provided by the Bank in case of a reduction of its credit rating.** Some of the collateral agreements to which the Bank is a party within the framework of the ISDA agreements, state that the threshold amount and the minimum transfer amount shall be reduced in the event that the Bank's credit rating would be reduced. Accordingly, in such cases the Bank would be required to provide to the foreign bank collateral in higher amounts (in the event that the foreign bank has a profit on derivatives).

Disclosure regarding over the counter derivatives

	December 31	
	2010	2009
	In NIS millions	
Gross positive fair value of contracts <sup>(1)</sup> :		
Interest rate contracts:		
Shekel/CPI	1	2
Other	1,100	881
Foreign currency contracts	970	769
Contracts on shares	82	139
Commodities and other contracts	47	218
Total Gross positive fair value of contracts	2,200	2,009
Potential off balance sheet exposure <sup>(2)</sup>	1,709	*1,590
Netting benefits	(1,996)	(1,283)
Current credit exposure after netting <sup>(2)</sup>	1,913	2,316
Held collateral	(150)	(140)
<b>Net derivatives credit exposure</b>	<b>1,763</b>	<b>2,176</b>

\* Reclassified.

Footnotes:

(1) Including embedded derivatives, as at December 31, 2010, in the amount of NIS 72 million (December 31, 2009 NIS 74 million).

(2) Potential off-balance sheet credit exposure with respect to derivative instruments is calculated based on the notional principal amount of the entire counter-party portfolio, multiplied by the "Add-on" coefficient.

## ACTIVITY IN DERIVATIVE FINANCIAL INSTRUMENTS

Note 20 to the financial statements presents details of operations in derivative instruments - scope, credit risk and maturities. Part 2 of the aforementioned Note presents details of credit risk with respect to derivatives by counter party, on a consolidated basis. Following are further details regarding data presented in part 2 of the aforementioned Note.

(1) Following are details according to rating of balances of assets derived from transactions in derivative instruments where the counterparty is a bank:

	On December 31, 2010	On December 31, 2009
	In NIS million	
Balances of assets deriving from transactions in derivative instruments where the counterparties are foreign financial institutions		
With an AAA rating	-	1
With an AA+ rating	179	184
With an AA rating	201	215
With an AA- rating	539	240
With an A+ rating	158	124
With an A rating	175	237
With a BBB rating	24	16
Not rated	20	5
<b>Total against foreign financial institutions</b>	<b>1,296</b>	<b>1,022</b>
<b>Total against Israeli financial institutions</b>	<b>384</b>	<b>265</b>
<b>Total balances of assets deriving from transactions in derivative instruments</b>	<b>1,680</b>	<b>1,287</b>

(2) Following are details according to rating of off balance sheet credit risk in respect of transactions in derivative instruments where the counterparty is a bank:

	On December 31, 2010	On December 31, 2009
	In NIS million	
Off Balances of assets deriving from transactions in derivative instruments where the counterparties are foreign financial institutions		
With an AAA rating	-	23
With an AA+* rating	1,098	1,755
With an AA** rating	971	1,416
With an AA-*** rating	2,877	1,440
With an A+**** rating	558	684
With an A***** rating	639	1,184
With an BBB+ rating	-	1
With an BBB rating	59	61
Not rated	52	19
<b>Total against foreign financial institutions</b>	<b>6,254</b>	<b>6,583</b>
<b>Total against Israeli financial institutions</b>	<b>2,861</b>	<b>1,604</b>
<b>Total off balances of assets deriving from transactions in derivative instruments</b>	<b>9,115</b>	<b>8,187</b>

\* December 31, 2010 - includes an amount of NIS 140 million with Credit Suisse and NIS 938 million with JP Morgan Chase. December 31, 2009 - includes an amount of NIS 923 million with Deutsche Bank and NIS 680 million with JP Morgan Chase.

\*\* December 31, 2010 - includes an amount of NIS 482 million with HSBC Bank PLC, NIS 385 million with BNP Paribas and NIS 72 million with Societe Generale. December 31, 2009 - includes an amount of NIS 898 million with HSBC Bank PLC and NIS 246 million with BNP Paribas.

\*\*\* December 31, 2010 - includes an amount of NIS 406 million with Barclays Bank PLC, NIS 446 million with UBS, NIS 290 million with Commerzbank AG, NIS 399 million with Royal Bank of Scotland Plc and NIS 1,071 million with Deutsche Bank. December 31, 2009 - includes an amount of NIS 438 million with Barclays Bank PLC, NIS 347 million with UBS and NIS 289 million with Commerzbank.

\*\*\*\* December 31, 2010 - includes an amount of NIS 273 million with Citibank and NIS 197 million with Merrill Lynch International Bank. December 31, 2009 - includes an amount of NIS 446 million with Citibank.

\*\*\*\*\* December 31, 2010 - includes an amount of NIS 387 million with Morgan Stanley, NIS 246 million with Goldman Sachs Group. December 31, 2009 - includes balances of five foreign financial institutions, the highest of which amount to NIS 434 million, NIS 410 million, NIS 290 million, and none of the other institutions exceeds the amount of NIS 46 million.

(3) Following are details of the column "Other" according to the overall credit to the public risk per economic sectors:

	On December 31, 2010	On December 31, 2009
	In NIS million	
Agriculture	12	15
Industry:		
Machines, electrical and electronic equipment	178	179
Mining, chemical industry and oil products	290	335
Other	257	107
<b>Total industry</b>	<b>725</b>	<b>621</b>
Construction and real estate:		
Acquisition of land for construction	-	6
Real estate holdings	161	59
Other	29	12
<b>Total construction and real estate</b>	<b>190</b>	<b>77</b>
Electricity and water	20	19
Commerce	147	206
Hotels, hotel services and food	1	2
Transportation and storage	121	84
Communications and computer services	65	99
Financial services:		
Financial institutions (excluding banks)	417	361
Private customers active on the capital market	1,558	1,003
Financial holding institutions	249	485
Insurance and provident fund services	194	162
<b>Total financial services</b>	<b>2,418</b>	<b>2,011</b>
Other business services	102	107
Public and community services	7	16
Private individuals - housing loans	-	-
Private individuals - other	157	210
<b>Total</b>	<b>3,965</b>	<b>3,467</b>

\* Reclassified.

## SECURITIZATION EXPOSURE

IDB New York invests in several types of securitized securities, in marketable mortgage backed securities (CMBS), in securities of the "trust preferred CDO" type and residential mortgage backed securities (RMBS).

IDB New York is an investor in securitized securities and is not the issuer of any securitized securities.

For the purpose of averaging the risk of securitization exposure, IDB New York makes use of ratings published by the international rating agencies Moody's, Fitch and S&P.

The securitization exposure included in the following Table does not include mortgage backed securities issued by GNMA, FNMA and FHLMC agencies, due to the fact that they do not include layers according to repayment order.

For further details, see Note 3 to the financial statements and "Investment in asset backed securities" under "Developments of assets and liabilities" above.

Securitization exposure

	Total exposure	
	December 31	
	2010	2009
	In NIS millions	
Mortgage-backed securities (MBS):		
Other mortgage-backed securities (including CMO, REMIC and STRIPPED MBS)	194	325
Bond backed securities (TRUPS CDO)	12	16
<b>Total mortgage and asset-backed securities</b>	<b>206</b>	<b>341</b>

	December 31			
	2010		2009	
	Total exposure	Capital requirements	Total exposure	Capital requirements
	9%		9%	
	In NIS millions			
Risk weights:				
20%	-	-	35	*-
50%	36	1	44	*2
100%	19	2	8	1
Deductions from capital	151	151	254	254
<b>Total</b>	<b>206</b>	<b>155</b>	<b>341</b>	<b>257</b>

Footnote:  
The above exposures do not include exposures issued by agencies operating under the auspices of the U.S. Government (GNMA, FHLMC, FMNMA).

## CREDIT EXPOSURE TO FOREIGN FINANCIAL INSTITUTIONS

**General.** In view of the financial crisis which began in 2008 and apprehensions regarding the implications of the crisis on foreign financial institutions, banking corporations are required to include in the Directors' Report a separate disclosure regarding credit exposure to foreign financial institutions.

Foreign financial institutions include: banks, investment banks, brokers/dealers, insurance companies, institutional entities and entities controlled by the said entities.

As opposed to the definition of the "financial services" economic sector for the purpose of disclosure in the Management Review concerning the "Overall credit risk according to economic sectors", the exposure in respect of foreign financial institutions presented in the table hereunder includes exposure to foreign banks and to foreign investment banks, which, on the one hand, are not included in credit granted to the public, and on the other hand, does not include exposure in respect of investment in asset backed securities and in respect of potential off-balance sheet exposure.

**Developments in world markets.** The global financial crisis caused deterioration in the financial condition of a number of countries and the breakout of a debt crisis in the Euro block. Periphery countries such as Spain, Greece, Ireland and Portugal were

significantly affected, the crisis being reflected in a significant additional and swift increase in returns on bonds of such countries. International rating agencies have decreased the credit rating of Greece below the investment rating based on the concern it will find it difficult to face the burden of its debt and concerns that it will not receive the international financial assistance promised to it. The rating of Ireland was sharply reduced by five grades in December 2010.

The trend of government debt of the PIIGS countries since the beginning of 2011 was not uniform. While in January, Spain, Ireland and Portugal successfully completed the issuance of debt securities, resulting in a reduction in returns and in CDS spreads of these countries and in a relaxation of the debt crisis, further on during the year, in view of the disagreement between the Euro Block countries regarding the future bailout plan and the fear of a need of a bailout plan for Portugal, on the background of its high need for funds, the insurance premium of certain of the PIIGS countries took a turning to the worse. Furthermore, the credit rating of Spain and Greece has been reduced once again on the background of the structural problems in these countries.

The Bank is monitoring developments and volume of exposure to markets in general and to markets of the said countries in particular. This is performed on an ongoing basis and at the Group level. The Bank's dealing room monitors these markets in order to obtain a comprehensive picture and to react in real time to currency risks in accordance with the risk profile of each customer and the approved credit facilities. Furthermore, the business divisions conducted a comprehensive examination regarding customers that may be adversely affected by the crisis in Europe.

As seen from Schedule "D" to the Management Review below regarding "Exposure to foreign countries", the direct exposure of the Group to the said country is not material and in a downward trend. However, it is not possible at this stage to evaluate the indirect effect, particularly if a global crisis develops as a result of the crisis in the said countries.

**The manner of managing credit risk applying to foreign financial institutions.** The Bank's policy with regard to various exposures to foreign banks and financial institutions, has been re-examined, and is reflected in the following items:

- The Bank has adopted a conservative policy as regards management of exposure to foreign banks and financial institutions;
- The allocation of credit facilities to foreign banks is more strictly and conservatively conducted, using mathematical auxiliary tools that had been re-examined and modified to the lessons of the crisis;
- Deposits by the Bank are made on a selective basis, mainly at banks in the U.S. and Western Europe, having a rating of "A+" at the least;
- The Bank has reduced the volume of deposits abroad;
- The Bank has adopted a policy according to which exposure to financial derivatives requires a signed ISDA agreement with every financial institution with which the Bank enters into transactions of this kind. This process is being conducted gradually with respect to foreign financial institutions (a signed ISDA agreements exist with most financial institutions dealing in derivatives, until the end of 2011, the Bank intends to sign ISDA agreements with all parties with whom it engages in financial derivative transactions;
- The clearing risks facilities are individually examined, with the clear aim of significantly reducing clearing risks, while using the CLS tool, being a central tool for mutual dual clearing;
- A policy has been adopted regarding exposure to less developed countries (LDC). This policy defines exposure at low amounts and for relatively short terms;
- A methodical and close management with upgraded monitoring, supervision and control systems, and cooperation of all involved factors at the Bank and the Group;
- The development of a supporting integrative and innovative information system that will assist in obtaining an image on a group basis, regarding exposure to foreign banks and financial institutions.

The Group's credit risk related to banks and foreign financial institutions is managed by the Corporate Banking Division, as follows:

- The credit facilities to foreign countries and banks are approved by the Board of Directors and the Bank's credit committees, in accordance with the recommendations of the financial institutions and at the corporate banking division. This recommendation is based upon mathematical models determining the maximum credit facility to states and banks. These models are based, among other things, on the rating of states and banks by the international rating agencies and on the banks' financial data, while taking

into consideration the country in which the banks operate and the size of the economy to which the Bank is exposed;

- A reduction in the rating of a foreign bank and/or a deterioration in its financial data are weighted into the model, and where necessary, the Bank reduces its credit facility accordingly;
- The financial institutions unit of the Corporate Banking Division allocates the credit facilities approved by the Board between members of the Group, and the various units at the Bank, including the Bank's dealing room for which the Finance Division is responsible. Allocation of credit facilities to the Bank's dealing room is in most cases directed towards banks incorporated in developed countries. Monitoring the Bank's compliance with limitations applying to credit facilities approved to the various institutions is conducted according to accepted practices at the Bank with respect to the monitoring of compliance with approved exposure limitations. The department, on a current basis, provides Management with reports regarding actual exposure levels at the Bank as well as regarding negative indications, if such are received;
- Deviations from credit facilities, if at all, are reported to the echelon in charge of the unit to which the credit facility had been allocated, in accordance with credit granting authority;
- The financial institutions unit at the Corporate banking Division received the Bank's exposure data regarding foreign financial institutions from the Finance Division, from various functions at the Bank and from the Bank's foreign subsidiaries and extensions. These data are consolidated at Group level and are reported to various factors at the Bank and to the Supervisor of Banks, as required.

In managing the clearing risks, the Bank in its considerations takes into account the level of exposures and their distribution among the foreign banks.

**Credit exposure to foreign financial institutions.** The Bank's exposure to foreign financial institutions comprises mostly of exposure to banks and investment banks. As seen from the data presented hereunder, about 88% of the exposure as of December 31, 2010, is to financial institutions rated "A-" rating or higher.

The states in respect of which the Bank has exposure as stated above for the year ended December 31, 2010, include, inter-alia, the United States, Germany, Switzerland and Great Britain.

Losses in respect of impairment of securities in the amount of NIS 47 million are included in respect of exposure to foreign financial institutions.

Following are details of present credit exposure to foreign financial institutions<sup>(1)</sup>, on a consolidated basis:

	Balance sheet credit risk <sup>(2)(4)(5)</sup>	Present off balance sheet credit risk <sup>(3)(4)</sup>	Present credit exposure <sup>(4)</sup>
in NIS millions			
As at December 31, 2010			
<b>Present credit to foreign financial institutions<sup>(6)</sup></b>			
<b>External credit rating<sup>(7)</sup></b>			
AAA up to AA-	3,964	178	4,142
A+ up to A-	2,124	555	2,679
BBB+ up to BBB-	470	9	479
BB+ up to B-	308	-	308
Not rated <sup>(8)</sup>	109	51	160
<b>Total present credit exposure to foreign financial institutions</b>	<b>6,975</b>	<b>793</b>	<b>7,768</b>
Balance of problematic bonds	17	-	17

Following are details of present credit exposure to foreign financial institutions<sup>(1)</sup>, on a consolidated basis (continued):

	Balance sheet credit risk <sup>(2)(4)(5)</sup>	Present off balance sheet credit risk <sup>(3)(4)</sup>	Present credit exposure <sup>(4)</sup>
in NIS millions			
As at December 31, 2009			
<b>Present credit to foreign financial institutions<sup>(6)</sup></b>			
<b>External credit rating<sup>(7)</sup></b>			
AAA up to AA-	4,599	120	4,719
A+ up to A-	2,236	432	2,668
BBB+ up to BBB-	568	2	570
BB+ up to B-	291	-	291
Not rated <sup>(9)</sup>	96	111	207
<b>Total present credit exposure to foreign financial institutions</b>	<b>7,790</b>	<b>665</b>	<b>8,455</b>
Of which credit exposure to foreign financial institutions			
In the USA <sup>(10)</sup>	3,234	15	3,249
Balance of problematic bonds	11	-	11

Notes:

- (1) Foreign financial institutions include: banks, investment banks, brokers/dealers, insurance companies, institutional entities and entities controlled by the said entities.
- (2) Deposits with banks, credit to the public, investment in bonds, borrowed or acquired securities as part of buy-back agreements and other assets in respect of derivative instruments.
- (3) Mainly guarantees, including guarantees securing third party indebtedness.
- (4) The credit risk is stated net of the specific provisions for doubtful debts.
- (5) For further information regarding the composition of the credit exposure reflected in the table showing derivative instruments in relation to banks/dealers/brokers, see Note 20 to the condensed financial statements.
- (6) Credit exposure does not include exposure to financial institutions that have explicit and full government guarantees, and which do not include investment in mortgage backed securities (for additional details regarding mortgage backed securities, see Note 3 to the condensed financial statements).
- (7) According to Moody's rating, and in its absence, the Fitch rating or S&P.
- (8) Most of the off-balance sheet credit risk which has no rating is in respect of guarantees by private Swiss banks and Swiss banks owned by banks in Western Europe that are rated AA- and above.
- (9) Most of the off-balance sheet credit risk which has no rating is in respect of wholly owned subsidiaries of bank which have a rating and small banks and financial institution. Most of the off-balance sheet credit risk which has no rating is in respect of exposure to a company engaged in foreign trade insurance in an OECD country that had an investment rating of A-.
- (10) As of December 31, 2009, the United States was the only country in respect of which exposure exceeded 15% of the capital base of the Bank; accordingly, the data for 2009 relating to it is presented separately. Exposure as of December 31, 2010 did not exceed the said limit, accordingly, the data in respect of which is not presented separately.

In addition to the exposure presented in the above table, as of December 31, 2010 and 2009 a potential off-balance sheet exposure exists in respect of derivative instruments of foreign financial institutions (as defined in Section (4)(a) to the definition of indebtedness in Proper Banking Management Directive No. 313 regarding "Restrictions on indebtedness of a single borrower and of a group of borrowers", namely, 10% of the outstanding balance of a future transaction of the "Future rate agreement or of the forward rate agreement" type), in the amount of NIS 6,254 million and NIS 6,583 million, respectively.

## CREDIT RISK IN RESPECT OF LEVERAGED FINANCE

**Definition of leveraged finance.** The Bank defines credit for transactions for the finance of acquisition of means of control, as defined in Proper Banking Management Directive No. 323, in which the financing ratio exceeds the norm, as leveraged finance (the said definition was changed during 2010, and the comparative data for 2009, presented below have been reclassified accordingly).

Financing the acquisition of means of control over corporations is typified by large amounts or by high financing rates, the repayment of the loan being mainly based on the acquired corporation, at times even without recourse to the borrower.

**Credit risk in respect of leveraged finance.** In view of the complexity involved in such transactions, the Bank takes great care in granting such credit and acts in accordance with a credit policy unique to this field. Furthermore, transactions for the finance of acquisition of means of control are being reviewed twice a year and reported to the Bank's Management and Board of Directors. Proper Banking Management Directives determined restrictions regarding the finance of acquisition of means of control, which the Bank abides by.

Following are data regarding credit risk pertaining to leveraged finance. Disclosure is focused on exposure in respect of the acquisition of means of control, each of which exceeds NIS 50 million.

The Banks exposure to leveraged finance according to the economic sector of the acquired corporation:

Sector	Balance sheet credit as of December 31,	
	2010	2009
	in NIS millions	
Agriculture	525	544
Industry	381	410
Construction and real estate	957	718
Commerce	100	-
Communications and computer services	435	-
Financial services	435	490
Other business services	125	-
<b>Total</b>	<b>2,958</b>	<b>2,162</b>

\* Reclassified.

Additional details:

Exposure to leveraged finance (as defined above) as of December 31, 2010 amounted to NIS 2,958 million, compared to NIS 2,162 million at the end of 2009, an increase of 37%. The outstanding balance of exposure presented in the above table is net of a provision for doubtful debts of NIS 45 million at the end of 2010, similar to the end of 2009. After deducting qualified collateral (in accordance with Proper Banking Management Directive No. 311), the total balance sheet exposure in respect of leveraged finance as of December 31, 2010 amounted to NIS 2,854 million, compared to NIS 1,994 million at the end of 2009, an increase of 43%.

The off-balance sheet exposure to leveraged finance as of December 31, 2010 amounted to NIS 50 thousand, compared to with NIS 12 million at December 31, 2009, and reflects a commitment to grant credit for the finance of acquisition of means of control in a corporation.

## MANAGEMENT OF MARKET AND LIQUIDITY RISKS

**Market risk.** Market risk is the risk of impairment of the Bank's equity and profitability stemming from changes in financial markets which have an effect on the Bank's assets or liabilities: interest rates, foreign exchange rates, inflation, prices of securities, product prices, the fluctuations in these parameters and in other economic indices.

**A liquidity risk** is the risk of the Bank finding it difficult to meet its liabilities due to unforeseen developments, and being forced to raise funds in a way that would cause it a material loss.

## STRATEGIES AND PROCESSES

**Market and liquidity risk management policy.** The market risk policy is intended to reduce the level of financial risk created by the Bank's current activity, alongside increasing the Bank's profits stemming from undertaking initiated and controlled exposure. The Bank has two policy documents on this subject, the one - market risk management policy, and the other - liquidity risk management policy. Both these policy documents have been approved by the Board of Directors.

The policy documents define the principles of risk management, the tools for measuring exposure and the limitations on exposure in relation to the Bank's overall activity, commercial operations, specific files and quantitative scope limitations on instruments that may be operated by the Bank. In addition, the document defines the responsibility of the various factors dealing with market and liquidity risk management, both as regards the determination of limitations as well as in the treatment of deviations from restrictions. Furthermore, the liquidity risk management policy document has defined a group of indicators for use in the identification of trends in the liquidity risk situation, and also includes a plan regarding preparations for a liquidity crisis situation.

The principal subsidiaries also have policy documents for the management of market and liquidity risks.

No deviations in applying the determined policy were recorded in 2010 (except for several specific deviations of negligible scope). For details, see below.

**Group risk management.** Proper Banking Management Directive No. 339 states that the risk management system of a banking corporation should also cover its branches in Israel and abroad and should take into account the risk exposure of its subsidiaries in Israel and abroad, based on available information received from these entities as part of the information and management layout.

The Boards of Directors of the banking subsidiaries have determined policies regarding the maximum exposure to market and liquidity risks, based on the Bank's policy. The subsidiaries manage their market and liquidity risk, each subject to the policy determined by its own Board of Directors. Notwithstanding, within the framework of the implementation of the Group policy for market and liquidity risk management, the Board of Directors has instructed the principal banking subsidiaries in Israel and abroad to modify, to the extent possible, their market risk management and measurement methodologies to those applied by the parent company, taking into consideration the specific characteristics of operations of each subsidiary.

The Bank applies the necessary steps for measuring and assessing the overall exposure of the Group to risks, as well as to absorb the group management concept at the Bank and at the Group's companies. Determination of the Group's risk inclination has been put into practice, at the first stage, for the Group's market risk as a whole. The Board of Directors determined in this respect Group restrictions in VaR terms and in terms of the maximum loss upon a parallel change in interest graphs and in linkage base exposure terms.

The current management of market and liquidity risks is conducted separately at the Bank and at each of its main banking subsidiaries. Notwithstanding, the Bank frequently reviews, the inclination of the Bank and its banking subsidiaries to take risks and the actual market and liquidity risks. These reports are presented to the Board of Directors as part of the exposure document.

The reporting of exposure of the Group to market and liquidity risks in 2010, includes for the first time also the data for ICC, the credit card company in which the Bank has an interest of 71.83%, as well as the data for BLD, the severance pay fund for the Bank's employees. The data presented in this review, include therefore, the Bank, Mercantile Discount Bank, Discount Mortgage Bank, IDB New York, IDB (Swiss) Bank, ICC and BLD.

**Main changes in exposure policy and risk management procedures.** Steps were taken in recent years to tighten the supervision over market and liquidity risks management in the principal banking subsidiaries, including actual exposure, policies and appetite for risk. This, while maintaining a continuous dialogue between the professional staff in the Bank and in its subsidiaries.

During 2010, a statement of policy was approved in the matter of market and liquidity risks at Discount Mortgage Bank. Furthermore, several changes in the policy documents of the various subsidiaries were approved during the year.

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## STRUCTURE AND ORGANIZATION OF THE MARKET AND LIQUIDITY RISKS MANAGEMENT FUNCTION

The organizational structure, by which the market and liquidity risks are being managed, is, as stated, composed of three control circles.

**The Board's risk management committee.** The Board's risk management committee serves as an extension of the Board for the market risks management issue. The committee holds a preliminary discussion on each subject related to market risk management within the Bank Group, and forms an opinion as well as recommendations, which are brought for discussion before the full board of Directors. In addition, the committee follows developments in risk exposure, including stress test scenarios, taking into consideration the market situation and the business environment of the Bank and the group. Furthermore, the committee examines the introduction of new limitations and of proposals for new operations while assessing market risks that such operations may create, the Bank's ability to manage, measure and control these operations' risks and the determination of limitations in accordance therewith.

**Current management and supervision.** Current management and supervision in the area of market and liquidity risks management are performed by four committees:

- **Asset and liability management committee (ALM committee).** This committee is headed by the CEO and meets once a month. The duty of the committee is to determine the goals of exposure to market risks based on a situation evaluation of expected developments in the market and subject to limitations determined by the Board of Directors, to approve changes in models for the management of market and liquidity risks, to update parameters included in such models and to study the profitability of the various activities as well as abiding by the capital adequacy targets. The committee is authorized to approve a temporary deviation from the limitations set by the Board;
- **The financial forum** is an internal committee of the finance division, headed by the head of the finance division. The forum meets on a weekly basis for the purpose of evaluating current developments in the markets and monitoring the implementation of guidelines issued by the ALM committee. Where necessary, the forum is authorized to approve a temporary deviation from goals set by the ALM committee;
- **Stress tests forum.** Headed by the Chief Risk Manager and meets at least once in each quarter. Presented to the Forum is the potential impairment under stress tests determined by the Bank and by the subsidiaries in the Group, and the Forum decides as to the stress tests that should be examined within the framework of market risk management; it has been decided recently that this Forum shall act as a stress test forum which will also refer to credit risk.
- **The liquidity forum** is headed by the manager of the asset and liability management department and meets on a weekly basis. The forum performs an ongoing follow-up of the liquidity situation and of the implementation of decisions made by executive factors.

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## INTERNAL CONTROL MECHANISM REGARDING THE PREVENTION OF DEVIATIONS FROM THE POLICY

The Bank operates control mechanisms preventing deviation from the limits determined by the Board of Directors, which include three control circles as follows:

**The first control circle.** The Finance Division coordinates the Bank's overall financial activity that includes both the business factors (those who take the risk) and the back office and middle office (the control factors). The Bank's procedures requires those who accept the risk and the control factors to report to the Head of the Finance Division and to the risk management department in respect of any exceptional events, e.g. loss exceeding the predetermined limit, deviations from limitations and so forth.

Any deviation from the limitations is immediately reported to the Head of the Finance Division, who determines how these deviations should be dealt with as well as the reaction to exceptional developments in the various markets. Any deviations, if at all, are reported to the asset and liability management committee, to the market risk controller and to the Board of Directors (by means of the exposure document).

In addition, internal limitations determined by the Head of the Finance Division, are monitored on an ongoing basis.

**The second control circle.** This circle includes the risk management department, the market and liquidity risks controller and the stress test forum. The market and liquidity risk management department provides to Management and to the Board of Directors a status report regarding the Bank's market and liquidity risks level, the principal subsidiaries and the Group as a whole.

The department deals with the definition of risk types, with the development of tools and methodologies for the identification and measurement of exposure to market and liquidity risks. This, among other things, in accordance with the guidelines and recommendations of the regulatory authorities relating to risk management.

The department serves as the professional body providing guidance regarding these subjects to the relevant units of the Bank and its subsidiaries.

The department prepares the exposure document, which presents an updated statement of exposure as against the restrictions, as well as reporting deviations from policy, procedures and restrictions laid down by the Board of Directors.

An additional factor in the second control circle is the market and liquidity control unit, the main duties of which are: validation of models used in the management of market and liquidity risks, examination of compliance of actual activity and exposure with the approved principles and limits, examination of the reasonableness of the stress tests and fairness of the market and liquidity risk measurement process.

**The third control circle** includes the internal audit, which performs an overall evaluation of the risk management quality at the Bank. For this purpose it includes in its annual work plan appropriate audit operations. The internal audit checks, reviews and evaluates the implementation of policy and execution of Board decisions and guidelines in the matter of management, assessment and control of risks, compliance by the Bank with exposure limitations set by the Board, reliability and availability of management information and financial and operational reports submitted to the Bank's Board and Management.

**Organizational structure at the principal subsidiaries.** The Organizational structure at the principal subsidiaries includes the functions and control circles described above, with certain changes appropriate to their size:

- Mercantile Discount Bank. The ultimate forum for the management of market and liquidity risks is the "extended nostro committee", which is headed by the CEO and meets on a monthly basis. Responsibility for the ongoing risk management lies with the "reduced nostro committee" headed by the head of the finance and client's assets management division, which meets on a weekly basis. During 2010, the responsibility for market and liquidity risks management was transferred to the Finance and Customer Asset Management Division, as a part of the organizational preparations stemming from the implementation of Bank of Israel directive in the matter of "Chief risk manager".
- IDB New York has a Chief Risk Manager, with a status of member of Management, whose sole responsibility is risk management. IDB New York has a Management committee for the management of market risks (the ALCO committee), which operates subject to the risk management committee of Management. Members of the committee are the CEO, senior members of Management and representatives of the treasury and risk management. The committee meets on a monthly basis. The committee discusses the exposure situation and the strategy for changing the exposure situation in the light of economic evaluations and expected changes in the markets.
- Discount Mortgage Bank. An organizational change was made during 2010, within the framework of which the Executive Vice President in charge of the Finance Division was defined also as the Bank's Chief Risk Manager reporting to the President & CEO. The Division is responsible for the management of all the risks, among which are also market and liquidity risks. A market risk controller has been appointed as a second circle, the duty of whom is to perform independent control over those who take risks at the Bank. Statements of policy for the management of market and liquidity risks were approved in the course of 2010.

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## CHARACTERISTICS AND SCOPE OF REPORTING AND RISK MEASUREMENT SYSTEMS

Measurement of exposure to market and liquidity risks, including the calculation of the various risk assessments is performed at the Bank on a weekly basis, using the "Riskpro" system. The system is used as a basis for financial data, which contains the financial information required for the purpose of risk management, and which refers to the range of financial instruments operated by the

Bank, including embedded options, for market data (such as indices, exchange rates and interest rates), their volatility level and the statistical correlation between them, as well as financial and behavioral models.

The system is used for computing risk assessments and for simulations regarding the overall operations at the Bank and Group levels, regarding operations/files. Likewise, additional risk indices and interest rate exposure are computed and measured (it should be noted that the system is also used for fair value measurement for the purpose of the accounting report).

This system is also used by Mercantile Discount Bank in computing its exposure to market and liquidity risks.

**IDB New York.** Measurement of the exposure to market and liquidity risks is performed by the first circle (Treasury) through an independent risk management system providing a computation of risk assessments at monthly intervals. The risk management controls the exposure to market and liquidity risks.

**Discount Mortgage Bank** measures and reports interest rate exposure levels using outsourcing services. DMB is in the midst of a preparation process towards the use of a risk management system that is used by the Bank.

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## HEDGING AND/OR RISK REDUCTION POLICY

**Hedging of market risk policy.** The Bank's policy and its banking subsidiaries as regards market risks management is based on the management of exposure to market risks, within the framework of quantity active limitations determined with respect to such exposures while defining the manner of operation and protecting it.

The means used for compliance with the determined limitations include:

- The purchase and sale of marketable instruments in all linkage segments (mainly securities for various periods);
- Investment in and raising of non-marketable financial instruments (mainly deposits by banks and large customers);
- Activity in derivative financial instruments with banks and large customers.

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## MANAGEMENT AND MEASUREMENT OF MARKET RISKS

The Directive in the matter of risk management No. 339 published by the Supervisor of Banks specified basic principles for the management and control of the various risks. Within this framework, a duty has been imposed on the Board of Directors to discuss the Bank's policy with respect to risk management and to approve it, intensifying the Board's involvement in these matters. Among other things, the Board discusses the exposure document that summarizes the total market risks to which the Group is exposed. According to the said Directive, the Bank is required to manage exposure to market risks through an information system based on an internal model.

### (1) BASE RISK EXPOSURE

The exposure to base risk is reflected in the loss which may incur as a result of changes in exchange rates or in the consumer price index, due to the difference between the value of assets and liabilities, including the effect of forward transactions and the effect of options embedded in the base exposure. Exposure to linkage base risk is measured in the CPI linked segment and in the foreign currency segment (including Israeli currency linked to foreign currency).

The following is a summary of the net linkage balances<sup>(1)</sup>:

As at December 31, 2010					
	Non-linked shekels	CPI linked shekels	Foreign currency <sup>(2)(3)</sup>	Non-monetary asset	Total
in NIS millions					
Assets	93,112	27,743	58,827	6,132	185,814
Liabilities	85,645	22,654	65,316	630	174,245
<b>Balance sheet difference</b>	7,467	5,089	(6,489)	5,502	11,569
Derivative instruments	(1,257)	(2,679)	3,936	-	-
Options	(241)	12	226	3	-
<b>Total Difference</b>	5,969	2,422	(2,327)	5,505	11,569

As at December 31, 2009					
Assets	*86,750	28,323	*66,052	*6,692	187,817
Liabilities	*80,631	23,286	*72,681	*924	177,525
<b>Balance sheet difference</b>	6,116	5,037	(6,629)	5,768	10,292
Derivative instruments	(89)	(4,773)	4,862	-	-
Options	(164)	146	16	2	-
<b>Total Difference</b>	5,863	410	(1,751)	5,770	10,292

Footnotes:

- (1) The above presented data reflect the accounting positions, which differ from the economic positions in the various linkage segments, on the basis of which the daily exposure management is actually performed (see hereunder).
- (2) The base exposure is computed in accordance with generally accepted accounting principles, as stated in Note 17 to the financial statements. For current management purposes, certain changes have been implemented, which take into account the Bank's economic approach to base exposure. Exposure to foreign currencies is permitted within the limitations approved by the Bank's Board of Directors.
- (3) Including foreign currency-linked shekels.

The exposure to base risk is measured and managed as a percentage of the Bank's available economic capital. The Bank's available economic capital is defined as the Bank's equity, less fixed assets and with the addition of investments in foreign subsidiaries that are financed from foreign currency deposits and with the addition of adjustments required for the economic presentation of exposure to base risks. The mix of investments of the available economic capital in the various linkage segments is determined on current basis within the framework of the limitations presented below and on the basis of forecasts regarding the relevant market variables.

Following is the distribution of investment of the Group's actual available financial capital compared to the limitations (the data is presented in relation to the available economic capital):

Segment of operations	Limitation	2010				2009			
		Year end	Range of exposure		Year end	Range of exposure			
			From	To		From	To		
Non-linked Shekel	The balance	69%	68%	95%	79%	90%	75%	93%	83%
Linked Shekel	(40%)-80%	29%	2%	30%	19%	5%	5%	22%	14%
Foreign currency	(25%)-25%	2%	1%	5%	3%	5%	1%	6%	3%

\* The comparative data for 2009 have been modified to agree with the computation made in 2010, which includes also exposure to linkage base risk of ICC and of the severance pay fund.

No deviations from the limitations were recorded in 2010.

**Capital sensitivity to changes in exchange rate.** The capital's sensitivity to changes in exchange rate is presented in the following table, which provides details regarding the impact of changes in exchange rates of the major currencies on the Bank's equity as of December 31, 2010.

The Bank's capital sensitivity of changes in exchange rates				
in NIS millions <sup>(1)</sup>				
Segment	10%	5%	-5%	-10%
USD	(115)	(58)	44	83
EUR	(14)	(12)	25	54
GBP	6	8	(8)	(16)
CHF	(1)	-	-	1

Notes:

- (1) The theoretical change in the economic value of the Group (in terms of present value) as a result of the scenario.
- (2) The theoretical calculation made in respect of the Japanese Yen indicated negligible changes in the economic value, and therefore is not presented in the table.

This effect has been computed on the basis of the expected change in the fair value of the Group in the various currencies, given the scenario determined by the Supervisor of Banks.

## (2) INTEREST RISK EXPOSURE

### A. General

Interest risk is the risk of impairment of the Bank's capital and earnings as a result of changes in market interest rates. The risk derives from the exposure to future changes in interest rates and their possible effect on the present value of assets and liabilities including certain economic amendments. Management of interest risk exposure is performed for each of the linkage segments separately.

### B. Sensitivity analysis to the effect of changes in interest rate based on the fair value of financial instruments

**Fair value of financial instruments.** Most of the Bank's financial instruments do not have a ready "market price" because there is no active market in which they are traded. Therefore, in accordance with the instruction, fair value is based on accepted pricing models, such as the present value of future cash flows discounted at a rate which reflects the estimated risk level related to the financial instrument.

Assessing the fair value by discounting future cash flows and determining the discount rate, is subjective. Therefore, the data for most of the financial instruments given hereunder, does not serve as an indication for the realization value of the financial instrument on the reporting date. Discounting the future cash flows was made, where possible, by discount rates in effect at the reporting date, without taking into consideration fluctuations in interest rates. Using different discount rates assumptions, may result in significantly different fair value amounts. This relates particularly to financial instruments bearing a fixed interest rate or non-interest bearing. Additionally, in arriving at the fair value amounts, no consideration was given to commissions receivable or payable as part of the business activity, neither do they include the tax effect.

It should be further noted, that the differential between the book value of the financial instrument and its fair value, may never be realized, as the Bank usually holds the financial instrument to maturity.

In consequence of the above, it should be stressed that the data included in this Note, is no indication of the Bank's value as a going concern.

Furthermore, due to the wide range of valuation techniques and possible assessments used in determining the fair value, and in view of the methods and assumptions used in applying the instruction, care should be taken when examining the fair value data itself as well as when comparing it with the fair value data presented by other banks.

**Hybrid financial instruments** are debt instruments, in which are embedded derivative components that have not been separated

there from. In providing information regarding fair value, the Bank is not required to classify financial instruments as hybrid financial instruments, because, according to the Bank of Israel's guidelines, the interest rate exposure of these instruments included the division of such transactions according to maturity dates, while separating the option component from these instruments. Following are details of the hybrid financial instruments, where in the disclosure regarding exposure to changes in interest rates, the separated option and the host instrument have been treated as standalone instruments (the effect on the financial statements is not material): deposits with the option of a fixed rate of interest or of a variable rate of interest, savings deposits linked to the CPI or linked to foreign currency with an option for changing the linkage base and an option securing the Shekel principal sum deposited, deposits and loans linked to the CPI or linked to foreign currency with an option for securing the Shekel principal sum.

For further details regarding the main methods and assumptions used in assessing the fair value of financial instruments, see Note 21 to the financial statements.

Fair value of the Bank and its consolidated subsidiaries' financial instruments, excluding non-monetary items (before the effect of hypothetical changes in interest rate

	December 31, 2010					
	Israeli currency		Foreign currency**			Total
	Non linked	CPI linked	US\$	Euro	Other	
In NIS millions						
Financial assets*	90,554	28,781	45,919	7,237	4,874	177,365
Amounts receivable in respect of derivative and off balance sheet financial instruments***	60,445	961	42,125	9,528	8,283	121,342
Financial liabilities*	(83,103)	(23,236)	(52,165)	(8,905)	(3,913)	(171,322)
Amounts payable in respect of derivative and off balance sheet financial instruments***	(61,699)	(4,785)	(38,499)	(8,231)	(9,246)	(122,460)
<b>Net fair value of financial instruments</b>	<b>6,197</b>	<b>1,721</b>	<b>(2,620)</b>	<b>(371)</b>	<b>(2)</b>	<b>4,925</b>

For notes to the table see next page.

Fair value of the Bank and its consolidated subsidiaries' financial instruments, excluding non-monetary items (before the effect of hypothetical changes in interest rate (continued)

	December 31, 2009					
	Israeli currency		Foreign currency**			Total
	Non linked	CPI linked	US\$	Euro	Other	
In NIS millions						
Financial assets*	85,510	29,611	51,381	8,756	4,913	180,171
Amounts receivable in respect of derivative and off balance sheet financial instruments***	48,993	521	31,365	10,184	8,672	99,735
Financial liabilities*	(78,941)	(24,123)	(56,672)	(11,485)	(4,115)	(175,336)
Amounts payable in respect of derivative and off balance sheet financial instruments***	(48,820)	(5,920)	(28,541)	(7,531)	(9,420)	(100,232)
<b>Net fair value of financial instruments</b>	<b>6,742</b>	<b>89</b>	<b>(2,467)</b>	<b>(76)</b>	<b>50</b>	<b>4,338</b>

\* Not including balances of derivative financial instruments and fair value of off-balance sheet financial instruments.

\*\* Including Israeli currency linked to foreign currency.

\*\*\* Amounts receivable (payable) in respect of financial instruments, discounted at interest rates used to compute the fair value presented in Note 20 to the financial statements.

Effect of hypothetical changes in interest rate on the fair value of financial assets of the Bank and its consolidated subsidiaries, excluding non-monetary items

December 31, 2010									
Change in interest rate	Fair value of financial instruments, excluding non-monetary items****						Change in fair value		
	Israeli currency		Foreign currency**				Total	Total	Total
	Non linked	CPI linked	US\$	Euro	Other	Offsetting effects			
In NIS millions									
Immediate parallel increase of 1%	6,045	1,825	(2,904)	(370)	(1)	(2)	4,593	(332)	(7%)
Immediate parallel increase of 0.1%	6,188	1,731	(2,610)	(390)	-	-	4,919	(6)	-
Immediate parallel decrease of 1%	6,381	1,599	(2,607)	(416)	1	(3)	4,955	30	1%
December 31, 2009									
Immediate parallel increase of 1%	6,685	159	(2,523)	(70)	46	-	4,297	(41)	(1%)
Immediate parallel increase of 0.1%	6,783	103	(2,502)	(89)	49	-	4,344	6	-
Immediate parallel decrease of 1%	6,921	36	(2,756)	(117)	53	-	4,137	(201)	(5%)

\* Not including balances of derivative financial instruments and fair value of off-balance sheet financial instruments.

\*\* Including Israeli currency linked to foreign currency.

\*\*\* Amounts receivable (payable) in respect of financial instruments, discounted at interest rates used to compute the fair value presented in Note 21 to the financial statements.

\*\*\*\* The net fair value of financial instruments presented in each linkage segment, is the net fair value in the segment, on the assumption that the change noted in all interest rates applying to the segment has in fact occurred. The total net fair value of financial instruments is the net fair value of all financial instruments (excluding non-monetary items) on the assumption that the change noted in all interest rates applying to all segments has in fact occurred.

Raising the discount rate by one percentage point would have reduced the fair value of problematic debts by NIS 74 million. Raising the discount rate by 0.1 percentage point would have reduced the fair value of problematic debts by NIS 4 million (compared to NIS 54 million and NIS 6 million respectively, as of December 31, 2009).

**C. Data used for the management of interest rate risk.** The data presented in item "B" above, was computed on the basis of fair value, as required by the public reporting directives of the Supervisor of Banks and in accordance with the computation of Schedule "D" to the Management Review, hereunder.

The current management of exposure to interest rates applies to all of the Bank's operations, and takes into consideration additional data that represent the Bank's economic approach to the management of exposure of the economic value of the Bank's equity to changes in interest rates. Taken into special consideration are the following:

- Various future exposure which do not match the requirements for inclusion in the accounting computation approaches;
- Prices reflecting the alternative cost as seen by the Bank according to changes in market prices (and not in relation to changes in the credit risk of cash flows);
- Balances that have an economic effect that differs from their accounting effect (such as adjustments relating to tax hedging on investments in foreign subsidiaries).

This additional data leads to an assessment of the economic value and to assessments of the exposure to interest rate changes, which differ from the parallel assessments derived from the accounting data.

Following are details of the effect of hypothetical changes in interest rates of 100 base points on the Group's economic value:

December 31, 2010					
The change in interest rates	Unlinked	CPI linked	US dollar	Other foreign currency	Total
In NIS millions					
An increase of 100BP in interest rates	(102)	(36)	(87)	8	(217)
A decrease of 100BP in interest rates	120	25	(194)	9	(58)

December 31, 2009*					
The change in interest rates	Unlinked	CPI linked	US dollar	Other foreign currency	Total
In NIS millions					
An increase of 100BP in interest rates	(89)	31	(51)	1	(108)
A decrease of 100BP in interest rates	102	(40)	(218)	(4)	(160)

\* The comparative data for 2009 have been modified to agree with the computation made in 2010, which includes also exposure to linkage base risk of ICC and of the severance pay fund.

The limitation determined by the Board for interest risk exposure in the various linkage segments relates to the maximum damage to economic capital resulting from concurrent movements in the yield curve of 1% in each segment.

The limit was set at 9% of the equity on the group's exposure to a change of 1% in the interest graphs in addition to the limits determined by the banking subsidiaries. In 2010, the Bank and the Group complied with the determined exposure limits.

Measurement of the risk at the Bank is performed in weekly intervals. The results of the measurements are reported to the financial forum on a weekly basis and to the asset and liability management committee on a monthly basis, and in quarterly intervals to the Board of Directors, within the framework of the exposure document.

The measurement at the banking subsidiaries is carried out using a similar methodology and at a frequency of at least once a month. Exposure to interest risk is managed individually by each of the companies by means of the entities authorized for this purpose.

#### D. The characteristics of interest rate risk with respect to the banking book

The banking book contains most of the interest rate risks of the Group and includes the Bank's activity in the granting of credit, in the purchase of securities and in attracting deposits and the issuance of capital notes. Such activity is affected by strategic considerations and by a long-term view of the Bank's interest rate risk propensity.

The Group's banking book in Israel is directed towards risking exposure to Shekel and CPI linked interest rate changes, while the banking book of the foreign subsidiaries includes exposure to foreign currency interest rate risks (primarily U.S. dollar interest rate), including the risk of early repayment of the Bank's assets and liabilities.

Following is the effect of a hypothetical change of 100 base points in the interest rate applying to the Bank portfolio:

December 31, 2010					
The change in interest rates	Unlinked	CPI linked	US dollar	Other foreign currency	Total
In NIS millions					
An increase of 100BP in interest rates	(99)	(34)	(76)	6	(203)
A decrease of 100BP in interest rates	116	23	202	(8)	(71)

Following is the effect of a hypothetical change of 100 base points in the interest rate applying to the Bank portfolio (continued):

December 31, 2009*					
The change in interest rates	Unlinked	CPI linked	US dollar	Other foreign currency	Total
In NIS millions					
An increase of 100BP in interest rates	(82)	5	(46)	(8)	(130)
A decrease of 100BP in interest rates	94	(14)	(223)	5	(137)

\* The comparative data for 2009 have been modified to agree with the computation made in 2010, which includes also exposure to linkage base risk of ICC and of the severance pay fund.

No weekly cumulative change occurred in the past ten years, which had it occurred in the reported period would have adversely affected the "going concern" assumption used at the basis of preparation of the financial statements.

The following is a summary of the Bank's and its consolidated subsidiaries' exposure to fluctuations in interest rates, including the internal rate of return (IRR) and the average maturity, as per the various linkage segments (in NIS millions) Including assumptions regarding early repayments:

	As at December 31, 2010			As at December 31, 2009		
	Shekels		Foreign currency and foreign currency linked	Shekels		Foreign currency and foreign currency linked
	Non-linked	CPI linked		Non-linked	CPI linked	
Total Assets	150,999	29,742	117,966	134,503	30,132	115,271
Total Liabilities	144,802	28,021	120,959	127,761	30,043	117,764
Average maturity (years):						
Assets	0.99	3.83	1.05	0.99	3.69	0.86
Liabilities	0.66	3.98	0.69	0.74	3.83	0.73
<b>Average maturity gap</b>	0.33	(0.15)	0.36	0.25	(0.14)	0.13
<b>IRR gap</b>	3.60	0.76	2.13	3.04	0.59	2.51

### (3) THE VALUE AT RISK (VAR)

**General.** As detailed above, the Bank implements various measures to manage exposure to market risks, in addition to the probability model - the VaR model. This model is compatible with directives for risk management issued by the Supervisor of Banks. The VaR comprises a principal indicator to the extent of the Bank's exposure to market risks. An analysis of its results and examination of changes therein over time allow management to obtain information as to the market risk level inherent in the Bank's overall activities. The VaR assesses the maximum damage that might be caused to the Bank as a result of market risks being materialized in a given time period and at a defined statistical security level. This damage reflects erosion in the Bank's value (in fair value terms).

The Bank is required to manage the exposure to market risk by means of an information system based on an internal model, which enables a current measurement of the Bank's overall exposure to market risk by assessing the VAR.

**The nature and scope of the risk reporting and measurement systems.** The VaR computation (at the Bank's level) is made by the Riskpro system. By using the system, the VaR is computed on all the activity at the Bank level and on operations/portfolios, similarly additional risk indices and simulations are carried out and the interest rate exposures are measured.

The VaR is computed according to a parametric model based on the historical behavior of various market risk factors in the period preceding the computation (one year), assuming normal distribution of the changes in the parameters. The computation regarding all the activity at the Bank level is performed on a weekly basis and on a daily basis regarding the trading activity.

The Board of Directors determined a limitation according to which the VaR of the Group's portfolio (for a range of ten days and at a precision level of 99%) should not exceed 4% of the equity. The VaR at the Group level is computed on a monthly basis.

Following are data regarding the assessment of Discount Group's VaR amount:

	2010			2009	
	At year end <sup>(1)</sup>	Yearly average	Maximum	Minimum	At year end
	in NIS millions				
Estimate of VaR amount (in NIS millions, Group)	180	130	180	72	144

The weight of the VaR in relation to the shareholders' equity as of December 31, 2010 is 1.6%, compared with 1.4% at the end of 2009. The increase in the assessment of the group VaR stems, mostly, from the inclusion of the assets of the severance pay fund in this assessment.

**Back Testing.** The VaR model, as a statistical model, requires concurrent testing of the reliability of its forecasts, through post factum measurement (Back Testing). This test computes the actual change in the Bank's economic value. The validity of the model is tested according to quantitative deviation of the loss amount from the VaR estimate. The tests that have been implemented to date confirm the model's validity.

Over the past three years, Back Testing examination has revealed 2 deviations (in the amounts of NIS 17 and 21 million), a fact that supports the validity of the model.

**Limitations of the VaR model.** As stated, the VaR constitutes a statistical tool that bases assessment of the value at risk on previous market performance and on assumptions regarding future cash flow performance. The limitations of the model are sourced in:

- The model assumes that the changes in risk factors are divided normally. While this assumption is required for approximation purposes, it does not necessarily reflect market performance;
- The computation of the VaR for a holding period of ten days assumes that the positions are realizable or could be terminated within that period. In certain market circumstances such an assumption may not materialize and the loss would be greater;
- Utilization of a significance level of 99% disregards losses that may be realized beyond this level of significance (end distribution);
- Utilization of historical data may not include extraordinary events in the sample.

Accordingly, the VaR does not assess a loss that may occur in such circumstances and its results should not be treated as a real loss barrier, which the Bank might sustain in extreme scenarios. A more appropriate assessment may be obtained through examination of the potential loss in an extreme scenario (as detailed below).

#### (4) ANALYSIS OF THE IMPAIRMENT IN ECONOMIC VALUE UNDER STRESS TESTS

Global and domestic markets are subject to periodic instability resulting from extraordinary events. Such events may be related to a general crisis (e.g. war, political upheaval, natural disaster, etc.) or to turbulence in financial markets, and are reflected in material changes in interest rates exchange rates, and/or in exceptional fluctuations in these factors, which deviate from general historic behavior. The risk management process is intended, inter alia, to protect the Bank from an extreme loss that may be incurred as a result of such events. Even though the VaR is the most suitable measurement tool for assessing the overall exposure to market risk, it does not provide information as to losses that may occur in "abnormal" market situations, which exceed the clear levels which had been determined.

Stress tests enable the examination of the possible implications of such extreme events, thus constituting a complementary layer for the examination of exposure to market risks performed in accordance with the VaR model.

The Bank has established a stress test forum, headed by the Bank's CRM, that examines extreme scenarios, at least once every quarter. Participating in the Forum are the chief economist, representatives of the business factor (assets and liabilities management and the dealing room) as well as the risk management department and the market and liquidity risks controller. In the forum meetings, the results of defined scenarios are reviewed and their effect on the Bank's portfolio are examined. The forum also sets, to the extent necessary, additional extreme scenarios which ought to be examined.

Following changes in the markets, new extreme scenarios were added in September 2008.

The Forum also determines extreme scenarios for the banking subsidiaries and examines the effect of these scenarios on their operations.

The Bank and its principal subsidiaries examine some fifteen extreme scenarios that include changes in interest graphs (corresponding and non-corresponding), changes in currency exchange rates and in the CPI and changes in the spreads of investments in corporate bonds.

Following are details of the main extreme scenarios implemented at the Bank:

- Scenarios of extreme changes in market data as from the year 2000;
- Scenarios of changes occurring in the markets during the crisis of October 1998;
- Scenario of deterioration in the security situation in Israel;
- Scenario of a financial crisis in the U.S.A. and in Europe (a theoretical scenario updated and tested in view of the crisis in those markets in recent years, where the theoretical scenario is even more severe in certain parameters);
- Scenario of a global rise in prices;
- Scenario of a crisis in emerging markets;
- Scenario of an extreme event that includes severe assumptions as regards changes in interest rates.

The limit applying to the maximum damage to the economic value of the Bank's equity in extreme scenarios, was determined so that it should not exceed 12.5% of the Bank's equity.

The Bank has complied with this limitation during 2010.

#### **(5) THE NET INTEREST INCOME (NII) MODEL AND THE EARNINGS AT RISK (EAR)**

In addition to a sensitivity test of the economic value of the equity, the Bank examines the impact of defined changes in interest rates on interest income. This examination is implemented through dynamic simulation of the net interest income for the coming year, in order to test the impact of various strategies for asset and liability management on the Bank's future interest income. The EAR index measures the sensitivity of interest income to changes in market yield.

It should be noted that this model is not used for the management of exposure to the Bank's interest rate risk, but serves as a model for the management of exposure to interest rate risks at IDB New York, and at Mercantile Discount Bank.

#### **(6) BEHAVIORAL ASSUMPTIONS APPLIED IN THE ASSESSMENT OF MARKET AND LIQUIDITY RISKS**

**Creditory current accounts spread model.** For purposes of assessing the exposure to interest risks, the Bank assumes that a significant part of creditory current account balances is not expected to be withdrawn immediately and is distributed over periods of one to seven years, in accordance with behavioral assumptions that are updated from time to time. The model was updated at the end of 2010, in a manner reflecting the Bank's assessments as to the measure of stability of current account balances.

**Models for quantifying early repayment of assets risk - prepayment risk.** The Group operates several models forecasting early repayments in its asset portfolio. The Bank also manages the early repayment risk of mortgage loans granted by Discount Mortgage Bank within the "Discount Outline". The model operated by the Bank is based on historical data of early repayments, similar to the model operated by Discount Mortgage Bank.

The subsidiary IDB New York makes use of models accepted in the U.S. for the forecasting of early repayment rates in the mortgage backed asset portfolio held by it.

### (7) THE STANDARD APPROACH TO THE ALLOCATION OF CAPITAL TO MARKET RISKS

The Bank computes the capital allocation required in respect of the exposure to market risks in accordance with the standard approach, as prescribed by Proper Banking Management Directive No. 208. The allocation of capital to market risks is done as follows:

- Interest rate and shares risk - allocation in respect of the portfolios managed at the Bank for trading purposes, including the overall activity of the dealing room. Computation of the interest rate risk is performed in accordance with the "period to redemption" method;
- Foreign exchange rate - allocation in respect of the Bank's overall activity;
- Option risks - allocation in respect of the Bank's overall activity, including embedded options. The computation is performed according to the "Delta plus" method.

Following are details of capital allocation to market risks according to the standard approach (Basel II guidelines):

	Capital allocation	
	As of December 31, 2010	As of December 31, 2009
The Bank:	In NIS millions	
Interest rate risk	*96	*69
Foreign exchange rate	76	*70
Share risk	1	-
Option risk	26	17
Total for the Bank	199	156
Total for subsidiary companies	33	64
<b>Total for the banking Group</b>	232	220
Allocation in risk terms	2,907	2,752

\* Including the specific risk in the amount of NIS 4 million and NIS 0.2 million in the years 2010 and 2009, respectively.

The allocation to market risks in risk asset terms comprises 2.05% of the total risk assets as of December 31, 2010, compared with 1.95% as of December 31, 2009.

The increase in the allocation of capital to market risks, stemmed from increased exposure of the Bank to the U.S. dollar and Euro currencies. Such increase was partly offset by a reduction in the allocation of capital in respect of subsidiaries.

### (8) MANAGEMENT OF TRADING POSITIONS

The Bank distinguishes between exposure created in the course of managing the Bank's assets and liabilities and exposure to trading. The trading positions are the result of the Bank's activity as a market maker and a result of dynamic management of its liquid financial asset portfolio. The trading activity is intended at creating income while enabling exposure within the approved risk range for this activity, and maintaining daily and sub-daily monitoring and control.

The Board of Directors has determined separate sets of limits pertaining to trading activities and to asset and liability activities. Limitations on trading activity were determined by the Board of Directors in terms of scope of activity, sensitivity to risk factors and theoretical losses incurred, including in extreme scenarios, and in terms of the value at risk (VAR). The management and

control factors regarding these activities have also been determined.

The trading activity is conducted while measuring on a daily basis compliance with the limits, effected by the entity managing the portfolio and a daily control effected by the entity in charge of controlling compliance and profitability.

For the purpose of computations of capital allocation to market risks in the first pillar, the Bank has determined the positions to be included in the trading portfolio. Such positions comply with the requirements of Basel II guidelines and include financial instruments held for trading as well as instruments hedging other components of the trading portfolio. The Bank has defined that the portfolio shall include the activity of the dealing room as well as certain activities relating to bonds. The volume of the trading portfolio of subsidiaries is not material.

### **(9) OPTION RISKS**

Option risks relate to the loss that might be incurred as a result of changes in base assets and the volatility thereof, which affect the value of such options, including standard deviations.

The Bank's Board of Directors has set out guidelines regarding the permitted activity in options both as regards overall volume and in terms of the maximum impairment in value under stress tests and in case of a moderate scenario.

The scenarios relate to simultaneous changes in exchange rates or indices and in the volatility of base assets. In addition, the dealing room procedures include limitations on maximum changes in the value of the option portfolio in terms of sensitivity indices ("GREEKS").

The boards of directors of the principal banking subsidiaries have also set limitations on the activity in options. No deviations from the limits set out by the Board of Directors were recorded in 2010.

### **(10) ACTIVITY IN DERIVATIVE FINANCIAL INSTRUMENTS**

The Bank's transactions in derivative financial instruments are made partly with banking institutions or Tel-Aviv Stock Exchange members, who are subject to capital adequacy requirements or compliance with the level of security required by the Tel-Aviv Stock Exchange, and partly with other Bank's customers, who provide security in accordance with the Bank's procedures.

These transactions are implemented both for the Bank's customers and for the Bank itself, for hedging and for other purposes. The dealing room implements trading activity and risk hedging activity for customers as part of its market risk management. Subject to the limitations set out by the Board of Directors, further internal limitations were fixed for the dealing room with regard to this area of operations.

The Bank is active in a wide range of derivative financial instruments both in shekels and in foreign currency, including regular options and "exotic" options of certain types and acts also as a "market maker" for some of which. A substantial part of the transactions are made "over the counter" (OTC) in accordance with customer needs and those of the Bank. The price determination for these transactions is based on returns and prices of base assets using accepted pricing models and taking into account market competition.

The Board of Directors has determined the mode of the Bank's operation in derivative financial instruments, maximum volume of activity and the range of financial instruments in which the Bank may engage (whether on behalf of its customers or its own account). The volume of operations for each derivative financial instrument has been determined in addition to other limitations, this, among other things, in order to restrict the operational risk involved in such operations therefore, the volume of activity in respect of a certain instrument does not necessarily represent the level of risk inherent therein.

One deviation from these limits was recorded in 2010.

In addition, the Bank has determined limits to the combined exposure to certain currencies of all Bank customers. Two deviations from such limits were recorded in 2010.

Exposure created as a result of transactions in derivative financial instruments, both as regards linkage base and as regards interest rates, is included within the framework of the various limits imposed by the Board of Directors on exposure to linkage base, interest rates and options. The total exposure and compliance with the Board of Directors limits are being measured and controlled on an ongoing basis by the middle office.

Following are data as to the volume of operation in derivative financial instruments of the Bank and its consolidated subsidiaries

	As at December 31,	
	2010	2009
	in NIS millions	
Hedging derivatives	-	1,378
ALM derivatives	131,963	108,704
Other derivatives	44,826	42,476
Credit derivatives and SPOT foreign currency	5,164	4,630

**Accounting aspects.** The accounting policy with regard to the measurement of the value of derivative financial instruments and the results thereof is stated in Notes 1 J and 20 to the financial statements.

According to the said directives of the Supervisor of Banks, most of the transactions in derivative financial instruments made by the Bank for managing market risks resulting from its financial base assets (ALM) are classified as "ALM transactions" and not as "hedging transactions". In terms of the said directives more stringent criteria have to be complied with so that transactions in derivative financial instruments could be considered as "hedging transactions".

The majority of base assets, the exposure of which to market risk, as stated, was hedged by derivative financial instruments, are not marketable. Income and expenses generated by such assets are recognized on the accrual basis while the results of the transactions in derivative financial instruments defined as "ALM transactions" are computed, according to "fair value". Accordingly, no correlation exists between the recording of the base assets and the results they produce in accordance with generally accepted accounting principles and the transactions in derivative financial instruments in respect of those base assets, which are classified as "ALM transactions". The effect of the above was a reduction in the earnings from financing operations by NIS 146 million in 2010, compared with a decrease of NIS 247 million in earnings from financing operations in 2009.

Details of financing income from derivative financial instruments are presented in Note 23 to the financial statements.

**Activity in the Ma'of market.** The Bank operates in the Ma'of share index market only on behalf of customers, while maintaining the security level required by the Tel-Aviv Stock Exchange. The Bank operates in options on the dollar exchange rates in the Ma'of market both on customers' behalf and on behalf of the Bank itself. The Bank permits selected customers to operate on credit in the Ma'of market while monitoring closely, on an ongoing basis, the risk involved in the portfolio as compared with security received.

## MANAGEMENT AND MEASUREMENT OF THE LIQUIDITY RISK

The liquidity risk is a risk where the Bank will have difficulties in honoring its obligations due to unexpected developments, and will be forced to raise funds or to liquidate assets in a manner that will cause it material losses. As this involves an uncertainty situation, in which the liquidity risk always exists, the Bank has determined the maximum exposure to liquidity risk that it is willing to take.

The current measurement of the exposure to liquidity risk is intended to provide decision makers with indicators that forewarn the intensification of this risk, allowing the Bank a period of time in which it may counteract the risk without having to sustain material losses.

**Liquidity risk management.** The Bank manages its liquidity risks subject to the policy approved by the Board of Directors and reflecting the guidelines of the Regulator on the subject and the accepted principles in this matter. This policy, formed and approved during 2010, represents a higher level of capability to manage the liquidity risk and apply the Basel guidelines in this respect. The policy includes reference to a number of stress tests, the structure of the resources of funds, the liquidity cushion and the fixing of limits regarding the various risk assessments. The policy includes in addition the Bank's plan for dealing with a liquidity crisis, including defining indicators used for the identification of trends in the liquidity risk.

The internal model used at present by the Bank is an improved model tested during 2010, alongside use of the previous model. At the beginning of 2011, the Board of Directors approved the use of this model for liquidity risk management.

The internal model for the assessment of the liquidity risk and examines the effect of various stress tests on the Bank's assets and liabilities, whether stemming from events having a specific effect on the Bank's liquidity or stemming from developments affecting the general system.

The model is based, among other things, on the following principles:

- Separation between short-term and long-term liquidity;
- Separate management of the liquidity risks in the shekel segment (including CPI linked and foreign currency linked) and in the foreign currency and foreign currency linked segment;
- Differentiation between depositors according to behavioral pattern;
- Classification of assets and liabilities according to maturity periods on an economic basis.

In addition to the said internal model an improved version of the model in the stage of experimental operation is concurrently also in operation.

The liquidity risk management process takes into account, among other things, the Bank's policy and the trends in the financial markets, the structure and distribution of deposits and their recycling rates, the Bank's goodwill and rating, volume of the securities portfolio and extent of its diversity, the size of the relevant market and price volatility.

The Bank's liquidity risk model also takes into consideration the Bank's evaluation regarding the liquidity situation of subsidiaries, including their present and future liquidity requirements.

The Banking subsidiaries also conduct their liquidity risk management in accordance with the requirements.

A Liquidity Forum is run by the Bank convening at least once a week discussing the liquidity situation and examines the application of decisions made by management factors.

**Limitations on the exposure to liquidity risks.** The limitations determined by the Board of Directors in the approved new policy document, refer to a number of risk assessments as well as to the structure of assets and liabilities.

No deviations from the overall liquidity ratio were recorded at the Bank in 2010.

## SHARES POSITION IN THE BANK'S PORTFOLIO

### Strategy and processes

Within the framework of the policy for the diversification of investments, the Bank acts in two principal areas:

- Private equity funds, venture capital funds and a fund of hedge funds;
- Direct investments in companies considered as non-financial investments. For details as to the investment policy and the entities in which the Bank invests, see "Nonfinancial companies sub-segment" under "Activity of the group according to principal segments of operation".

Following are details regarding investments in shares

	December 31			
	2010		2009	
	Equity value	Fair Value	Equity value	Fair Value
	In NIS millions			
Investments in shares of affiliated companies <sup>(1)(2)</sup> :				
Non marketable shares	152	152	163	163
Shares in the available-for-sale portfolio:				
Marketable shares	39	55	50	53
Non marketable shares	626	626	650	650
Total shares in the available for sale portfolio	665	681	700	703
<b>Total investment in shares</b>	<b>817</b>	<b>833</b>	<b>863</b>	<b>866</b>

Footnotes:

(1) For further information, see Note 6.

(2) For details regarding an investment in the First International Bank, not included in the table, see Note 6 to the financial statements and "First International Bank of Israel Ltd." under "Main investee companies" below.

Capital requirement regarding share position<sup>(1)</sup>

	December 31	
	2010	2009
	In NIS millions	
In respect of investments in venture capital funds, in private equity funds and in fund of hedge funds <sup>(2)</sup>	69	68
In respect of investments in other shares <sup>(3)</sup>	17	20
With respect to owner's loans	10	11
<b>Total capital requirement regarding share position</b>	<b>96</b>	<b>99</b>
Investments deducted from capital <sup>(4)</sup>	1,548	1,654

Footnotes:

(1) The capital requirement was calculated on the basis of 9% and it does not include capital requirement in respect of investments in trading portfolio shares.

(2) These investments are averaged at risk weight of 150%.

(3) These investments are averaged at risk weight of 100%.

(4) Including investment in FIBI.

## OPERATIONAL RISKS

**General background.** An operational risk is defined in the directives of the Bank of Israel as a loss risk resulting from faulty data processing systems, human error and the lack of proper checks and controls.

The Discount Group offers its customers a wide range of financial services, starting with banking products such as deposits and commercial loans, continuing with foreign currency services, securities services, advisory and distribution services for pension products and ending with investment portfolio management, underwriting services, mortgage loans and so forth.

Realizing that a sizable operational risk is inherent in such a wide range of services and banking operations provided by the Bank and its subsidiaries, they endeavor to minimize the exposure to operational risk.

**Organizational structure of the operational risk management function.** The Chief Risk Manager bears the overall responsibility for the management of this risk at the Bank and the Group. Each Division or Layout Head is responsible for the management of

operational risks inherent in his area of activity. In addition, operating risk controllers serves at all of the Bank's divisions and layouts, the duty of which, among other things, is to assist the division or layout head in managing operating risks, including identification of the risks, their measurement and formation of plans for reducing them. Operating risk controllers communicate with and report to the risk management department. The Risk Management Department, which reports to the Chief Risk Manager, is in charge of formulating the operational risk management policy and is responsible of verifying its implementation while providing the necessary tools in this respect, formation of a methodology for identification and measurement of risks, monitoring and reduction of risks and reporting the results to the Risk Managers Committee, the Bank's Management and the Board of Directors. The department is also responsible for integrating the culture of managing the operating risks within the units of the Bank and the Group.

This structure of risk management enables the separation between those who take the risks at the various divisions and layouts who directly create the exposure to the risk and manage it, and those who engage and the factors engaged in the independent management of the risk.

Concurrently, the control entities – the officer in charge of money laundering prohibition, internal audit and compliance officer are independent entities who report directly to Management and/or to the Board of Directors.

The subsidiary companies have formulated an organizational structure to support the management of their operational risks along the same lines mutatis mutandis. Such an organizational structure will enable an efficient and overall Group management of the operational risks in the Group.

**Operational risk management policy.** In February 2011, a proposal for the updating of the policy was presented to the Risk Management Committee of the Basel, including a declaration of the risk appetite applying to the operational risks as well as monitoring thresholds. Upon approval of the proposal by the Board of Directors, the Bank will act to adopt it at Group level.

The objectives of the operational risk management policy are to define and communicate the operational risk management requirements to all the Bank's and group's units and to ensure the effectiveness of managing, controlling and supervising the operational risks inherent in the Bank's activities. The policy is also intended to ensure:

- Existence of processes for the identification, evaluation and ongoing monitoring of the risks, minimizing risk and current control in all Bank units;
- Existence of an organizational and operational structure at the Bank supporting operational risk management;
- Full reporting of failure events, including "almost failed" events, and the existence of an effective process for drawing conclusions.

In addition, the policy states that:

- The Bank's Management, by means of the Risk Management Department, is to examine consistently and in an ongoing manner the substance and intensity of the operational risks affecting the Bank in order to confront such risks in an effort to minimize the Bank's exposure to the occurrence of failure events. Such examination should take into consideration material changes in the following factors: relevant regulatory instructions, the economic situation and the level of exposure to risks in Israel and the world over, the organizational structure and work procedures at the Bank, information systems supporting the various procedures, business or operational processes, the volume of the Bank's operations (business and operational activities) which might change the scope of potential damage, technological tools, including the opening of systems to new distribution channels, implementation of means of control, integration of new information systems and the launching of new products;
- The Bank's Management on the one side and the Board of Directors on the other will examine, improve and intensify, where required, the core principles in the field of operational risk management, the risk tolerance declaration, definition of authority framework for taking on risks, definition and maintenance of the organizational structure supporting operational risk management;
- The limitations on the exposure to operational risks at the Bank and Group levels, will enable effective, responsible and cost

saving operational activity;

- The Chief Risk Manager is responsible for the development of methodology and models and for forming work tools and evaluation methods for the assessment of the operational risks of the Group in order to create quality, effective and active risk management at the Bank. The Chief Risk Manager is also responsible for reporting to Management and to the Board of Directors;
- In each division or layout, the officers taking the risk, from the lowest managerial level to top management level, are those in charge of the risk and responsible for its ongoing management by identifying the risk, evaluating its level, monitoring the risk, determining and effecting plans to reduce the level of the residual risk, as well as reporting to their superiors and to the Risk Management Department;
- The Risk Management Layout is responsible for the implementation of operational risk management by defining optimal work processes and procedures in this field;
- An examination, analysis and self evaluation of the operational risk management and their scale (RCSA) are to be performed periodically with respect to each risk center, taking into consideration the changes occurring in new processes, new operations and products. The evaluation is to be performed in accordance with the risk evaluation methodology used by the Bank during the operational risk survey, while giving special attention to the control environment.

**Risk evaluation methodology.** The risk evaluation methodology has been formed by the risk management layout and is used by the Bank and its subsidiaries in their current evaluation, both of existing risks and of new risks involved in new work processes and new products.

Each manager of a risk center is responsible for identifying and evaluating the risks and controls existing in the work processes under his responsibility. The risk center manager is responsible for identifying and updating the various parameters related to risk evaluation, following changes in work processes or a change that affects the quality of the control environment.

The risk evaluation averages out the characteristics of the process and the volume of the damage that might occur as well as the effectiveness level of existing controls, based on defined parameters. The combination of risk evaluation and existing controls enables the evaluation of the residual risk in qualitative terms.

**Allocation of capital.** Allocation of capital in respect of operating risk is undertaken by the Discount Group according to the basic indicator approach. Under this approach, the capital allocation required in respect of the operational risk, is computed by multiplying the net gross income by a coefficient of 15%.

In accordance with guidelines of the Supervisor of Banks, banks using the basic indicator approach will be required to adopt the standard approach no later than the report for 2012. Under this approach, gross income is divided into eight business lines defined by Basel II, which are grouped into three groups of coefficients: retail banking income is multiplied by a coefficient of 12%; corporate and commercial banking income is multiplied by a coefficient of 15%; income from the financing of corporations in respect of mergers and acquisitions, dealing rooms operations and investment income are multiplied by a coefficient of 18%.

The Bank makes preparations in order to comply with the time table determined by the Supervisor of Banks.

**Current management of operational risks.** The Bank examines on an ongoing basis exposure to operational risks and implements measures for the reduction in the material risks level. The risk centers managers (the reviewed units) are taking steps towards the implementation of the risk reduction plans and update on a quarterly basis, the information regarding the progress of implementation of the new controls. The performance status regarding the implementation of the reduction plans is reported to management and the Board of Directors on a quarterly basis. The risk centers managers update the risk maps on a regular basis, following the implementation of controls (information systems, procedures, reports etc.), identify and evaluate risks and controls applying to new work processes or following changes in existing work processes, etc.

**Operating failure events.** Investigating and reporting failure events comprising an integral part of the current risk management in its framework, the managers of risk centers report and investigate failure events that have occurred, draw conclusions and improve and strengthen controls over the various processes. The Bank is setting up a data base concerning the realization of operating

failure events based on reports by the Bank's different risk centers. The Bank endeavors to achieve a wide and comprehensive data base of failure events, including events where no damage had been suffered by the Bank or which are considered "almost suffered". Such data base will enable the analysis of failure factors, the treatment of risk centers identified and the establishment of risk indicators that would allow, in the future, the monitoring of risks prior to their materialization.

The Bank is at the final stages of the project for the modification and integration of the operational risk management system that will serve the Bank Group. The system will be gradually integrated in the Bank and in the Group during the years 2011-2012.

**Reducing exposure to operating risks through the purchase of insurance.** The means applied by the Bank with a view of reducing exposure to operating risks, include, among other things, the purchase of a designated bank insurance policy within a responsibility limit of US\$100 million, that hedges a part of operating risks to which the Bank is exposed.

The Bank's insurance policy includes several relevant sections, namely: (1) Banking insurance section, focusing on events such as betrayal of trust by Bank employees, monies and valuable assets at the Bank's premises, monies and valuable assets in transit, forgery of checks, forged collateral and forged monies; (2) Computer offences insurance section, focusing on events such as fraudulent or malicious input of electronic data directly into the Bank's computer systems or of a service bureau, or into an electronic money transfer system or to a customer communications system, fraudulent or malicious change or destruction of electronic data; (3) Professional liability insurance section, intended to insure the Bank in respect of its legal obligations to third parties, considering a lawsuit or claim for damages in respect of a financial loss resulting from negligent action, error or omission or betrayal of trust on the part of a Bank employee; (4) Personal deposit boxes insurance intended to insure the Bank in respect of loss or damage to customers' assets, including cash and jewelry stored in personal safety deposit boxes provided on the Bank's premises within the boundaries of the State of Israel.

Furthermore, within the framework of the insurance policy issued to companies in the Discount Bank Group, the Bank had purchased insurance coverage for claims against Directors and Officers within a responsibility limit of US\$100 million.

In addition, the Bank purchased an "Expanded Fire" policy to insure its property, an insurance covering its liability under law for bodily harm in the amount of US\$50 million, and employer liability insurance in the amount of US\$30 million.

The scope of the Bank's insurance coverage has been examined with the assistance of an independent professional advisor and is in compliance with Proper Banking Management Directives Nos. 301 and 352.

## INFORMATION TECHNOLOGY RISK MANAGEMENT

**General.** The IT layout is a central component in the proper operation and management of a banking corporation, in view of the information, including all its aspects and ramifications, having a decisive influence over the stability of the corporation and its development. The IT risks are operational risks applying to information systems in the process of production, cross company IT processes as well as new activities.

The head of the Technologies and Planning Division is responsible for IT risk management at the Bank and at the subsidiary companies. He serves as chairman of the group information technology risk management committee and reports to the Board of Directors and to Management, at fixed intervals, on deviations from the risk tolerance limit applying to the IT field at the Bank and at the subsidiaries in the group, which receive services from the Technologies and Planning Division. Such reports refer to risks at a "very high"/"high" exposure level, material failure events and correcting measures taken in their respect.

In order to deal with IT risks and in an attempt to minimize the exposure of the Bank and its subsidiaries in the Group to failure events in the information systems, the Bank's Management has appointed an IT risk manager, whose duties are to outline the IT risk policy, to guide and control the computer units of the Bank and of the Group in managing the IT risks on a consistent and ongoing basis. As a general rule, the methodology for managing the IT risks is based on the Bank's methodology for the management of operational risks as defined and applied by the risk management layout (with the necessary adjustments to the information technology field).

Among his duties, the IT risk manager has to act in accordance with the policy for IT risk management, in order to assure the

existence of the following processes:

- Control procedures assuring that exposure to IT risk shall not deviate from the IT risk appetite and exposure limits determined in accordance therewith;
- Real-time monitoring of IT exposure;
- Initiating a periodic self evaluation of the risk and of the effectiveness of the risk management process;
- The integration of the principles of the IT risk management policy at the Bank and at the subsidiary companies, and the existence of supervision and control procedures over the appropriateness of the implementation of the policy, within the framework of the group risk management.

**The core processes for risk management.** Identification of IT risks – a process, the aim of which is to assure that all risk factors and their characteristics are fully identified in relation to the Bank's every system, infrastructure and the operation, so as to avoid a situation where the Bank is exposed to unidentified or partly identified IT risks.

Measurement and evaluation of IT risks – one of the central stages of the risk management process serving as a basis for the monitoring of exposure and applying preventive measures.

The Bank is in the midst of forming an IT risk management policy document, in which, among other things, will be defined the duties and authority of the various control circles, in accordance with the principles outlined in the basic risk management document. Approval of the policy and its integration and implementation in the Group document may constitute a significant improvement in the ability and quality of risk management at the Discount Group.

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## IT RISKS

**IT crosswise processes risks.** Operational risks inherent in the crosswise work procedures performed at all computer units of the Technologies and Planning Division. Identification of risks is achieved by the operational risk management survey made by the Bank. The survey is performed once every several years and covers all of the Bank's operational activity. It is the responsibility of the IT risk manager to manage the risks identified in the crosswise IT processes of the Bank and of its subsidiaries in the Group, including the monitoring and control over the ongoing updating of the risk map and the monitoring of the implementation of the risk reduction programs by the managers of the risk centers. The IT risk unit, headed by the divisional operational risk controller answering to the IT risk manager, acts towards the realization of this responsibility.

**Risks applying to the production systems and to infrastructure components of the IT.** Risks stemming from the current operation of the system and/or an infrastructure component, including information security risks and direct communication banking risks, which may materially affect the Bank's business and/or operational processes at various critical levels. Under Proper Banking Management Directive No.357, the Bank has to perform a risk evaluation of the IT layout, with the aim of identifying the production systems and infrastructure components at a high risk level, with reference to the overall potential risks relating to the management of the IT layout, including the banking corporation's internal and external users of the system, the environment of the system, operation of the system and its impact on the business of the corporation, the sensitivity of the information and outsourcing. The risk evaluation process is continuous and is updated in accordance to changes in the various risk factors.

In according with the risk evaluation, a multi-annual work plan is being formed for the performance of information system surveys, information security surveys and controlled penetration attempts of the IT layout.

**Risks applying to new activities of the IT.** Project risks - project risks are defined as risks that may hinder attainment of the project targets (content, budget, time-tables). Such risks are managed as an integral part of the project management and supported by the **project management tools**. The project manager in the Technologies and Planning Division is responsible for the risk management and control process as well as for the implementation of risk reduction plans and alternative plans.

Launching risks – Launching and transition to production dates are defined as a critical stage having high exposure level of risk

components. Therefore, identification of risks and their evaluation is made at this stage. Identification of risk at the various work stages (characterization, development, tests etc.) of new activities and projects is made within the framework of orderly methodology and procedures in the field of IT.

## ENVIRONMENTAL RISKS

On June 11, 2009 the Supervisor of Banks issued a letter regarding the exposure to environmental risks and their management. The letter presents various possible aspects regarding exposure of banking corporation to environmental risks and emphasizes the need to relate to these risks individually.

These risks may be included within the framework of the other risks (such as: credit, market, operating, legal and liquidity risks). Environmental risk may derive from an impairment of collaterals when realized. Furthermore, the risk might be realized in an indirect manner as a result of deterioration in the financial condition of another party due to environmental costs resulting from regulations regarding environmental protection. A reputation risk may also apply as a result of a possible claim in which the bank is connected to an entity causing an environmental hazard.

The letter also clarifies that the identification and evaluation of environmental risks comprise a part of the proper process of identifying and evaluating risks involving banking corporation and accordingly banking corporations are required to include management of environmental risks within the overall risks managed by them, including by way of integrating procedures for the identification of material risks upon the granting of credit and by combining the evaluation of environmental risks with the periodic evaluation of the quality of credit granted to customers.

The boards of directors of banking corporations were required to approve by June 30, 2010, criteria and time table for the implementation of the requirements.

On June 21, 2010 the Banks Board of Directors approved a policy concerning environmental risks. The said policy implements the directives of the Supervisor in this matter with the aim of managing the Bank's exposure to environmental risks and minimizing them. Within this framework, the manner of evaluating the environmental risks of the Bank's business customers has been defined, while separately addressing customers classified as having a potentially high environmental risk.

Within the framework of integrating the credit policy, reference has been added to the subject in the credit application and in the current discussion.

## LEGAL RISKS

A legal risk is defined in the directives of the Bank of Israel as the risk of a loss resulting from the lack of ability to enforce the performance of an agreement by legal means.

In accordance with the framework of Basel II, the legal risk is more extensive and, among other things, includes loss from exposure to fines, punitive damages and claims against the Bank (whether criminal or civil).

Among the principal legal risks, the following may be mentioned: ignorance of the law, taking into account the many changes occurring in it from time to time, absence of legal certainty regarding the applying law, default in identifying changes in the law, retroactive changes in the law, erroneous legal advice, business activity without legal support, use of inappropriate standard documents, non-compliance with the law and/or regulations, which might result in monetary sanctions and/or criminal liability of the Bank and/or of its staff.

The Bank's chief legal adviser serves as legal risks manager and is responsible for the legal risk management at the Bank and the Group. As part of legal risk management, the Bank acts towards the collection and concentration of information relating to legal risks at the Bank and the Group, including information as to changes in legislation and/or updated court rulings that have material implications upon the Bank's operations, as well as information with respect to material legal actions and proceedings in which the Bank is involved. The Bank has a legal risk management policy intended to minimize exposure to legal risks. In this framework, the Bank acts towards pinpointing legal risk centers and the formation of processes, procedures and reporting routines

for the purpose of treatment and monitoring such risks.

The Bank has reviewed the definition of the legal risk in light of its definition in the Basel II documents, and is preparing to form an updated policy document.

## REGULATION RISKS

Regulation risk has been defined by the Bank as a loss stemming from non-compliance with various regulatory directives applying to the Bank and the Group, excluding directives relating to bank-customers relations, which are treated separately within the framework of the management of compliance risk.

The Bank's operations are regularized by various regulatory directives, under which various limitations are imposed on its fields of operation and sources of income and which impose on the Bank different duties applying to it due to its status as a "banking corporation". These directives include, among other things, the Banking Law (Licensing), 1981, the Securities Law, 1968, the Regulation of Engagement in Investment Consulting and in Investment Portfolio Management Law, 1995, the Anti Trust Law, 1988, Proper Banking Management Directives, including regulations, rules and additional duties imposed on the Bank by the various supervisory authorities to which the Bank is subject within the framework of its operations.

The Bank and the subsidiaries under its control are exposed to frequent changes in legislation and various regulatory directives, which at times apply retroactively and which expose the Bank and its subsidiaries to risks involved in frequent changes in work procedures and to costs involved in the preparations required for the implementation of the relevant directives. As part of managing the regulation risk, the Bank conducts an ongoing follow-up of changes in legislation and regulation that have a material effect on the Bank's operations, in order to prepare for the implementation of the directives applying to the Bank and its subsidiaries.

## COMPLIANCE RISKS

Compliance risk has been defined by the Bank as a risk stemming from the non-compliance with the provisions of the law and regulations applying to the Bank with respect to bank-customer relations ("consumer instructions"). According to Proper Banking Management Directive No. 308, the compliance officer is responsible for compliance with the consumer instructions. The activity of the Bank and of its subsidiaries is subject to legislation in Israel and abroad and regulatory directives both in the field of banking and in other areas, as detailed in the section "Legislation and supervision" hereunder.

Entry into new activities, frequent changes in legislation and the many regulatory directives that apply to the Bank and to its subsidiaries, in areas of existing or new operations, require modification of the infrastructure supporting the duties derived from the relevant regulatory instructions. Non-compliance with the consumer instructions may expose the Bank to legal actions as well as to the results of enforcement actions, which the various supervisory authorities to which the Bank is subject within the framework of its operations, are empowered to take, including the imposition of monetary sanctions in material amounts in the case of violation of the regulations.

**Supporting infrastructure.** The Bank maintains an infrastructure of a detailed system of procedures, intended to bring about the enforcement of compliance with the various legal and regulatory demands. The procedures are updated from time to time in accordance with the legislative and regulatory directives and in accordance with the various activities performed by the Bank. Concurrently, the systems supporting the operations are also updated and the employees are trained accordingly.

**Control and supervision.** Compliance with the provisions of the law, the regulations and the procedures are enforced on a regular basis by means of various control and supervision systems. Some other control factors also exist, such as the internal audit, the compliance officer and the officer in charge in accordance with the Prohibition of Money Laundering Law.

The internal audit constantly and continuously examines all areas of operation of the Bank. For details of the activities of the internal audit, see the section "The internal audit in the Group" below.

**Compliance officer.** In accordance with Proper Banking Management Directive No.308, a compliance officer operates at the Bank, who acts in this role also at a number of the Bank's subsidiaries. Other subsidiaries in Israel have appointed their own compliance officers in accordance with the said Directive, and the Bank's compliance officer communicates with them on an ongoing basis. In the course of 2010, the compliance unit was transferred to the responsibility of the Risk Management layout, subject directly to a member of Management – the Chief Risk Manager.

The Compliance Officer assists the Bank's Management and the Board of Directors in managing the responsibility for compliance with the instructions of the law and regulations in the field of bank-customer relations ("consumer instructions") with a view of reducing exposure to lawsuits and to other sanctions that may be imposed on a banking corporation with respect to non-compliance with consumer instructions.

For the purpose of her work, the Compliance Officer is assisted by the coordination committee that meets once in every quarter. The compliance officer monitors the preparations by the Bank for the fulfillment of the duties imposed on it under the consumer instructions, including verification of fulfillment of the said duties relevant to new operations of the Bank, as well as monitors the rectification of various deficiencies in complying with the consumer instructions. The compliance officer submits quarterly reports that include a summary of her operations, to the Bank's President & CEO as well as to the CEO's of the subsidiaries in which she serves as a compliance officer. In addition, The compliance officer submits to the Bank's President & CEO, to the CEO's of the said subsidiaries and to their Boards of Directors, an annual report summarizing her operations of the Bank and of the subsidiaries.

In accordance with Proper Banking Management Directives and at intervals determined therein, the Bank conducts an infrastructure survey that includes mapping of the consumer instructions applying to the Bank and the duties stemming from them, the potential exposure arising from the non-fulfillment of the said duties and of the infrastructure supporting the fulfillment of such duties (work procedures, computer infrastructure and other means of control). The Bank is acting towards completion of the integration process of a computer system designed to assist in the monitoring of the elimination of differences identified in the infrastructure survey as well as in the ongoing monitoring of preparations towards the implementation of new consumer instructions.

In order to increase awareness to the importance of compliance, the Bank conducts study sessions on the subjects of compliance among the staff, including managers in general, and of compliance with the consumer instructions relevant to the work environment of specialized groups of employees in particular.

With a view of improving control mechanisms and strengthen supervision over compliance with the said instructions, including on the subject of money laundering prohibition, compliance trustees have been appointed at the Bank for various organizational levels (branches, regions and divisions) within the Retail and Corporate Banking Divisions, and at the level of division/layout at the other relevant divisions/relevant layouts.

**The officer in charge of money laundering prohibition** was appointed in accordance with the Prohibition of Money Laundering Law and related regulations, and he is responsible for the fulfillment of the duties imposed on the Bank with respect to money laundering and the financing of terror activities. In accordance with the requirements of Proper Banking Management Directive No. 411. As stated, the unit of the officer in charge forms a part of the Bank's risk management layout.

Non-compliance with directives applying to the Bank with respect to money laundering exposes the Bank to monetary sanctions, goodwill risks as well as to criminal proceeding, in respect of violation of the provisions of the law relating to this issue.

The officer in charge of the prohibition of money laundering is responsible for the writing of work procedures and the establishment of a computerized infrastructure required for the compliance with the provisions of the law applying to the Bank in this respect, as well as for the submission of reports to the Prohibition of Money Laundering Authority, in respect of operations subject to reporting in accordance with the law. The Bank is assisted by a computerized system in monitoring transactions that seem unusual and should be reported.

The Bank conducts ongoing instruction sessions at its various units intended to increase awareness and knowledge of this subject. During 2010, the Bank continued to act towards the correction of deficiencies found by an audit with respect to money laundering

carried out at the Bank by the Supervisor of Banks. In this framework, as stated, unit compliance trustees have been appointed, who operate in the relevant units in order to improve the control mechanisms over compliance with procedures relating to the prohibition of money laundering and the finance of terror.

The officer in charge of money laundering prohibition communicates with the subsidiaries in Israel and with the Bank's foreign extensions for the purpose of monitoring the implementation of the Bank's policy and regulatory directives regarding money laundering prohibition and the finance of terror on a Group basis and this in accordance with the Group's policy approved by the Bank's Board of Directors in July 2010. This activity is supported by the integration of the unit of the officer in charge of money laundering prohibition with the Bank's risk management layout.

See "Prohibition of Money Laundering Law and Prohibition of the Financing of Terror Law" under "Legislation and supervision" below regarding legislation in the matter of money laundering.

## RISK FACTORS TABLE

Banking corporations in Israel are required to include in their report a table indicating risk factors, classified as follows, according to their impact on the business of the banking corporation: high impact, medium or low impact. This table contains an evaluation of the effect of risks on the Group.

Considerable difficulties exist in evaluating the risks and their impact. Evaluation of the effect of a risk requires assumptions regarding the intensity of the future event and the probability that such an event will in fact occur. Reliable implementation of such evaluation requires utilization of advanced models, which are usually not available at this stage.

The risk evaluation and its effect, as presented in the table below, is therefore, a subjective assessment by the Bank's Management formed according to the methodology for group risk profile assessment, based on the identification and evaluation of the risk inherent in the activities of the Group and taking into consideration the existing control layout, which is reflected in the risk management quality evaluation. This method serves the Bank also for the purpose of evaluation of the fairness of its capital within the framework of the ICAAP report.

In view of the above, utmost care should be taken in examination of risk factors and evaluation of their impact, and in comparison between banks in this matter.

It should be noted, that in 2010 the Bank completed the process of evaluation of the its capital adequacy and in this framework the various risks and their impact on the Bank had been examined, using a different methodology than that used in the past. Upon completion of the process, the Bank found it necessary to change the assessment of a part of the risks included in the table, from that published in the past.

## RISK FACTORS TABLE

The risk	Risk factor Impact	Risk description
1. Overall impact of credit risk	Medium	A risk of the impairment in the value of the Bank and its profitability as a result of a decline in the ability of borrowers to honor their obligations. The Bank manages the risk by determining a credit policy and exposure limitations relating, among other things, to the type of borrowers, market sectors, segments of operation, collateral, credit control, etc.
1.1. Quality of borrowers	Medium	A risk of the impairment in the value of the Bank and its profitability and collateral risk as a result of the quality of borrowers being in effect poorer than previously estimated and/or the collateral provided by the borrowers having a lower value than previously assessed. The Bank manages the risk, among other things, by way of monitoring and control over the borrowers, examination of the propriety and value of the collateral in accordance with the policy of collateral reliance, with adaptations to the Bank's credit policy.
1.2. Industry concentration risk	Low	A risk of the impairment in the value of the Bank and its profitability as a result of a decline in the business activity of a particular sector of the economy. The Bank adopts a conservative policy as regards industry concentration of credit. The high industry concentration at the Bank is in the real estate and construction sector, which is mitigated by a large distribution and the quality of borrowers and collateral.
1.3. Borrower/groups of Borrowers	Medium	A risk of the impairment in the value of the Bank and its borrowers concentration risk profitability as a result of a decline in the business activity of a borrower/large group of borrowers. Directives of Bank of Israel determine limits for the concentration of indebtedness of borrowers and groups of borrowers. The Bank has not deviated from these limits and maintains ongoing control in this regard. The Bank analyses and monitors the activity and financial stability of the said borrowing groups. The updated evaluation of the risk effect, which has been increased to "medium", took into consideration the effect of the financial crisis on large borrowers and borrower groups in the market, as well as the volume of capital, which the Bank is required to allocate in respect of this risk.
2. Overall impact of market risks	Low-Medium*	A risk of the impairment in the value of the Bank and its profitability as a result of changes in economic parameters in the different financial markets that affect the value of the Bank's assets or its liabilities. The overall exposure to market risks, as assessed by the VaR model and various stress tests as adjusted to Basel II, is low-medium in relation to the Bank's equity, does not deviate from the exposure limits determined by the Board of Directors and is being controlled on a current basis.
2.1. Interest rate risk	Medium*	A risk of the impairment in the value of the Bank and its profitability as a result of future changes in interest rates and their possible impact on the present value of the Bank's assets and liabilities. Exposure to interest rate risks, which is assessed by means of accepted tools, does not deviate from determined exposure limits and is monitored on an ongoing basis.
2.2. Inflation rate risk	Low	A risk of the impairment in the value of the Bank and its profitability as a result of changes in the CPI due to the difference between assets and liabilities, including the impact of future transactions. The Bank's exposure to inflation risk is not material in relation to its volume of operations and its shareholders' equity, does not deviate from the set limits and is controlled on a current basis.
2.3. Exchange rate risk	Low-Medium*	A risk of the impairment in the value of the Bank and its profitability as a result of exchange changes due to the difference between assets and liabilities, including the effect of future transactions. The Bank's exposure to exchange rate risk is not material in relation to its volume of operations and its shareholders' equity, does not deviate from the set limits and is controlled on a current basis. Notwithstanding, extreme changes in the exchange rate might adversely affect the Bank's capital adequacy and, indirectly, its profitability.

\* The assessment relating to this risk factor has changed in comparison with that included in the annual report for 2009, this, as stated, following the completion of the risk examination process within the framework of assessing the appropriateness of the capital adequacy.

**RISK FACTORS TABLE (CONTINUED)**

The risk	Risk factor	
	Impact	Risk description
2.4. Share price risk	Low	A risk of the impairment in the Bank's value of the Bank and its profitability as a result of changes in the market price of securities held by the Bank. The Bank owns a considerable amount of securities held as investments and not for trading.
3. Liquidity risk	Low	A risk to the Bank's income and equity resulting from the inability to provide for its liquidity requirements and/or an uncertainty existing as to the availability financial resources. The risk involved therein is that the Bank would not be able to meet its obligations as a result of unexpected developments, and shall be obliged to raise funds or realize assets in a way that would cause it material losses. Exposure, as measured by an internal model, the examination of the volume and stability of deposits as well as by additional indicators, is low and is controlled on a current basis.
4. Operating risk	Low-Medium*	A risk of loss as a result of the improper or failure of internal processes, human error and the absence of proper examination and control processes, failure of the Bank's systems or as a result of external event, such as physical damage. The Bank monitors on an ongoing basis both the exposure to operational risks and the events of realization of such risks, and applies controls regarding the various procedures.
5. Legal risk	Low	A risk of loss as a result of the inability to enforce compliance with an agreement by legal means definition of the legal risk includes also, among other things, legal claims to which the Bank is a party. Legal risk includes the regulatory risk stemming from changes in the Law, including changes in legislation, in Court decisions and principally in the guidelines that are being published frequently by the regulatory bodies, to which the Bank is subject, and which impose various duties upon the Bank. The Bank has not suffered material losses as a result of this risk and believes that the legal controls applied by it are appropriate.
6. Compliance and Money Laundering risks	Low-Medium*	A risk whereby the banking corporation will be affected by a legal or regulatory sanction, sustaining as a result a material financial loss, or damage to its reputation as a result of non-compliance with the provisions of the law or regulation, applying to the Bank in the area of Bank/customer relations and/or the provisions of the law and regulation regarding prohibition of money laundering and the finance of terror. The Bank operates ongoing monitoring and control tools, which are believed to reduce this risk.
7. Reputation risk	Low-Medium*	A risk for impairment in the business position of the Bank as a result of impairment in the Bank's image, resulting from various publications, whether correct or incorrect, in the eyes of customers, correspondent banks, investors, regulatory authorities and others. A negative image might be created as a result of the materialization of a large number of factors, all together or separately, such as: embezzlement, damage to profitability or to capital adequacy, collapsing systems, etc. Materialization of the risk to reputation may be expressed in material damage/loss to the Bank and the Group and may develop even to liquidity difficulties. The Bank takes action to minimize this risk through ongoing supervision and control over the implementation of instructions and procedures as regards customers, suppliers and employees.
8. Strategic risk	Low-Medium*	The risk of a material deterioration in the Bank's earnings, in its equity or in its goodwill, stemming from changes in the business environment in which the Bank operates, from entry into new activities, new markets or products, from erroneous strategic decisions, and from differences in the quality of risk management.

\* The assessment relating to this risk factor has changed in comparison with that included in the annual report for 2009, this, as stated, following the completion of the risk examination process within the framework of assessing the appropriateness of the capital adequacy.

Within the framework of preparing the ICAAP document (see hereunder), the Bank is studying the various risks and their effect on the Bank, using new methodologies. It should be mentioned that once the process is completed, it may turn out that the assessment of risks and their effect differs from the data presented in the above table.

## **BASEL II**

### **GENERAL**

The Basel Committee is an international body established in 1974 by the central banks of various countries. The decisions and recommendations of the Committee, though not legally binding, determine the supervisory principles according to which the authorities that supervise the banking systems in a significant number of countries around the world operate. In June 2004, the Basel Committee published new recommendations intended to ensure proper regulation with respect to capital adequacy of banks in the various countries (hereinafter: "Basel II"). In June 2006, the final and updated version of the instructions was published. The Basel II recommendations replace the previous instruction of 1988, named Basel I, which included capital requirements with respect to credit risks and was expanded in 1996 in order to include capital requirements also with respect to market risks.

While the Basel I guideline has been mostly concerned with the allocation of capital in respect of credit and market risks, the Basel II guideline extends the reference also to other types of risk and puts great emphasis on the quality of risk management. This, in order to increase stability of financial institutions also by way of integrating risk management and control practices. Accordingly, the Basel II instructions include, in addition to a material change in computing capital (the first pillar of the instruction), also two additional pillars, as detailed hereunder.

In December 2010, the Basel Committee published new recommendations, "Basel III", designed to intensify the risk management directives and the capital requirements in respect thereof, with a view of improving the position of banks in times of crisis. These recommendations include reference to the improvement of capital quality, with an emphasis on tier I of the core capital, to a restriction on the leverage ratio (tier I capital divided by total balance sheet and off-balance sheet assets), as well as liquidity ratios, with an emphasis on liquidity of up to thirty days. The recommendations are to be implemented in Europe as from January 2013. At this stage, the Supervisor of Banks has not yet announced his position regarding the date and manner of implementation of the recommendations in Israel (notwithstanding, see "Capital policy for the interim period" in the Chapter "Capital resources" above).

### **THE IMPLEMENTATION IN ISRAEL OF THE BASEL COMMITTEE RECOMMENDATIONS**

The Supervisor of Banks published on December 31, 2008 rules for the implementation of the Basel II guidelines in Israel - according to the "standard approach", within the framework of the provisional instruction in the matter of "framework for measurement and capital adequacy", which came into effect on December 31, 2009.

The Basel II instructions are comprised of three pillars:

- First pillar - minimum capital requirements - defines the manner of computing the capital to risk components ratio. Its aim is to expand and improve the measurement framework for computing the minimum capital requirements in respect of credit risk, market risk and operational risk. The process of computing capital adequacy according to the first pillar is based upon a rigid set of guidelines that does not allow the banking corporation subjective considerations.
- Second pillar - Supervisory evaluation (SREP - Supervisory Review and Evaluation Process) emphasizes the supervision and control process, the quality of risk management as well as capital adequacy in relation to the risk profile of the banking corporation. Within the framework of the second pillar banking corporations are required to conduct an internal process designed to evaluate the appropriateness of capital adequacy and to adopt a strategy intended to ensure capital adequacy -

Internal Capital Adequacy Assessment Process ("ICAAP"). As part of the ICAAP, banking corporations are required to re-evaluate their capital needs, both in respect of risks treated within the framework of the first pillar and in respect of material risks not so treated and to determine in a subjective manner what is the adequate level of capital required in respect of such risks (capital adequacy evaluation). The additional risks included in the second pillar are composed of risks, not treated within the framework of the first pillar, the scope of exposure to such risks and the capital allocation in their respect can be computed on a quantitative basis (such as: credit concentration risk, interest rate risk regarding the banking book) and qualitative risks which are examined within the framework of the overall examination of capital adequacy (such as: reputation risk, compliance risk, strategic-business risk, etc.). Furthermore, within the framework of the second pillar banking corporations are required to prepare extreme scenarios for the examination of the capital position. This process of evaluation of the capital adequacy shall be performed regularly and on an annual basis.

The first ICAAP report in respect of 2009, was submitted to the Bank of Israel in June 2010 (For details regarding the supervisory review procedure over the ICAAP, see "The supervisory review process" hereunder).

The Supervisor of Banks has stated that the overall minimum ratio of capital shall not fall below 8% in respect of the first pillar and an additional 1% in respect of the second pillar.

- Third pillar - "market discipline" - Banking corporations are required to provide proper disclosure and to expand public reporting with respect to risks involved in the Bank's operations in a manner that would enable the public to better understand the overall risks to which the Bank is exposed, the manner in which they are being managed, and the volume of capital allotted in their respect.

**The supervisory review process.** On June 20, 2010, the supervisor of Banks published a document in the matter of the supervisory review process that focuses within the framework of the said review process, in a manner which together with Proper Banking Management Directive No. 211 "Evaluation of the appropriateness of capital adequacy", completes the adoption of the second pillar of Basel II by the Supervisor of Banks. Among other things, the document provides details of the measures which the Supervisor of Banks may take during the process of the supervisory review.

This process is designed to ensure that banking corporations allocate adequate capital in order to support all risks inherent in their business, and furthermore, encourage banking corporations to develop and use improved techniques for risk management in order to monitor and manage their risks.

The Supervisor will evaluate to what extent banks have succeeded in assessing their capital requirements in relation to their risks and will intervene where required.

The Supervisor is aware of the relation existing between the total amount of capital held by the banking corporation in respect of exposure to risk and the soundness and effectiveness of the risk management processes and its internal controls. However the increase in the total amount of capital will not be considered as the only option for handling increased risks facing banking corporations. Other means for risk management should also be considered, such as strengthening the risk management process, imposing internal limitations, increasing provisions and reserves and improving internal controls.

The central principles of the supervisory review process are as follows:

- A banking corporation shall establish a process for the evaluation of its total capital adequacy in relation to its risk profile as well as a strategy for preserving its capital level;
- The Supervisor shall review and evaluate the internal capital adequacy assessments and the strategies of the banking corporations as well as their ability to monitor the supervisory capital ratios and to ensure compliance with them. The Supervisor shall exercise the required supervisory measures in cases where he is not satisfied with the results of the said process;
- The Supervisor expects the banking corporations to maintain higher capital ratios than the minimum supervisory ratios and is empowered to require them to maintain capital over and above the minimum required level;
- The Supervisor may intervene at an early stage in order to prevent a decline in the capital level below the minimum level required to support risk characteristics of a particular banking corporation, and shall demand speedy corrective action in cases

where the capital level is not maintained or does not revert to its required level.

**Basel II - tightening banking corporations' corporate governance.** For details regarding the new Proper Banking Management Directive No.301, including the reference included therein to issues of risk management and corporate governance, see below "Group management" in the Section "Structure of the banking Group". For details regarding the adoption of a corporate governance code, see "Corporate governance code for the Discount Bank Group" under "Miscellaneous" hereunder.

Discount Group's preparations for the implementation of the requirements of Basel II

**General.** A supreme Group steering committee, headed by the Bank's CEO with the participation of senior executives of the Discount Group, promoting the subjects relating to the application of Basel II. The Bank's Risk Management Committee is in charge at the Bank's level.

In the course of 2006 the Bank has completed the first stage, which included the formation of an appropriate risk management strategy, a comprehensive gap analysis and the preparation of a project program. In 2007 the second stage of the preparations continued, focusing on the definition of risk governance issues, including the definition of the appropriate organizational structure for enterprise risk management (ERM), risk management charter, determination of a framework for policy documentation, regarding risk management. This being part of the Bank's preparations for the implementation of the requirements of the second pillar of Basel II. In the course of 2008, the Bank continued the process of establishing a system for the calculation of capital adequacy and credit risks management, in order to be fully ready for the implementation of the Basel II requirements by the end of 2009. In 2009, the Bank and the relevant subsidiaries completed the preparations for financial reporting according to the first and third pillars of Basel II.

The overall preparations for the implementation of Basel II required investment of a considerable volume of resources. Among other things, changes and adjustments to work processes and infrastructure systems were required as well completion of data collection processes, establishing data bases, development of various models and integration of new systems for the implementation of the computation of capital requirements.

**First pillar.** In the course of 2009, the Bank began to compute capital adequacy in respect of credit risk, market risk and operating risk in accordance with the Basel II guidelines, alongside computing capital adequacy in accordance with the Basel I guidelines.

The capital requirement in respect of credit risk is computed in accordance with the standard approach, on the basis of independent credit ratings.

In 2010 the Bank improved the system for the computation of capital adequacy and credit risk management that enables the implementation in full of the Basel II requirements in respect of credit risk. The implementation plan has been activated by the entire Discount Group in Israel and abroad. Within this framework the Bank has studiously improved and upgraded the data.

The Bank is advancing its preparations for the inclusion of additional eligible collateral within the framework of the competition of the Bank's capital adequacy in accordance with the Basel II guidelines.

The Bank engaged an international corporation specializing in credit rating for the performance of a project whereby the said corporation will develop for the Bank a number of models for credit rating of medium and large size customers in the real estate, industry, commercial and services fields. The products of these models will be used to improve the credit management procedures and will serve as foundations for future use by the Bank in computing capital requirements in respect of credit risk based on internal credit rating models, within the framework of the implementation of "advanced approaches" for measuring capital adequacy.

Capital allocation in respect of operating risks is computed according to the "basic indicator" approach, according to which gross earnings are multiplied by a fixed coefficient. Towards the year 2012, banking corporations will be required to compute the capital allocation according to the standard approach, whereby gross earnings from different business lines would be multiplied by a different coefficient for each line of business.

In a letter dated May 20, 2010, the Supervisor of Banks announced that in view of the central importance of the capital adequacy

ratio of banking corporations and credit card companies, banking corporations and credit card companies are required to engage their independent auditors, by an engagement letter, to perform an examination regarding the propriety of the reporting to the Supervisor with respect to the capital adequacy as of December 31, 2010, the findings of which are to be submitted to the Supervisor of Banks by May 1, 2011.

**Second pillar.** Preparation by the Bank in 2010, for the implementation of the second pillar, included:

- Submission to the Supervisor of Bank's staff (in June 2010) of the ICAAP report, on the basis of the data as of December 31, 2009;
- Meetings with the Supervisor of Bank's staff within the framework of the SREP process, during which the Supervisor of Banks presented his comments to the ICAAP report submitted by the Bank;
- Continued formation of the Internal Capital Adequacy Assessment Process (ICAAP), including the improvement of processes and methodology, in view of the insight and feedback gained in the SREP process;
- Formation and updating of the risk management policy documentation;
- Continuation of the implementation of the work plan for the elimination of gaps found by the review performed by the Bank, compared to the risk management principles required in the documents published by the Basel committee (BIS), and gaps found during the formation of the ICAAP process.

The Supervisor of Banks required the banking corporations to submit the ICAAP document based on the December 31, 2009 data by the end of June 2010, for the purpose of its review. The Bank has submitted to the Bank of Israel the ICAAP document on the required date. This document included a work plan intended to eliminate the gaps discovered by the second pillar gaps review. As seen from the ICAAP computations submitted to the Supervisor of Banks the Bank has an excess reserve of capital to fall back on with respect to the risks to which it is exposed. The bank has to submit the ICAAP document based on data as of December 31, 2010, by May 15, 2011. The Bank is preparing to submit this document on the due date while implementing the lessons learnt during the supervisory review process conducted by the Supervisor of Bank's staff with respect to the ICAAP document for 2009.

**Third pillar.** The Basel II guidelines broaden the disclosure requirements, both qualitative and quantitative, in the matter of management of exposure to credit risks, market risks and operating risks. In continuation of the "framework" dated December 31, 2008, the Supervisor of Banks issued in October 2009, a provisional instruction regarding "the application of disclosure requirements included in the third pillar of Basel II - in financial statements of banking corporations for 2009 and thereafter".

Qualitative and quantitative disclosure regarding the various risks is presented above in the Chapter "Exposure to risks and risk management". Additional qualitative and quantitative data is presented in this Chapter as well as in additional parts of the annual report. A table relating the disclosure requirements stated in the provisional instruction to the different parts of the annual report in which the required information is presented, appears at the end of this Chapter.

On June 20, 2010, the Supervisor of Banks issued new proper banking management directives in the matter of "Measurement and capital adequacy", which integrate the provisional directive regarding "Framework for measurement and capital adequacy", initially applied on December 31, 2009. Certain changes have been introduced into the new directives, including a change in the risk weight of banks so that they will be ranked one grade lower than the country in which they are incorporated, instead of specific ranking, as well as approval of the treatment of bonds issued by banks' issue companies as bonds of the banks controlling these companies. Updates of the Directive were published on December 27, 2010, including an update of the weighting of the foreign currency exposure of banking corporations to the State of Israel, so that under certain conditions a risk weight of 0% may be applied to it.

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## IMPLEMENTATION OF A FRAMEWORK FOR MEASUREMENT AND CAPITAL ADEQUACY

The framework for the measurement and capital adequacy, as adopted by the Supervisor of Banks, applies to the Discount Group headed by the parent company, Discount Bank. The said framework applies also to banking corporations and auxiliary corporations of the Discount group: Mercantile Discount Bank, Discount Mortgage Bank and Israel Credit Cards.

The framework is being implemented on a consolidated basis and there is no difference between subsidiaries included on a consolidated basis in accordance with generally accepted accounting principles and the supervisory consolidated basis of the framework. For details of the principal subsidiaries of the group, see Note 6 to the financial statements.

Investments in financial companies, in which the Bank has a material influence and which are included in the Bank's books in accordance with generally accepted accounting principles, are deducted from capital for the purpose of implementation of the Directive. The principal investment in an affiliate as stated above, is the investment in the First International Bank.

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## CAPITAL TRANSFERABILITY

Capital transferability is a key component in establishing capital adequacy for the Group. Discount Group regards a high level of capital transferability within the Group as supportive of Group capital adequacy, due to the capacity to transfer capital, if needed, between Group companies.

Capital transfer between Group companies may be achieved by issuing tier I and tier II capital between Group companies, purchase/sale of risk assets, or even by providing letters of indemnity so as to reduce the need for the actual capital transfer. Regulation and improvement of capital transfer procedures makes a material contribution to robustness of claims with regard to capital adequacy of the Group and of each individual subsidiary.

It should be noted that such capital transfer may be effected between subsidiaries, or from the parent company (the Bank) to subsidiaries. Indeed the Bank has, in fact, invested in capital and capital notes of certain subsidiaries, and has indemnified other subsidiaries. Capital transfer from subsidiaries to the parent company is not relevant. However, excess tier II capital in a subsidiary may serve the parent company in calculating capital adequacy, without an actual transfer.

## TABLE RELATING THE DISCLOSURE REQUIREMENTS ACCORDING TO THE THIRD PILLAR TO THE DATA PRESENTED IN THE REPORT

With a view of grouping together the information required by the provisional instruction, banking corporations have been required to include in the report a table relating the disclosure requirements stated in the instruction to the sections in the Directors' report or to the Notes to the financial statements in which the information required to be presented in the annual report is included. The required information as above is reflected in the following table.

Table No.	Topic	Location*	Page No.
Table 1	Scope of application	Basel II - The implementation in Israel of the Basel committee recommendations	
Table 2a	Capital structure - qualitative disclosure	Note 14 to the financial statements	
Table 2b,c,e	Capital structure - quantitative disclosure	Capital resources - The Bank's capital adequacy Note 14(1),14(4) to the financial statements	
Table 3a	Capital adequacy - qualitative disclosure	Capital resources - The Bank's capital adequacy	
Table 3b,d,e,f,g	Capital adequacy - quantitative disclosure	Capital resources - The Bank's capital adequacy Note 14(3) to the financial statements	
Section 824	General qualitative disclosure	Risk management policy and objectives, The structure and organization of the risk management function - factors involved in risk management	
Table 4a	Credit risk - qualitative disclosure	Credit risk management	
Table 4b	Credit risk - segmentation of credit risk according to the main credit exposure types	Credit risk management - Quantitative disclosure regarding credit risk	
Table 4c	Credit risk - main geographic distribution of exposures	Management review - Schedule "F"	
Table 4d	Credit risk - Counterparty type distribution of exposures	Credit risk management - Quantitative disclosure regarding credit risk	
Table 4e	Credit risk - Residual contractual maturity breakdown of the whole portfolio	Credit risk management - Quantitative disclosure regarding credit risk	
Table 4f	Credit risk - problematic debts	Management review -Schedule "E" Note 4b,c to the financial statements	
Table 4g	Credit risk - problematic debts classified according to main geographical areas	Management review -Schedule "F" Note 4b to the financial statements	
Table 4h	Credit risk - movement in the balance of provision for credit losses	Note 4c to the financial statements	
Table 5	Credit risk - disclosure as to credit files managed according to the standard approach	Credit risk management - Disclosure as to credit files managed according to the standard approach	
Table 7	Credit risk mitigation	Credit risk management - Reduction of credit risk	
Table 8	General disclosure for exposure related to counterparty credit risk o	Credit risk management - General disclosure regarding exposure related to credit risk of a counterparty	
Table 9	Securitization	Credit risk management - Securitization	
Table 10	Market risk	Management of market and liquidity risks	
Table 12	Operational risks	Operational risks	
Table 13	Share positions in the bank's portfolio	Share positions in the bank's portfolio	
Table 14	Interest rate risk in the banking book	Management of market and liquidity risks	

\* Unless stated otherwise, the location is under "Exposure to Risks and Risks management" or as a Note to the Financial Statements.

## MAIN DEVELOPMENTS IN ISRAEL AND AROUND THE WORLD IN 2010

### DEVELOPMENTS IN GLOBAL ECONOMY

The global product grew in 2010 by 5%, led by the developed countries, following a decline of 0.6% in 2009. A positive growth was also recorded in 2010 in most developed countries, though at a more moderate rate compared with the developing markets. The growth in the world in 2010, was accompanied by an increase in volume of world trade (following a decline in 2009) and a rise in prices of commodities.

The governmental debt crisis that had developed in several Euro block countries (mostly the PIIGS countries) stood at the center of 2010. This crisis threatened financial stability and compelled the Euro block countries to adopt budget cuts, which slowed down the recovery process. On this background, alongside high unemployment in certain of the Euro block countries, 2010 recorded a growth of 2% (in contrast to a decline in 2009), with differences between the economically strong countries of the block and the peripheral countries.

The U.S. economy grew in 2010 by 2.8% (following a decline of 2.6% in 2009), with an accelerated growth rate in the second half of the year. Notwithstanding, the unemployment level remained high, the real estate market did not manage to recover and the government debt continued to grow. The fiscal policy in the U.S. was not uniform. While in the first half of the year, the fiscal incentives introduced during the crisis to support the economy were cut, a new incentive program was announced towards the end of the year.

On the background of the moderate growth rate in most developed economies, a low level of inflation has been maintained, which permitted the central banks to leave the interest rates at low levels.

Growth in the developed markets was conducted during the year in view of high domestic demand, where the highest growth rate among the emerging markets was recorded in Asia. The product in China grew by 10.3%. The accelerated growth rate, alongside the rise in the prices of commodities, resulted in high inflation rate in several of the developing countries, which forced their central banks to raise interest rates several times.

Trade on the global financial markets was conducted in 2010 on the background of the continued process of recovery from the world crisis and was characterized by high volatility on the stock markets, with a decline in prices in the first half of the year and a rise in prices in the second half. The capital markets have mainly been influenced by the macro-economic environment alongside good financial reports. In conclusion for the year, the S&P 500, and the DAX indices rose by 13% and 16%, respectively, while the Chinese Shanghai index recorded a decline at the rate of 14%.

Until the beginning of the fourth quarter of 2010, the bond market registered a decline in returns on U.S. and German government bonds, both regarded as safe assets "Flight to Safety". This, principally on the background of the uncertainty regarding the recovery rate and developments in the debt crisis in the Euro block, which caused the scaling down of the credit rating of certain of the PIIGS countries, alongside a steep rise in returns on government bonds and their CDS spreads. Trade was also affected by the plans of the U.S. central bank for the purchase of government bonds. Towards the end of the year, on the background of the fiscal expansion in the U.S. and economic data indicating the continued economic growth in the U.S. and in the economically strong countries in the Euro-block, a rise in returns on U.S. and German governments bonds was recorded. Notwithstanding, taken as a whole for the year, returns have declined.

Trade on world currency markets was mostly affected in 2010 by macro-economic developments and in particular, by the debt crisis in Europe, alongside demand for financial assets of the U.S. Government, due to aversion to risk. Moreover, world currency exchange rates were affected by the activities of central banks in various countries in the world, which tried to intervene in the foreign currency markets using various measures ("the currency war"). As a result of the said developments the U.S. dollar strengthened against the Euro in conclusion for the year by 6.5%, this despite the strengthening of the Euro against the dollar in the second half of 2010 (by approximately 9%). In contrast, the dollar weakened against the Japanese Yen and the Swiss Franc by 15% and 11%, respectively.

## MAIN DEVELOPMENTS IN THE ISRAELI ECONOMY

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### GENERAL

The economic recovery experienced in the second quarter of 2009 continued also during 2010. As a result, the domestic economy grew by 4.0% (compared to 0.8% in 2009). An even sharper increase was recorded in the business product - 5.3%.

The fast growth in 2010 was supported by a rise of 14% in the export of goods and services alongside a growth of 12% in investments in fixed assets, items that recorded a sharp decline in 2009. Concurrently, private consumption accelerated to a rate of 4.9% (1.7% in 2009).

The unemployment rate declined from 7.5% in 2009 to 6.6% in 2010, with a steep increase in the participation rate to 57.3% on an annual average (a record level of 57.8% in the last quarter of 2010) and recruitment of about one hundred thousand new employees.

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### MAIN DEVELOPMENTS IN ECONOMIC SECTORS

The development of the industrial sector in 2010 was not uniform. Whilst an increase in industrial production was recorded in the first half of 2010, the trend was reversed in the second half of the year with a cutback in exports. In total for the year, industrial production grew by 8%, led by the hi-tech sector, alongside a growth of 2% in the number of employed persons in this sector.

The turnover of the commercial and services sectors grew by 8% in 2010 principally as a result of the increase in wholesale trade turnover and in the turnover of real estate assets and business services.

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### DEVELOPMENTS IN THE ACTIVITY OF THE ISRAELI ECONOMY WITH OVERSEAS MARKETS

The year 2010 was characterized by contrasting trends - the continued decline in direct investments in Israel by foreign residents, alongside a sharp growth in financial investments. The financial investments were mainly affected in 2010 by the interest rate differences between Israel and the developed countries, alongside the low volatility in the exchange rate of the Shekel compared with the years 2008-2009, and the upgrading of the Israeli economy to the MSCI Index of the developed markets.

Direct investments registered a decline of over 50%, from US\$3.9 billion in 2009 to US\$1.8 billion in 2010.

In contrast, foreign residents made financial investments in marketable securities to the tune of US\$9.8 billion (US\$2.4 billion in 2009) about one half of which made in the last quarter of the year. The decisive part of these investments, an amount of US\$9.6 billion, was concentrated in MAKAM. On the other hand, investments in Israeli equities were insignificant (compared to US\$2.1 billion in 2009). This to a large extent, as a result of realizations on the Tel Aviv Stock Exchange in the first half of 2010, on the background of the upgrading of Israel to a developed economy in the MSCI Index.

A steep rise in both direct and financial investments abroad by Israeli residents was recorded in 2010. Direct overseas investments amounted in 2010 to US\$7.3 billion, of which US\$3.4 billion comprised one investment of an Israeli company in the pharmaceutical field. Financial investments in marketable securities amounted in 2010 to US\$10 billion, compared to US\$7.6 billion in 2009. The increase in financial investments is explained mostly by investments of the commercial segment (in contrast to realizations in 2009), while institutional investors reduced their overseas investments.

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### DEVELOPMENT IN FOREIGN EXCHANGE RATES AND INFLATION RATES

During 2010, sharp fluctuations took place in the exchange rate of the Shekel as against the leading currencies, these stemming mostly by developments in currencies around the world, the surplus on the current account of Israel, the interest rate differentials between Israel and the developed countries and the intervention by the Bank of Israel in the foreign currency trade. In conclusion

for the year, the Shekel strengthened against the Dollar by 6%, against the Euro by 13%, and the nominal effective exchange rate strengthened by 7%. The strengthening of the Shekel was particularly noticeable in the fourth quarter of 2010, by 3% against the Dollar and by 5% against the Euro, similarly to the weakening trend of these currencies in world markets, on the background of the fiscal expansionary plan in the U.S., alongside renewed development of the European debt crisis.

The Consumer Price Index (CPI) rose during 2010 by 2.7%, within the range of the targeted inflation rate of the Bank of Israel. Developments in the inflation rate this year were not uniform, characterized by falling prices in the first quarter of the year, acceleration in the second and third quarters and moderation in price increases in the last quarter of the year.

The main items causing the rise in the CPI were the housing item (comprising 20% of the CPI), which rose in 2010 by 4.9%, and the fruit and vegetables item, which rose by 16%.

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## FISCAL AND MONETARY POLICY

**Fiscal policy.** The continued economic recovery in 2010, alongside the price rises on the capital and real estate markets were reflected in the real term growth of 7% in tax revenues of the State, in contrast to a decline of 6% in 2009. The rise in tax revenues led to a surplus of NIS 11 billion compared to the original budget, when concurrently, the recorded financing expenses were NIS 3 billion lower, this on the background of the low interest environment.

As a result, the deficit for 2010 (excluding the granting of credit) was 30% lower than originally planned. In terms of the product, this comprises a deficit of 3.7% (compared to 5.5% according to the Budget Law), this compared to a deficit of 5.2% of the product in 2009.

**Monetary policy.** Bank of Israel maintained during 2010 a low nominal interest environment and a negative interest in real terms. The Bank of Israel interest rate was raised four times, to a level of 2% in October. Among the factors supporting the raising of the interest rate, the Bank of Israel noted the pace of economic recovery, the increase in housing costs, the need to revert the interest to a "normal level" and the fact that a number of central banks, in relatively fast growing economies, have also started a process of increasing the interest rate. In contrast, the growing uncertainty with respect to the continuing pace of economic growth and the expectations that the central banks of developed country will maintain the interest rate at its low level over a long period of time, together with the desire to moderate the strengthening of the Shekel, were the factors that slowed down the increase in the interest rate.

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## THE CAPITAL MARKET

The trade in equity was typified in 2010 by volatility. This, on the background of developments in global economy, principally the debt crisis in Europe alongside developments in the domestic economy and in particular, good economic data, the upgrading of the Israeli economy in the MSCI Index and developments in the gas and oil prospecting sector. As a result, and similarly to the trend the world over, equity prices dropped in the first half of 2010, but recovered in the second half of the year, the leading indices showing new historical records. In conclusion for the year, the general share index rose by 12.6%, compared to a rise of 79% in 2009, which was characterized by steep price increases on the stock markets, in view of the recovery from the global recession. As a result, the market value of shares and convertibles (excluding indices products) rose during the year by 13%, amounting at the end of December to NIS 806 billion.

The "TA 25" and the "TA 100" indices were 15%-16% higher compared to their level at the end of 2009. A rise of a similar rate was recorded also in the "Real estate 15" index. In contrast the Banks index recorded during 2010 a moderate increase of 7%. This, despite a decrease of 17% in the first half of the year. The oil and gas prospecting sector was particularly noticeable recording a steep rise of 49% and was characterized by volatility and high trading turnovers. Trading in these shares was influenced by developments in the discovery of natural gas since 2009, alongside developments in oil prospecting in Israel and the conclusions of the public committee (Shishinsky Committee) established for the purpose of regularizing the State royalty income from the

exploitation of natural resources.

In contrast to the volatility in the share indices, trading on the bond market during 2010 was mostly characterized by price increases, which were moderated in the fourth quarter of the year. This development was to a large extent affected by the trading on the U.S. bond market serving as a benchmark for the domestic market. In consequence, the index for the overall return on all classes of bonds rose by 8%, compared to 15% in 2009, mainly due to the halt in the steep price rises of non-government bonds, which increased during 2010 by 11%, compared to 32% in 2009. Government bonds recorded a rise of 6.3%

During 2010, the amount of funds raised by corporate bond issues increased by 18% compared to the preceding year, amounting to NIS 42.7 billion. Similarly to 2009, bond issues to institutional bodies amounted to NIS 3.2 billion. The volume of capital raised by way of public share offers increased during the year, amounting to NIS 8.6 billion, compared to NIS 2.5 billion in 2009.

The average daily trade turnover in shares and convertibles during 2010 increased by 20%, to a level of NIS 2 billion. This, among other things, due to a threefold increase in the trade turnover in oil and gas securities. A sharp increase of 85% in trade turnover was also recorded in short-term loans (MAKAM), with a significant increase in holdings by foreign investors. In contrast, the daily trade turnover in bonds during 2010 was 20% lower compared to the trade turnover in 2009, amounting to NIS 3.3 billion.

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## THE ASSET PORTFOLIO HELD BY THE PUBLIC

The value of the financial assets portfolio held by the public grew by 10% during 2010, amounting at the end of December to NIS 2.5 trillion, with an increase in weight of the marketable securities in the portfolio. A major part of the growth in value of the portfolio stems from an increase in prices of equities on the Tel Aviv Stock Exchange, alongside to a growth in net investments in equities and bonds, both in Israel and abroad.

Following are the changes in the composition of the portfolio recorded in 2009:

1. The equity securities component increased from 23.4% to 26.7%;
2. The non-linked assets component increased from 31.7% to 31.9%;
3. The CPI linked assets component decreased from 32.5% to 30.4%;
4. The foreign currency linked assets component decreased from 12.5% to 10.9%.

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## PRINCIPAL ECONOMIC DEVELOPMENTS IN JANUARY-MARCH 2011<sup>(1)</sup>

The International Monetary Fund raised the forecasts for global growth and global trade for 2011 to a level of 4.4% and 7.1% respectively. Mixed data was published in the United States. On the one hand, several indicators, mostly surveys and confidence indices, indicated the continued expansion of the US economy. On the other hand, the employment market data indicated no clear direction and concurrently, deterioration was recorded in industrial production. In the Euro block, the purchase managers indices in industry and manufacturing as well as the various confidence indices published indicated increasing optimism. During the reviewed period, the monetary interest rate in the US and the Euro block remained unchanged. Concurrently, the Euro block recorded an annual inflation rate of 2.4% in January, above the targeted rate of the central bank, while in the US inflationary expectations for the future increased. In China, in view of the "economic heating-up" and apprehensions regarding a "price bubble" with respect to certain sectors, the Chinese central bank continued its constricting monetary policy while raising interest rates and raising the reserve ratio.

The political crisis, which has developed in Arab countries, stood at the center of the reviewed period, causing fluctuations in trading on the capital markets, an increase in the price of oil and the rise in the CDS level of Israel.

The market activity indicators pointed to the continued trend of economic growth, the combined index for January rising by 0.4%. Collection of tax revenues in January increased by 11% in real terms in comparison with the corresponding period last year, and the overall surplus in Government budget (excluding credit) was higher than the seasonal outline. The inflation rate for January

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(1) All the data in this chapter refer to the period from January 1, 2011 to March 16, 2011.

was higher than forecasted reaching 0.2%, with a continued upward trend in the housing item and in prices of apartments. In parallel, inflationary expectations for the coming year, deriving from the capital market rose steeply. On background of these developments, Bank of Israel lifted the interest rates for February and March to a level of 2.25% and 2.5%, respectively.

Developments in the rate of exchange of the Shekel were no uniform, being influenced by regulatory measures taken by bank of Israel, the object of which was to reduce speculative operations by foreign investors, principally by imposing reporting duties and liquidity duties on the banks, alongside the intention of the Ministry of Finance to abolish tax exemptions on short-term investments by foreigners. In addition, trading in the Shekel was affected by the developing crisis in the Arab countries. In total for the period (until February 22) the Shekel weakened as against the US dollar by 2.4% and against the Euro by 4.9.

The trade in equities on the Tel Aviv Stock Exchange, similarly to the trend in the world, was volatile on background on the situation in the Arab world. In total for the period (until February 22), the "TA 25" and the "TA 100" indices dropped by 1%. The "Tel-Bond 20" index rose by 1%, reducing the spread in comparison to government bonds.

Most of the data published in the United States were positive and indicates the continued improvement in private consumption, expansion of the industrial sector and a decline in the rate of unemployment. The strong economies in the Euro Block continued to expand, alongside a decline in the rate of unemployment. On the other hand, after a calming down of the debt crisis of the PIIGS countries and success in issuance of debt securities by certain of these countries, the crisis returned to the headlines, with higher CDS spreads and the reduction in the credit rating of several countries. During the reviewed period, the monetary interest rate in the U.S. and in the Euro Block remained unchanged. Notwithstanding, on the background of the deviation of the annual inflation rate in the Euro Block from the determined target, the Governor of the ECB hinted the possibility of raising the interest rate already in the coming period. In China, in view of the "heated-up economy" and the fear of a "price bubble" in certain sectors, the Chinese central bank continued in its contracting policy while raising the interest rate and the reserve ratio. On this background, the economic data published in China indicated a slowdown in the rate of economic growth.

In addition, a strong earthquake occurred in Japan in the first half of March, resulting in fear of a developing nuclear catastrophe.

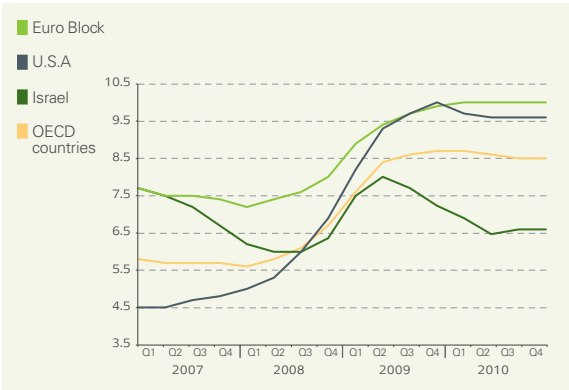
On the background of the said events, the S&P 500 index remained unchanged at the end of the reviewed period, compared with the end of 2010, while the DAX index dropped by 6%. This following a rise of 7% in these indices until the middle of February.

Most of the indicators of economic activity in Israel were positive. The combined index rose in February by 0.4%, in continuation of a rise of 0.5% in January. Tax revenues for the months of January-February recorded an increase in real terms of 12%, compared with the corresponding period last year, and the State budget recorded in the said months a surplus of NIS 3 billion. Furthermore, the export of goods recorded an increase. Notwithstanding, the consumer confidence and the purchase managers indices recorded a decline.

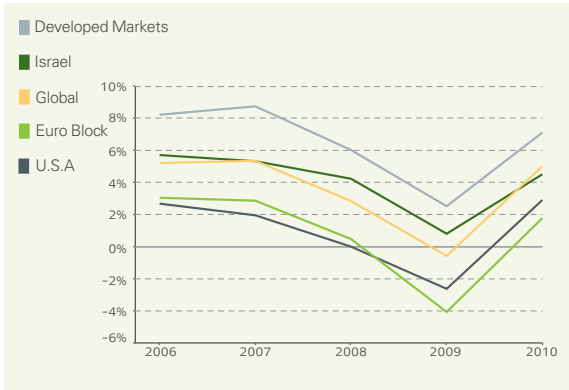
An upward trend was recorded in the rate of annual inflation in the months of January and February, with a deviation from the upper targeted limit. The CPI for February rose by 0.3%, the annual inflation rate reaching 4.2%. Concurrently, the upward trend in the housing item of the CPI and in housing prices continued, as well as inflationary expectations derived from the capital market. On the background of the said development, the Bank of Israel raised the interest rate for the months of February and March to a level of 2.25% and 2.5%, respectively.

Developments in the exchange rate of the Shekel were impacted by the relatively good condition of the Israeli economy, by interest rate differences with the developed countries, the developing crisis in the Arab states and the earthquake in Japan. In addition, trade was impacted by the regulatory measures of the Bank of Israel intended to reduce the speculative activity by foreign investors. This, alongside the intention of the Ministry of Finance to abolish the tax exemption granted to short-term foreign investments. In conclusion for the period, the exchange rate of the Shekel as against the U.S. dollar remained unchanged and weakened by 5% as against the Euro. The foreign currency balances of the Bank of Israel continued to rise reaching a record level of US\$74 billion at the end of February. **[לבדוק איך משתלבים]**

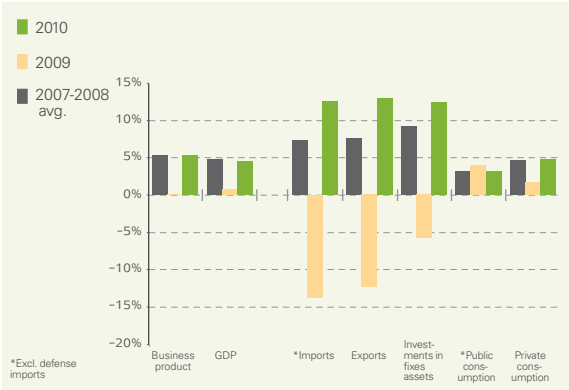
QUARTERLY UNEMPLOYMENT RATE



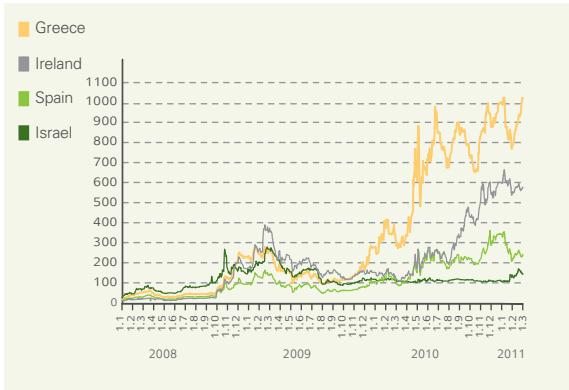
PRODUCT GROWTH - ANNUAL GROWTH RATE



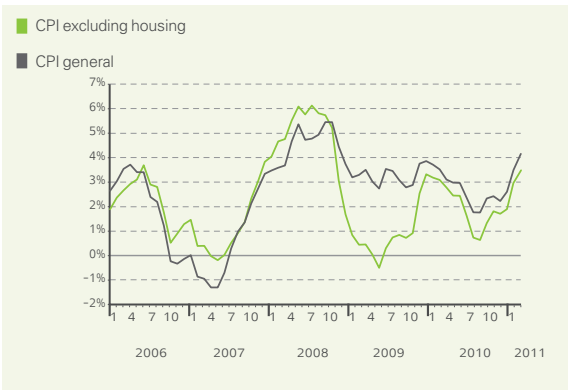
GROWTH IN ISRAEL



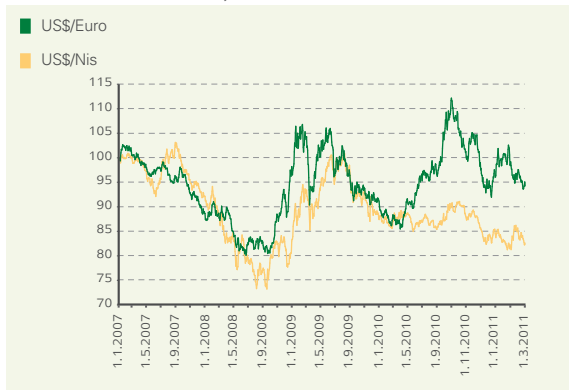
CDS SPREADS FOR 5 YEARS IN CERTAIN PIIGS STATES AND ISRAEL



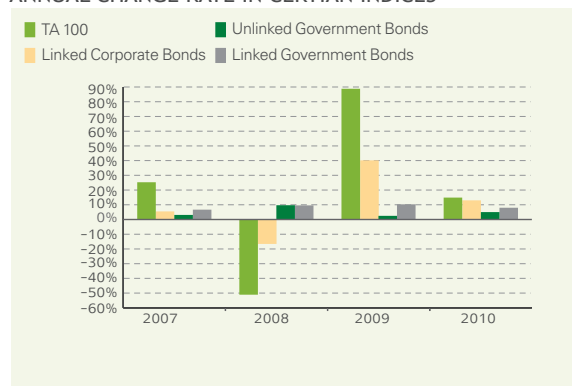
ANNUAL CHANGE RATE IN THE CPI



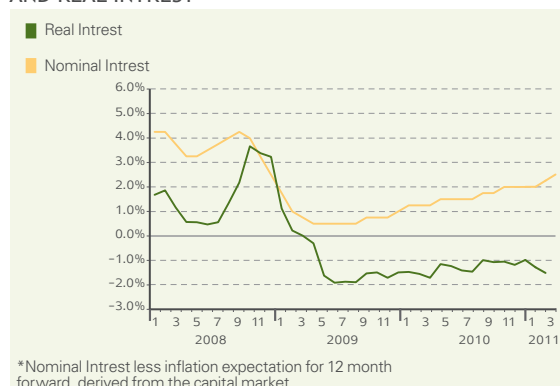
EXCHANGE RATE - CPI, JANUARY 2007=100



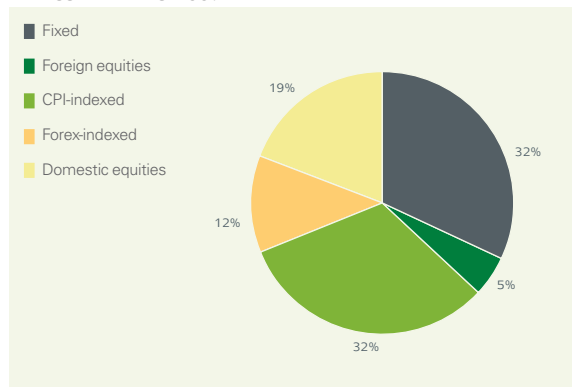
ANNUAL CHANGE RATE IN CERTIAN INDICES



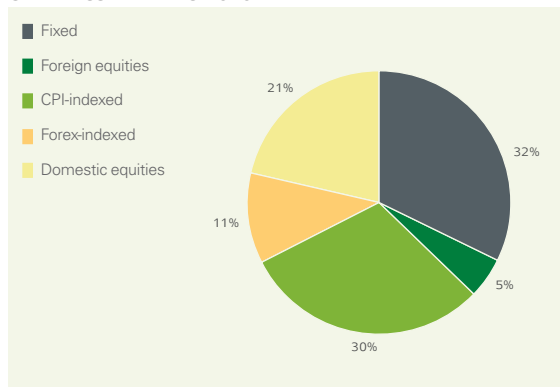
NOMINAL INTREST OF THE BANK OF ISRAEL AND REAL INTREST\*



DISTRIBUTION OF THE PUBLIC'S PORTFOLIO BY ASSET TYPES 2009



DISTRIBUTION OF THE PUBLIC'S PORTFOLIO OF BY ASSET TYPES 2010



## ACTIVITY OF THE GROUP ACCORDING TO PRINCIPAL SEGMENTS OF OPERATION

### GENERAL

A summary description of segments of operation, including the criteria for assigning customers to segments of operation, is generally included in the Section "Discount Group Segment of operations - condensed description" under "The Discount Group - general overview and structure of the Group".

Details regarding the distribution of human resources in the Group according to segments of operation are included under "Human resources" below. For details regarding the assumptions, assessments and reporting principles used in the preparations of the data, see Note 31 to the financial statements.

**The main differences between the managerial reporting format and the public reporting format.** The segment reporting presented in the financial statements and in the Directors' report have been prepared in accordance with the instructions and guidelines of the Supervisor of Banks in this matter. Certain differences exist between the managerial reports presented to the Bank's Management and the segment data and format presented in the financial statements.

The reports to the Bank's Management include, at this stage, a report of the Corporate Banking Division's data and the Banking

Division's data at the Bank level, up to the "earnings before tax" line. The Banking Division's data include the household segment customers, the small business segment and the private banking segment. The data for the Corporate Banking Division include the corporate banking segment and the commercial banking segment.

As stated, there are several principal differences between the reports to Management and the segment reporting in the financial statements:

- The report to Management does not address the allocation of profits from the severance pay fund as is the case in segment reporting according to the public reporting instructions;
- The financial activity segment includes both the activity of the Bank's "Nostro" management and risk management, which is subject to the responsibility of the Finance Division, as well as the investments in non-financial companies, which is not managed by that Division, and as stated, the activity of this segment is not presented in the said reports to Management;
- In the segment reporting according to the instructions of the Supervisor of Banks, tier I and tier II capital are allocated to each segment in accordance with each segment's risk assets, at the expense of the financial segment.

Following is the quantification of the main differences between the formats of managerial reporting and the reporting format dictated by the public reporting instructions:

	Households	Small Businesses	Corporate Banking	Middle Market Banking	Private Banking	Financial Management	Total Consolidated
in NIS millions							
For the year ended December 31, 2010							
Reported net income	184	183	279	117	56	(95)	724
Net income for Management reports	167	174	279	112	55	(63)	724
<b>Difference</b>	17	9	-	5	1	(32)	-
Following is the composition of the differences:							
Income (loss) from financing activities before provision for doubtful debts	1	4	(7)	4	-	(2)	-
Profit from severance pay funds	25	10	7	4	1	(47)	-
<b>Total income that was transferred</b>	26	14	-	8	1	(49)	-
Provision for taxes on operating income	9	5	-	3	-	(17)	-
<b>Difference</b>	17	9	-	5	1	(32)	-
For the year ended December 31, 2009							
Reported net income	*222	*199	*324	*33	*32	*113	923
Net income for Management reports	*161	*174	*305	*8	*28	*247	923
<b>Difference</b>	61	25	19	25	4	(134)	-
Following is the composition of the differences:							
Income (loss) from financing activities before provision for doubtful debts	3	5	*(3)	4	-	*(9)	-
Profit from severance pay funds	*93	*35	33	*35	*6	*(202)	-
<b>Total Income that was transferred</b>	96	40	30	39	6	(211)	-
Provision for taxes on operating Income	*35	*15	11	*14	2	*(77)	-
<b>Difference</b>	61	25	19	25	4	*(134)	-

\* Reclassified.

## STRUCTURE ADMINISTRATIVE

The Discount Group operates in Israel and overseas by way of the Bank, subsidiaries, branches and representative offices, in all areas of banking and financial services.

The Bank's business operations in 2010 were conducted by three divisions: Banking Division, Corporate Banking Division and Finance Division.

**The Banking Division** (formerly: the Retail Banking Division) conducts business with households, VIP customers, small companies and businesses, foreign residents, private banking customers and customers of direct banking. The division is also responsible for the Bank's investment consulting services - pension and securities consulting services.

**The Corporate Banking Division** is responsible for operations with the large and medium corporations (middle market) through business managers, business centers located all over the country, the Tel Aviv main branch, the foreign trade department Diamond, Exchange Branch and the London branch. Likewise, the Division is responsible for operations with segments of specific customers, such as: diamond companies, hi-tech companies, construction companies (real estate project financing), approved enterprises and large capital market operators.

**The Finance Division** is responsible for the Bank's financial investments and for management of the Bank's own account and liquidity, the dealing room (foreign currency, interest and securities), and for the management of market and liquidity risks. The division is also responsible for the management, development and operation of all the liability products, including securities. For details regarding the reorganization of the service layouts in the Corporate Banking Division and in the Banking Division, see below under "Human resources".

## RETAIL SEGMENT - GENERAL

The Bank presents two retail segments: the household segment and the small business segment. This general section includes several subjects that relate jointly to the two said segments.

### THE BRANCHES AS THE CENTER OF RETAIL OPERATIONS

The branches are the central link in the relations between the Bank and the retail customer, the retail experience taking place at the meeting point of the retail customer with the Bank - in the branch. A customer visiting a branch should undergo a retail experience as a result of a combination of four major components: A pleasant appearance of the branch and its staff, quality service throughout his stay at the branch, clarity and simplicity of the products offered and messages given to him and the availability and timeliness of consumption - simple processes and efficient performance.

The branches were modified to a customer focused structure, where against each group of customers the Bank provides a separate and different arrangement.

### BANK BRANCHES

At the end of 2010, the Bank operated a country wide layout of 147 branches and extensions, being organized within the framework of nine regions. Mercantile Discount Bank operated 77 additional branches.

**Opening of New Branches.** Two new branches were opened in 2010: "Discount home" branch in the "Large Block" area and "Discount Your Way" branch in the Tel Aviv University campus. For details regarding the modification of the branch network, complementary services and the consultation layout, see "The household segment" hereunder. Mercantile Discount Bank opened 4 branch 6 in 2010.

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## TARGETS AND BUSINESS STRATEGY

In 2004, the Bank adopted the people oriented banking vision. As part of its vision, the Bank strives to become the leader in retail banking.

As part of the strategy the branch layout was adjusted through the merger of branches and establishment of unique concept branches (see hereunder: "Adjustment of the branch layout" under "Household segment").

In order to provide an inviting and pleasant customer experience, the branch appearance has been changed to suit the retail business by introducing a branch commercialization as well as installing closed circuit TV screens and audio systems. The traditional Discount branches are undergoing a "face lift". Within this framework, each branch was divided into two areas: the daily banking area - "Discount rapid" and the specialized banking area. In addition intensive action is taken to improve the work process more by removing the operational activity from the branch allotting more time to initiative and marketing activity. The retail segment focuses on the development of the consumer credit field as a growth generator. Concurrently, with a view of improving the service experience of the customer, the Bank has deployed a line management system in the expert banking area at the branch.

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## THE SEGMENT STRATEGY

A strategy that outlines a way according to which a distinct differentiation is to be made between customers in order to succeed in maintaining the customers and exhaust the potential inherent in them.

In the course of 2010, the Bank continued to improve the segmentation of customers of this sector in order to provide appropriate service to each segment. In addition to the distribution to service teams at the branches, based mainly on financial parameters, customers were classified into sub-segments enabling improvement of the level of service provided to the customer, including the range of products, services and channels required by him.

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## CUSTOMER SEGMENTATION

**In the household segment**, which has been in focus in recent years, various strategic emphases were determined for operation with each segment, in accordance with its characteristics and needs. Based on the segmentation of the private sector, account channels have been established allowing the granting of structured credit facilities while offering unique channels to customers having financial wealth and/or salaried customers. These customers are offered a credit line of 30% of their net available financial wealth and/or up to five times the amount of their salary, respectively.

Modifying the credit facilities to the said population segments is achieved by initiating approach to the customer and accordingly adjusting the credit facility to the requirement of the customer, his repayment ability, and the acquaintance with him over the years as regards structured credit lines, in which the interest rate decreases gradually in line with the increasing utilization of the credit facility. This activity supports the development of the consumer credit field at the Bank and allows full compatibility with the needs of the customer.

**In the small business sector** three principal kinds of customers were identified: business, business plus and extended business. The segments are defined in relation to parameters of volume of operations vis-à-vis the Bank, as measured mainly in the credit field.

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## SERVICE CONCEPT

In order to create a competitive advantage, a new service concept has been formed. This concept defines a system of values, the integration of which will improve the service experience. Absorption of the new concept began in May 2010 and is expected to continue in the course of 2011.

Conduct of the personal and humane service is based on the following principles:

- Focus on the customer - specialization according to segments (customer arenas) instead of products - providing appropriate services and products in accordance with the characteristics and unique requirements of each segment;
- One stop shop - A comprehensive service to the customer at one service point;
- Team service - provides a response for a more comprehensive service at one address at the branch;
- Multi-channel - enabling the customer to perform banking operations everywhere, at any time, in every channel and individually customized;
- Expert banking - provision of various professional services in the credit and investment sectors, including customizing the product to customers' needs and requirements;
- People oriented banking - familiarity and warm and humane relations on the part of the service providers;
- Service initiative - anticipating the customer's needs and customizing products or services to such needs;
- The integration of standards for handling customer approaches and the continued reduction in complaints;
- The allocation of resources based on the requirements of the customer and the Bank's priorities.

A customer focused support system was integrated at the Bank's service layouts. This system places the customer at the center and customizes the products according to his needs and preferences.

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## "DISCOUNT KEY"

On May 27, 2010, the Bank launched a unique marketing campaign in the field of financial consumption - "Discount key". This campaign reflects a new approach which combines consumption culture with savings culture, with the aim of bolstering customer loyalty to the Bank.

In this respect, customers holding a Discount credit card (VISA ICC, Diners and MasterCard) were offered discounts at dozens of marketing chains and an array of benefits and surprises, as well as joining a unique savings deposit plan that accumulates money derived from credit cards transactions.

Bank customers may choose between three savings channels: rounding up transaction amounts to the nearest five or ten Shekel, accumulating discounts and benefits in the savings deposit, supplementing the deposits by a fixed monthly amount.

Over 263,000 "Discount key" savings deposits have been opened in the period of about seven months since the launching of the campaign.

On August 1, 2010, the Bank expanded the benefits granted under the "Discount Key" program upon the inauguration of a plan which allows free parking in Tel Aviv, Ramat Gan and Herzliya during the afternoon hours and on weekends. This move provides a response to the parking problem in Tel Aviv area and widens the reasons why it is "worthwhile to be a Discount customer".

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## "LEAN ORGANIZATION" PROJECT - REMOVAL OF OPERATIONAL ACTIVITY FROM THE BRANCHES

Integration of the project at the branch layout is intended to achieve the following targets:

- a. The customer may choose between teller assisted banking services and self service banking;
- b. Extension of branch operating hour;
- c. Removal of all operations not essential for customer service from the branch;
- d. Simplifying and shortening the remaining processes at the branch;
- e. Focusing on the customer and his needs in order to improve the service experience;
- f. Reducing the amount of paperwork and filing at the branch;
- g. Savings in manpower and costs.

As of date of publication of the financial report all the Bank's branches have a self service banking area, where the customer is able to conduct most of his daily banking transactions, including cash and check deposits and effecting payments. The services

included in the ATM infrastructure, have been expanded to include the withdrawal of foreign currency as well as cash withdrawals without a card. The service of depositing cash in the ATM infrastructure is under a pilot study.

Three back offices have been established in Tel Aviv, Jerusalem and Haifa, to which over 25 operating activities were transferred, including: clearing examination, establishment of authorizations for charging accounts and managing them, deposits through teller machines, etc. In addition, the back office is taking over from the branches the filing and maintenance of basic documents as well as the daily paperwork and their input on to the central computer system within 72 hours. The removal of basic documents has been carried out at about 50 branches. It is expected that in 2011 this process will be completed at 30 additional branches and business units. Removal of the daily paperwork has been carried out in most of the branches. These activities saved office space at branches, reduced the use of paper, shortened the time required for locating documents and reduces risks.

Since the beginning of this project, some 200 employees have been moved to the back office, while the total number of staff at the Bank was reduced by approximately 140.

A similar project is planned for Mercantile Discount Bank starting with the first half of 2011.

## RETAIL BANKING SECTOR - HOUSEHOLD SEGMENT

### SERVICE

**Banking products.** The principal banking products available to customers of this segment include current account management, credit, deposits, capital market activity and credit card services, as well as loans for the purchase, lease, enlargement, renovation or construction of a residential unit, and the granting of loans for any purpose, secured by a mortgage on a residential unit.

**Telebank - personal service.** Customer telephone answering service - automatic direction to direct banking for customers calling the branch switchboard (and not the direct lines of the staff). The project enables to improve the quality of telephonic response and to afford the staff of the branch more time to create for the customer added value from the aspects of initiative and sales.

**Telebank Internet.** Development and improvement of the service channel via the Internet. Encouraging customers to use this channel results in significantly lower costs as compared with the cost of identical services provided at the branches. For details regarding the upgrading of the Internet site, see below "Technological changes that may effect the segment".

**Discount by cellular.** A service based on cellular application enabling Internet access to the account, obtaining information and executing bank transactions by means of SMS/application at any place and at any time. Various services are provided to the customer, including obtaining support while surfing on the web.

**ATM stations adapted to the needs of the visually impaired.** Audio devices have been installed at some 340 ATM stations of the Bank and Mercantile Discount Bank all over the country, this in addition to existing identification measures by way of touch, which together help those with the visually impaired to perform banking operations. Most of the ATM stations are installed at a height that enables use by handicapped persons in wheelchairs.

### ADJUSTMENT OF BRANCH LAYOUT

As part of the Bank's differentiation measures, unique concept branches are being established with a view of providing customer tailored service to the various needs of retail customers.

**"Discount Rapid".** Discount Rapid is located at the front of the branch and provides rapid response to daily banking services. The area reflects novelty, leadership and flexibility. Rapid banking centers include several information desks, ATM machine, Telebank machine and Internet stations. Most importantly, Discount Rapid is manned by professional bank personnel and is open during special hours, from 8:00 - 20:00. At the end of 2010, 35 "Discount Rapid" centers were in operation.

**"Discount Your Way".** These branches, located in shopping malls, serve as service and sales points to customers of these malls, and are tailored to the retail environment of the malls. Opening hours are adapted to customers' needs and convenience: 10:00 - 22:00.

At the end of 2009, 6 branches of the "Discount Your Way" line were in operation: at the "Avnat" shopping mall in Petach Tiqva, at the "Across the Park" shopping mall in Ra'anana, at the "Giva'tayim shopping mall" in Giva'tayim, at the "Malcha" Shopping Mall in Jerusalem, at the Renanim Mall in Ra'anana, and of the Tel Aviv University campus.

At the beginning of March 2011, a "Discount your way" branch was opened at the "Sharonim" Mall in Hod Hasharon.

**"Household Discount"**. A branch designated at serving private retail customers only, based on an economic and efficient model for the penetration into residential areas and focused centers. These branches are located in large neighborhoods in cities and serve private customers until late hours. Business hours are adapted to the needs of customers living in the vicinity, the activity in hospitals, industrial areas, etc.: 8:00 - 20:00, 10 "Household Discount" branches operated at the end of 2010.

**Plan for 2011.** The plan for 2011 includes opening one "Discount Rapid" center, two "Discount Your Way" branch and two "Household Discount" branches.

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## CONSULTING LAYOUT

**Investment centers.** Customers having deposits of over NIS 750,000 or customers active in the capital market are entitled to consultancy services regarding their funds at ten investment centers. The account of the customer is managed at the branch, however the service is provided at the investment centers by expert investment consultants. Three extensions of investment centers were opened in 2010, which serve customers with deposits of NIS 120 thousand.

5 investment centers extensions were in operation at the end of 2010.

**Consulting services in Bank branches.** Customers with deposits in the range of NIS 250-750 thousand are entitled to advisory services provided at the branches by authorized investment consultants that specialize in the capital market.

**Pension advisory services.** As from March 2008, the Bank began providing pension advisory services at the Bank's branches and investment centers. The Bank has elected a unique model of providing pension advisory services by differentiated consultants specializing in pension advisory services to all types of customer. The Bank is considered a leader in this field and provides pension consulting services to self employed and salaried employees all over the country. (For further details see hereunder "Capital market activities" in the Chapter "Further details regarding the activity in certain products").

**Portfolio management.** Directing customers to outside and inhouse portfolio managers.

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## MARKETING AND DISTRIBUTION

Marketing and distribution are conducted by way of advertising campaigns on the printed media, television, radio and billboards. In addition, this activity is conducted through the following channels:

- At the branches - frontal activity through plasma screens located in areas where customers await service;
- Through the telephone either by way of an initiated approach to the customer or in response to an approach by the customer;
- By Discount TeleBank - either by way of an initiated approach to the customer or in response to an approach by the customer;
- At the Discount website on the Internet, which provides marketing messages and marketing offers;
- Through the Discount automatic teller machine, by which marketing messages and marketing suggestions are being communicated;
- In the interactive voice response (IVR) system in the "Telebank", by means of marketing messages and marketing suggestions while the customer is waiting for service;
- Direct mailing to customers (to which is attached a statement of account) and through the automatic service machines (ATM and Information Desk).

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## TARGETS AND BUSINESS STRATEGY

In view of the Bank's strategy to focus on the retail sector as the principal source for growth and profitability, the Bank is taking steps towards increasing its retail customer base. The four principal moves made in this respect in the last two years were:

- The State employee tender - the Bank was successful in obtaining the tender for loans to State employees at the Accountant General's terms and additional banking services (see below for the "Tender for provision of services to state employees");
- The teaching personnel tender - the Bank was successful in obtaining the tender for loans to teaching personnel at the Accountant General's terms (see below for the "Tender for provision of services to state employees");
- Continued recruitment of private customers as part of new customers recruitment campaign.
- Discount outline - A joint marketing campaign with Discount Mortgage Bank, focusing on turning the mortgage loan into a center product for attracting new active customers, by the offering attractive interest rates especially to customers who will arrange to have their salaries paid through the Bank (for further details see "Mortgage activity - Housing loans" in the Chapter "Further details regarding the activity in certain products").

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## POINTS OF EMPHASIS FOR THE COMING YEAR

- Continued leadership in personal and professional service;
- Strengthening the customer focused concept;
- Development of new and unique products and customizing them to customer needs;
- The continued attraction of State employees and teachers as customers, among other things, by way of a benefit basket especially structured for them and by the personal and people oriented service which they get from Bank employees;
- The continued positioning of the Bank as a leader in the pension consulting field;
- Emphasis on the preservation and fostering of customer loyalty and intensifying operations with new and existing customers;
- Intensifying operations on the liabilities side through capital market activity (for additional details regarding capital market activity, see "Operations in the Capital market" under "Further details as to activity in certain products");
- Shortening banking processes;
- The integration of processes for the removal of operational activities from the branches;
- Deployment of a queue management system;
- Multi-channel banking that would allow the customer to perform banking operations through any channel of his choice;
- Increased customer satisfaction by upgrading the service experience at the branch and raising the bar for service quality;
- The continued development and use of analytical models as a tool supporting decision making in the granting of credit.

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## COMPETITION

**Competitors.** The number of competitors in the household segment is the same as the number of banks operating in the market. The Bank's principal competitors are the four other major banks in Israel - Bank Hapoalim, Bank Leumi, the First International Bank and Mizrahi-Tefahot Bank. Israel Discount Bank is third in size amongst the five banks. Furthermore, competition has arisen in recent year from "off banking" financial entities, e.g. credit card companies, have entered the competitive market in recent years with respect to consumer credit, investment and insurance companies - inter alia with respect to capital market transactions.

**Means of handling the competition.** Handling the competition is conducted while making an effort to differentiate the Bank from its competitors on several levels:

- Increasing the retail market share by attracting customers while focusing on public sector employees;
- Preservation of customers by intensifying operations, improving service and providing Bank customers with differentiated proposals of value;

- The granting of mortgage loans through Discount Mortgage Bank, as a mechanism for attracting customers;
- As part of the overall proposal of value adapted to customer needs, the Bank operates service systems specializing in investment consulting, pension consulting and credit;
- Discount Bank was the first bank to extend the range of branches within the framework of improving the service and to launch unique concept branches. The activity includes over 100 branches, which are also open for customer service on Fridays.

In addition, as stated, the Bank focuses on implementing the segment strategy by specialization in the various fields and providing specialized service according to population segments and their needs.

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## DEVELOPMENT IN THE SEGMENT'S MARKETS AND CHANGES IN CUSTOMER CHARACTERISTICS

No material changes occurred in 2010 in the characteristics of customers in this segment. At the same time, the trend of increasing banking operations through the direct channels continues. (ATM, Discount Telebank, the Internet and cellular banking).

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## TECHNOLOGICAL CHANGES THAT MAY AFFECT THE SEGMENT

**In the securities operations site.** Improvements in existing questions have been made at the operations site and new information questions have been added, including: the "BULLS" system that provides extensive and up to date information in the Hebrew language regarding securities traded on stock exchanges in the U.S., as well as a mechanism for searching for basket certificates, which enables identifying and screening basket certificates according to given parameters. Furthermore, additional possibilities have been added, such as the possibility to choose a branch where pre-ordered checkbooks will be delivered to customers, direct loans granted to State employees whose accounts complies with the required terms, transfer of foreign currency, etc.

Furthermore, during 2010, the Bank changed the infrastructure of the Internet website for the operations of private customers within the framework of the "Retail" Project, which established also a new Internet access system at the branches.

**In the social media area** the Bank launched a Discount page on Facebook with a view of strengthening the link with the young people sector, promoting and marketing the Bank's products and services, promoting cultural activities under the Bank's sponsorship and promoting activities contributing to the community. This, under the assumption that the social media tool will serve the Bank as a fast and effective means of managing customer relations for the marketing of messages with a wide distribution and for the support and intensification of sales.

**In the pension consulting field,** the Bank operates a pension consulting simulator - an interactive and user friendly application in the field of pension savings plans that provides a general image of pension savings data for retirement age. The Bank offers its customers a pension information file was launched in June 2009, allowing a customer receiving consulting services to view, at the Bank's internet site the various pension products in accordance with information provided by the product suppliers. The Bank presents information received from most of the product suppliers in the market, which includes data regarding pension, provident and further education fund products.

**In the iPhone field.** The Bank offers its customers a service allowing them access to their account through the iPhone. In March 2010, the Bank launched a service enabling securities operations on the stock exchange market through the use of the iPhone. Proximate to the date of issue of the financial statements an Internet service for third generation appliances will be launched. In October 2010, the Bank launched a service enabling the transfer of funds from one account to another by means of iPhone appliances.

**In the SMS field,** The Bank also offers its customers SMS packages, which include: basic notification package, current account package, capital market package and business package.

In March 2010, the Bank launched a basic SMS package for use with the branches.

**In the Information station field.** Two new information requests were added in March 2010: a request for the screening of the

most recent statement of account and a request for a foreign currency account IBAN number. In July 2010 the Bank launched a service for the transfer of funds to another account and to permanent beneficiaries by means of the automatic teller machine. A service for the granting of loans to State employees by means of the automatic teller machine was launched in November 2010.

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## CRITICAL SUCCESS FACTORS IN THE SEGMENT

- Distribution of service stations and adaptation of business hours to the region and to the characteristics of the local population;
- Expansion of exposure and access to direct technological channels;
- Providing service and professional response to the customer compatible with his needs and preferences;
- The structuring of customer adapted products in the various banking channels;
- Flexibility and sensitivity to market changes, including regulatory requirements.

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## PRINCIPAL SEGMENT ENTRY AND EXIT BARRIERS

- Investment in branches layout all over the country;
- Investment in the establishment of advanced technological means, and in their maintenance and upgrading;
- Training of skilled service personnel engaged in providing a variety of banking products and activity;
- Maintaining the reputable service level, leadership, professionalism and reliability established over many years.
- The movement of customers from one bank to another requires the investment of efforts and impedes the attraction of new customers.

In order to facilitate the process of transferring business from one bank to another, the Supervisor of Banks issued in July 2005 an amendment to Proper Banking Management Directive No. 432, according to which a banking corporation is required to provide information to a customer considering to transfer his banking operations to another bank, and to carry out a series of operations on his behalf within a short and predetermined period.

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## PROVIDING SERVICES TO STATE EMPLOYEES

In 2007, the Bank succeeded in a tender issued by the Accountant General at the Ministry of Finance, for the granting of loans, credit facilities and other banking services to State employees (services provided until this point by Yahav Bank for State Employees Ltd.). The period of this engagement is for seven years beginning on January 1, 2008.

According to the terms of the tender, the Bank is to provide services to State employees at least 50 branches located at places determined in the tender terms. The Bank has opened branches in all the places specified in the tender, with the exception of the Government Compound at Sheikh Jarrah in Jerusalem, whose opening has been delayed because of legal problems.

The Bank estimates that the tender serves as a quality platform for the increase of its share in retail banking.

Following the success in the public tender, competition has developed between the Bank and Yahav Bank with respect to the provision of services to State employees.

The Bank grants the full benefits to which State employees are entitled under the terms of the tender, whether these State employees are new customers or long-standing customers of the Bank, as well as services and off-banking benefits adapted especially to the needs of State employees.

The Bank operate special branches within the framework of providing services, as stated, this under the permit granted to it in the past for operating provisional branches, under which the Bank may operate up to 30 provisional branches at any given time, subject to the various limitations determined in this permit. The validity of that permit has been extended to June 30, 2011.

It should be mentioned that within the framework of the tender, not all populations belonging to public sector's employees have

been defined by the Accountant General as eligible to special terms and benefits. Following the success achieved in the tender and approaches made by various organizations in the public sector, the Bank has entered into special arrangements with organizations not forming part of the population entitled to State employee terms, and has devised similar benefit terms to their employees. Until December 31, 2010, 68,325 new accounts of State employees were opened of which 5,524 operational accounts used for providing loans to State employees only.

For further details, see Note 19 C 18 to the financial statements.

**Vacating Yahav Bank branches from Government premises.** Following an approach made by the Bank to the High Court of Justice Department at the Attorney General's Office, in proceedings of a "pre-motion" to the High Court of Justice, the Attorney General's Office informed the Bank on March 16, 2010, that Yahav Bank is required to vacate all its branches conducting business on State property and to return such property, vacant and free in accordance with the law, to the possession of the Government Housing Administration no later than April 30, 2010. On June 7, 2010, The Jerusalem District Attorney's Office (civil cases) submitted to the Jerusalem Magistrate's Court a claim brief submitted in summary procedure for the eviction of the Yahav Bank branches located at Government office premises in the Capital (Ministry of Interior and Sheikh Jarrah). On October 5, 2010, the Court decided to admit the motion of Yahav Bank for permission to defend itself, and passed on the claim for hearing under an ordinary procedure. In December 2010, the case was referred to mediation.

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## PROVIDING SERVICES TO TEACHING STAFF

In 2007, the Bank succeeded in the tender issued by the Accountant General for the granting of subsidized loans to teachers and of conditional loans to education students (services provided at that time by the First International Bank of Israel Ltd.). The engagement period is for five years, as from November 1, 2007.

As of November 1, 2007, Israel Discount Bank is the only bank which grants loans out of State funds to teachers employed by the Ministry of education and to education students. The Bank has decided to expand its operation also to other teaching personnel employed by other institutions and to offer them preferred terms. In February 2009, the Bank signed an agreement with the Teachers Union. Within the framework of the agreement, members of the teachers' organization, whose salary is deposited into their account at Israel Discount Bank, enjoy the benefits due to them as teaching staff and in addition enjoy preferred terms unique to members of the teachers union.

Until December 31, 2010, 23,280 new accounts of teaching staff were opened, of which 12,225 operational accounts used for providing loans to teaching staff only.

For further details, see Note 19 C 19 to the financial statements.

For details regarding the marketing of mortgages within the framework of "Discount layout", see "Mortgage and housing loan activity" under "Further details as to activity in certain products" hereunder.

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## SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

**General.** Most of the income from credit card issue operations is related to the household segment.

**Income from financing operations** amounted to NIS 1,386 million in 2010, compared to NIS 1,253 million in 2009, an increase of 10.6%. The said increase is explained by the reduced erosion in spreads relating to deposits that occurred in 2009, due to the rise in interest rate.

**Net income** of the segment in 2010 amounted to NIS 184 million compared with NIS 222 million in 2009, a decrease of 17.11%. Excluding profits from extraordinary operations, the profit amounted to NIS 172 million compared to NIS 222 million in 2009, a decrease of 22.52%.

**The return on equity**, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets,

was 8.8% in 2010, compared with 12.9% in 2009.

**Provision for doubtful debts** in this segment amounted in 2010 to NIS 191 million, compared with NIS 249 million in 2009, a decrease of 23.3%. The decrease in the provision for doubtful debts stemmed from the hotel, communications, computer services and the construction and real estate sectors.

Following are the principal data relating to the operations of the household segment:

	Domestic operations				Total domestic operations	International operations:	
	Banking and finance	Credit cards	Capital market	Mortgage		Banking and finance	Total
For the year ended December 31, 2010							
in NIS millions							
Income from financing activities before provision for doubtful debts							
- From external sources	1,303	283	10	160	1,756	3	1,759
- Intersegmental	(279)	(51)	-	(43)	(373)	-	(373)
Total income from financial activity	1,024	232	10	117	1,383	3	1,386
Operating and other income	471	787	264	48	1,570	-	1,570
<b>Total Income</b>	1,495	1,019	274	165	2,953	3	2,956
Provision for doubtful debts	161	26	-	4	191	-	191
Operating and other expenses	1,463	655	176	118	2,412	1	2,413
Operating Income (loss) before taxes	(129)	338	98	43	350	2	352
Provision for taxes on operating income	(53)	114	38	16	115	(1)	114
<b>Net (loss) income</b>	(76)	157	73	27	181	3	184
Return on equity (percentage)	(10.5)	20.7	219.4	4.7	8.7	108.9	8.8
Average Assets	9,286	7,858	9	16,327	33,480	36	33,516
Average Liabilities	57,006	748	-	1,531	59,285	161	59,446
Average Risk-assets	10,289	10,880	472	8,016	29,657	36	29,693
Average assets of provident and mutual funds	-	-	27	-	27	-	27
Average customers' securities	-	-	33,360	-	33,360	-	33,360
Average other assets under management	861	-	1,215	1,538	3,614	-	3,614
Components of income from financial activities:							
Margin from credit activity	505	238	-	114	857	1	858
Margin from deposits activity	481	-	-	-	481	2	483
other	38	(6)	10	3	45	-	45
<b>Income from financing activities before provision for doubtful debts</b>	1,024	232	10	117	1,383	3	1,386

Following are the principal data relating to the operations of the household segment (continued):

	Domestic operations				Total domestic operations	International operations:	
	Banking and finance	Credit cards	Capital market	Mortgage		Banking and finance	Total
For the year ended December 31, 2009							
in NIS millions							
Income from financing activities before provision for doubtful debts							
- From external sources	(269)	275	10	173	189	7	196
- Intersegmental	1,180	(59)	-	(64)	1,057	-	1,057
<b>Total income from financial activity</b>	<b>911</b>	<b>216</b>	<b>10</b>	<b>109</b>	<b>1,246</b>	<b>7</b>	<b>1,253</b>
Operating and other income	551	767	260	49	1,627	-	1,627
<b>Total Income</b>	<b>1,462</b>	<b>983</b>	<b>270</b>	<b>158</b>	<b>2,873</b>	<b>7</b>	<b>2,880</b>
Provision for doubtful debts	159	77	-	-	236	13	249
Operating and other expenses	1,363	605	150	123	2,241	1	2,242
Operating income (loss) before taxes	(60)	301	120	35	396	(7)	389
Provision for taxes on operating income	*(42)	99	43	14	114	-	114
<b>Net income</b>	<b>(18)</b>	<b>149</b>	<b>77</b>	<b>21</b>	<b>229</b>	<b>(7)</b>	<b>222</b>
Return on equity (percentage)	*(3.9)	36.5	-	2.7	13.3	(74.7)	12.9
Average Assets	*8,314	7,682	7	14,879	30,882	141	31,023
Average Liabilities	*61,019	1,396	-	1,760	64,175	25	64,200
Average Risk-assets	7,725	6,301	7	12,350	26,383	141	26,524
Average assets of provident and mutual funds	-	-	55	-	55	-	55
Average customers' securities	-	-	29,366	-	29,366	-	29,366
Average other assets under management	580	-	1,307	1,772	3,659	-	3,659
Components of income from financial activities:							
Margin from credit activity	438	216	-	106	760	3	763
Margin from deposits activity	*440	-	-	-	440	4	444
other	33	-	10	3	46	-	46
<b>Income (loss) from financing activities before provision for doubtful debts</b>	<b>911</b>	<b>216</b>	<b>10</b>	<b>109</b>	<b>1,246</b>	<b>7</b>	<b>1,253</b>

\* Reclassified.

## LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SEGMENT

The Bank operates within the framework of laws regulations and regulatory directives applicable to the banking sector in Israel as promulgated by various supervisory bodies, viz., the Supervisor of Banks, the Commissioner of the Capital Market, Insurance and Savings at the Ministry of Finance, the Commissioner of Restrictive Trade Practices, the Securities Authority etc. The principal

restrictions applicable to this segment are briefly described hereunder.

**Commissions.** There are several private bills proposing to abolish current account fees, as well as obligating banks to pay interest on credit balances on current accounts. At this stage it is not yet possible to evaluate whether additional legislation and regulatory changes relating to banking services, commissions and/or interest in their respect, will take effect and what the applicable arrangements will be, if any, and how these may affect the banking services consumption habits of customers. Accordingly, it is not yet possible to assess the implications this might have upon the Bank's results of operations in the future.

For further details in these matters, see "Legislation and arrangements regarding banking commissions" under "Legislation and Supervision" hereunder.

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## THE RETAIL SEGMENT AT THE MERCANTILE DISCOUNT BANK

Most of the customers of Mercantile Discount Bank belonging to the household segment of this bank, receive banking services by means of the Mercantile Discount Bank branches organizationally belonging to the Acco and Nazareth regions (30 branches). Such branches are located in areas where the population has an absolute "non-Jewish" majority. Mercantile Discount Bank management believes that most of the customers belonging to such populations receive services from Bank Leumi and Bank Hapoalim, while the balance of the activity is divided among the remaining banks.

Mercantile Discount Bank views the retail segment as a central target of its business development and is diligently working on broadening the branch layout in the segment as well as improving the service to its customers. In this respect, Mercantile Discount Bank opened in 2009 two branches in areas having a potential for providing banking services to customers of this segment.

For details as to the consequences of the capital market Reform, see "Operations in the capital market" hereunder under "Further details as to activity in certain products".

## RETAIL BANKING SECTOR - SMALL BUSINESSES SEGMENT

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### SCALE OF OPERATIONS AND NET INCOME OF SEGMENT

**Net income** of the segment in 2010 amounted to NIS 183 million compared with NIS 199 million in 2009, a decrease of 8.04%.

**The return on equity** in 2010, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 17.3%, compared with 26.0% in 2009.

**Provision for doubtful debts** in this segment amounted in 2010 to NIS 214 million, compared with NIS 191 million in 2009, an increase of 12.04%.

Following are the principal data relating to the operations of the small business segment:

	Domestic operations					Total
	Banking and finance	Credit cards	Capital market	Construction and real estate	Mortgage	
For the year ended December 31, 2010						
in NIS millions						
Income from financing activities before provision for doubtful debts						
- From external sources	1,164	13	3	110	37	1,777
- Intersegmental	(815)	1	-	(30)	(13)	(857)
Total income from financial activity	799	14	3	80	24	920
Operating and other income	334	60	47	20	4	465
<b>Total Income</b>	<b>1,133</b>	<b>74</b>	<b>50</b>	<b>100</b>	<b>28</b>	<b>1,385</b>
Provision for doubtful debts	172	-	-	43	(1)	214
Operating and other expenses	777	65	31	19	10	902
Operating Income before taxes	184	9	19	38	19	269
Provision for taxes on operating income	65	4	6	13	7	95
<b>Net income</b>	<b>119</b>	<b>5</b>	<b>22</b>	<b>25</b>	<b>12</b>	<b>183</b>
Return on equity (percentage)	15.7	10.0	-	19.7	10.8	17.3
Average Assets	11,809	324	4	1,828	1,276	15,241
Average Liabilities	13,087	905	-	769	69	14,830
Average Risk-assets	10,895	753	87	1,819	1,517	15,071
Average assets of provident and mutual funds	-	-	10	-	-	10
Average customers' securities	-	-	9,186	-	-	9,186
Average other assets under management	-	-	347	-	-	347
Components of income from financial activities:						
Margin from credit activity	638	14	-	67	22	741
Margin from deposits activity	104	-	-	6	-	110
other	57	-	3	7	2	69
<b>Income from financing activities before provision for doubtful debts</b>	<b>799</b>	<b>14</b>	<b>3</b>	<b>80</b>	<b>24</b>	<b>920</b>

Following are the principal data relating to the operations of the small business segment (continued):

	Domestic operations					Total
	Banking and finance	Credit cards	Capital market	Construction and real estate	Mortgage	
For the year ended December 31, 2009						
in NIS millions						
Income from financing activities before provision for doubtful debts						
- From external sources	*693	15	3	84	45	840
- Intersegmental	16	-	-	(14)	(24)	(22)
Total income from financial activity	709	15	3	70	21	818
Operating and other income	*372	93	42	17	2	526
<b>Total Income</b>	1,081	108	45	87	23	1,344
Provision for doubtful debts	169	-	-	19	3	191
Operating and other expenses	*721	66	28	18	8	841
Operating income before taxes	191	42	17	50	12	312
Provision for taxes on operating income	*65	14	6	18	4	107
<b>Net income</b>	*126	22	11	32	8	199
Return on equity (percentage)	*20.9	99.7	-	51.9	10.1	26.0
Average Assets	11,318	305	3	1,693	1,262	14,581
Average Liabilities	12,369	1,064	-	686	87	14,206
Average Risk-assets	9,239	335	3	952	1,256	11,785
Average assets of provident and mutual funds	-	-	25	-	-	25
Average customers' securities	-	-	6,275	-	-	6,275
Average other assets under management	-	-	302	-	-	302
Components of income from financial activities:						
Margin from credit activity	578	15	-	58	18	669
Margin from deposits activity	*79	-	-	4	-	83
other	*52	-	3	8	3	66
<b>Income (loss) from financing activities before provision for doubtful debts</b>	709	15	3	70	21	818

\* Reclassified.

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## SERVICE TO SEGMENT CUSTOMERS

The small business segment provides a variety of services to small and medium size business customers. Customers entitled to a credit facility of up to NIS 500 thousand receive these services through personnel in branches specializing in the needs of this segment, and through direct banking channels (Internet and Discount Telebank). Customers entitled to a credit facility exceeding NIS 500 thousand receive services through regional credit centers (within the framework of the reorganization of the service layouts, the credit centers and business centers will be merged into one service layout of six business centers countrywide).

The foreign trade department serves customers engaged in international trade. Every customer benefits from the entire range of the Bank's foreign trade services in specialist industry units that deal with all aspects of foreign trade, viz., exports, imports, financing, future financial instruments, electronic communication and relevant information on customers and suppliers. (For further information, see below, 'Corporate Banking Segment').

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## POINTS OF EMPHASIS FOR THE COMING YEAR

- Continuous focusing on improvement of the customer service level by study sessions for the improvement of staff proficiency, measurement and control;
- Continuing the development of analytical models and the use thereof as a decision supporting tool for the granting of credit;
- Expansion of the use made of the direct channels, including a designated website for segment's customers, the "Business +";
- Completion of the move for the reorganization of the service layouts.
- Increasing the use of models analyzing the activity of the segment's customers (the "red lights" system).

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## CREDIT CENTERS

As stated, handling the business activity of customers having a credit facility exceeding NIS 500 thousand, is carried out at the regional credit centers. These centers are manned by teams of officers specializing in the credit field. As at the end of 2009, five credit centers in a nation wide distribution are in operation: the Sharon Credit center, the Tel Aviv credit Center, the Haifa Credit Center, the Lowland Credit Center and the Jerusalem credit center with a southern extension in Beer-Sheva. The credit centers serve as professional service bureaus, while the account of the customer and its current activity remain in the related branch office (as stated, within the framework of the reorganization of the service layouts, the credit centers and the business centers will be merged into one service layout of six business centers countrywide).

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## COMPETITION

The existing competition in this segment is mainly in the banking sector. The Bank's principal methods to cope with competition include timely response to customers' requests, development of personal relationships with customers and proposal of viable comprehensive professional solutions for financial requirements.

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## SERVICE

**"Business +" website.** In September 2010, the Bank launched a designated website for business customers, tailored to respond to needs of such customers. The website presents comprehensive data regarding the accounts of the business and allows the carrying out of transactions at lower costs.

**SMS business packages.** The SMS business package was launched in February 2011, allowing extension of current account services. Receiving messages regarding the following matters are available: notice in advance as to the termination of a guarantee,

outstanding balance of guaranties relating to the account, collection of post-dated checks (balance and payments), checks serving as collateral (balance, payments and shortage vis-à-vis the defined amount), order of check books, dishonored checks, etc.

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## THE SMALL BUSINESS SEGMENT AT THE MERCANTILE DISCOUNT BANK

The small business segment at the Mercantile Discount Bank is one of the outstanding segments of this bank and accordingly is a central target in its business development.

Around one half of the customers of Mercantile Discount Bank who belong to this segment live in areas where the population has an absolute "non-Jewish" majority and receive banking services by means of 30 branches of this bank belonging organizationally to the Acre and Nazareth regions. Mercantile Discount Bank management believes that most of the customers belonging to such populations receive their services from Bank Leumi and Bank Hapoalim, while the balance of the activity is divided among the remaining banks.

For details as to the legislation regarding bank commissions and its implications, see above.

## CORPORATE BANKING SEGMENT

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### REVIEW OF DEVELOPMENTS IN THE BUSINESS SECTOR IN 2010

The Israeli economy grew in 2010 by 4.6%, following a most moderate growth rate of 1% in 2009, this on the background of the continued global economic recovery, alongside an increase in domestic demand. The growth of the business product of 5.3% was even faster, led by the following factors:

- Increase at the rate of 12% in investments in fixed assets, following a decline in 2009, while accelerating in the second half of the year. An especially fast growth was registered in investments in transportation vehicles, as well as a growth in investments in machinery and equipment, alongside a marked acceleration in residential construction. In contrast, an only moderate growth was recorded in investments in infrastructure and in non-residential construction.
- On the background of the growth in global trading, and following a decline of 13% in 2009, an increase of 14% was recorded in 2010 in the export of goods and services, and a similar rate in industrial exports (excluding diamonds). Notwithstanding, a significant slowdown in the rate of expansion of exports was registered in the second half of the year, alongside a most moderate growth in industrial exports, excluding diamonds.
- A growth at the rate of 5% in private consumption with a growth of 13% in the consumption of durable goods and a steep rise (21%) in the consumption of motor vehicles. A significant acceleration in the consumption of durable goods was recorded in the last quarter of the year.
- A growth of 3% in public consumption expenditure (excluding defense imports), with a growth of 1% in purchases of the Ministry of Defense from the domestic business sector, and a growth of 4% in civil purchases.

Economic expansion in 2010 was accompanied by a growth of 12% in the import of goods and services (excluding defense imports) with a growth of 18% in the import of goods. In addition, an improvement was registered in 2010 in the employment market, where in the last quarter of the year, corporations in most of the sectors reported difficulties in hiring professional workers.

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### DEVELOPMENTS IN THE DEBT OF THE BUSINESS SECTOR

During 2010, the total debt of the business sector (excluding banks and insurance companies) increased by 3% (one third of the growth attributed to the last quarter of the year), amounting to NIS 759 billion, this, following a decline of 1% in 2009 (the rates of change are in nominal terms and are affected by changes in the exchange rate and in the CPI).

The increase in the debt balance in 2010 stems from a 6% increase in indebtedness to banks (following a decline at a similar rate

in 2009), when approximately one half of the annual growth occurred in the last quarter. Concurrently, the growth (15%) continued in the indebtedness of the business sector to households and corporations (marketable corporate bonds), with a significant moderation as compared with 2009. In contrast, indebtedness of the business sector to institutional bodies continued to decline (by 2%), as well as a decline of 7% in indebtedness of this sector to foreign residents.

As a result of the said developments, the weight of the banks in the total indebtedness of the business sector increased from 53% at the end of 2009 to 54.5% at the end of 2010. The increase in the volume of debt of the business sector to the banking industry in 2010, stemmed mostly from the following factors:

- An increase in current credit due to the increase in volume of activity and in working capital (mostly inventories and receivables);
- An increase in investments in plants and equipment on the background of a growth in activity and a positive horizon view in the field of demand;
- Improvement in the capital adequacy of banks permitting expansion in credit;
- Intensified competition in the banking industry, which resulted in lower costs to customers;
- Increase in volume of transactions for the finance of acquisition of means of control and of national infrastructure projects;
- A decline in raising of capital through bond issues, (excluding securities offerings by the financial sector) from NIS 26 billion during 2009 to NIS 22 billion during 2010;
- Reverting to selective investments abroad on the part of Israeli investors, on the background of the decline in the value of properties and the desire to utilize business opportunities.

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## DEVELOPMENTS IN SEGMENT MARKETS

The growth in business activity of most economic sectors continued in 2010, following the recovery in the domestic and overseas levels of demand, which had started in the second half of 2009.

Following are directions of development at industry level in 2010 as compared with 2009:

- Export inclined industrial sectors - an increase of 6.3% in the volume of industrial exports (excluding diamonds, in U.S. dollar terms), based on the electronics, pharmaceutical, chemical, and certain traditional industries (mainly foodstuffs, paper, metal, rubber and plastics). The rate of growth in industrial exports slowed down in the second half of 2010, to a large extent as a result of a decline in the pharmaceutical sector (which grew at a fast rate in the first half of the year) and to a slowdown in the volume of demand abroad and the low currency exchange rate environment. The increase in the volume of activity and efficiency measures adopted during the crisis period contributed to the rise in equipment utilization while improving operating profit margins and cash flows;
- The electronics sector - an increase in the volume of activity resulting from the increase in demand and in orders from electronics companies in the U.S., European block and certain Asian countries, mostly for chips and semiconductors (printed circuits) for the consumer electronic products market, which was one of the principal markets affected by the crisis. A moderate increase in the volume of demand was recorded in the chip and equipment market for communication operators, the volume of activity still remaining lower than that prior to the crisis;
- The chemical sector - Production of this sector recorded an increase of 19% in 2010 rising prices and declining inventories. The said improvement stemmed from a decline in the surplus of the global manufacturing capacity and the rise in prices on the international markets by the leading players therein;
- Defense industries - growth in foreign operations against the background of large orders for weapons transactions;
- Domestic industrial sectors - an increase in the rate of utilization of machinery and equipment and in the levels of inventories stemming from the rise in levels of domestic demand, resulted in an increase in the volume of the industrial production;
- Diamonds - a net increase of 52% in the export of raw and polished diamonds to US\$8.9 billion, compared to US\$5.9 billion last year, stemming simultaneously from a quantitative growth and from a certain rise in prices of raw and polished diamonds;

- Commercial sectors - a rise in income and in operating profit margins stemming from an increase in the volume of demand on the domestic market. The principal sectors influenced by the rise in the volume of operations were motor vehicle importers, various goods and raw materials, electronic components, foodstuffs, fashion brands and cosmetics; the sales index of the marketing chains rose by 3.0% compared to 2009;
- Services sector - a significant increase in volume of activity in the operational and financial lease, car rental services and computer services. The communication sector recorded a moderate increase in the volume of activity and in operating profit margins on the background of mergers and acquisitions and increased competition. The investment house sector recorded an increase in the volume of operations on the background of the boom in the capital market;
- Hotel sector - a significant increase of 10% in the number of bed/nights at hotels compared to 2009 (21.9 million bed/nights in 2010 compared to 20.0 million bed/nights in the previous year), this, due to a 22% increase in the number of foreign tourist bed/nights. The average countrywide room occupancy was 66% compared to 60% occupancy last year;
- In most of the economic segments, corporations recorded an increase in inventory levels and in investments in fixed assets.

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## ANTICIPATED DEVELOPMENTS IN THE SEGMENT'S MARKETS

Continuation of the increase in the activity of the business sector is expected in 2011 on the background of the continuing recovery of the domestic economy, which will cover most of the industrial, commercial and services sectors. According to the Bank of Israel forecast of September 2010, the business product is expected to grow in 2011 by 4.4%, compared to a growth of 5.3% in 2010.

Following are the main expected developments:

- Moderation in the rate of growth of exports, on the background of exposure to certain markets in the Euro block, which are still experiencing various levels of the crisis, the slow recovery rate of the U.S. economy and a low currency exchange rate environment;
- The continued growth in demand on the background of the growth in private consumption by households stemming from the decline in the unemployment rate, the increase in desire for consumption by the population (on the background of a positive horizon on the capital market) and a low interest rate environment;
- The continued accelerated activity rate in the building industry due to an accelerated growth in investments in residential construction;
- Stability in the volume of investments and inventories of corporations following the return to normative levels in view of expectations for additional growth in activity of this segment.

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## EXPECTED DEVELOPMENTS IN CREDIT TO THE BUSINESS SECTOR

A significant growth in bank credit is expected in 2011 as well as a relatively moderate growth in off-banking credit to the business segment due to the following developments:

- Continued growth in investments and in working capital requirements resulting from the improvement in the business environment of the domestic companies and expectations for the continuing growth in non-financial activity;
- Improvement of the capital adequacy of the banking industry over and above the required minimum;
- A decline in credit spreads and commissions following increased competition among the large banks;
- Increase in the volume of transactions for the acquisition of means of control in Israel and abroad by holding companies having liquid reserves;
- Increase in the volume of transactions for the financing of national infrastructure projects;
- The need for recycling of bonds in a significant amount, that is due for redemption during 2011;

The Bank believes that bank credit to the business segment is expected to grow by 5.5%, which is higher than the expected rate of growth of the business product (4.4%).

**The off-banking credit.** Growth is expected in the raising of funds through bond issues by large and leading corporations having a rating of "A" and above, on the background of the low returns on corporate bonds, a low interest rate environment and demand for investments, mostly on the part of mutual funds, which are not subject to the recommendations of the Hodek Committee.

The adoption by the Ministry of Finance of the principal recommendations of the Hodek Committee regarding the acquisition of bonds by institutional bodies, which include recommendations as to the evaluation of repayment ability, obtaining collateral, financial covenants and the increase in interest rate in case of reduced rating, might induce certain corporations to refrain from bond offerings, thus navigating their financial needs towards the banking industry. On the other hand, given preferential terms to bonds, it is possible that corporations that will offer bonds under the new limitations may find difficulties in obtaining bank finance. In any event, the volume of funds raised outside the banking industry will be affected by the conduct of the institutional bodies, while adopting a more selective policy than in the past.

According to the trend noticed in the bond market as from October 1, 2010 (date on which the directives determined following the Hodek Committee recommendations entered into effect), it seems that the volume of corporate bond issues has not been reduced though the process of raising funds by the issuing companies has become more lengthy and complex which includes among other things, due to the need to obtain the consent of the financing banks.

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## TARGETS AND BUSINESS STRATEGY

Within the framework of the focusing of the Bank on augmenting value, quality risk management and achieving capital adequacy targets, development outlines for the corporate segment have been defined, as follows:

- Able and controlled management of risk assets;
- The continued strengthening of corporate synergy and interface at Bank and Group levels in the matter of credit risk management;
- The pricing of risk by way of focusing on risk adjusted return on capital;
- Studying the possibility of sale of risk assets;
- Application of a selective sector policy of financing customers, with a focus on economic sectors that are characterized by growth potential and a reasonable credit risk level;
- Participation in the financing of large merger and acquisition transactions structured by the two large banks in Israel;
- Increasing related activities with existing and new customers;
- Expanding credit granted to medium sized and financially sound groups of borrowers having a growth potential;
- Intensifying the control and monitoring processes over current exceptional developments in the risk profile of customers;
- Continued improvement of the technological infrastructure supporting the identification, measurement, analysis and control of various risks, focusing on credit and operational risks.

In view of forecasts for the continuation of the positive trend regarding the activity of the business sector, which will be reflected in the continued remarkable growth in sales to the domestic market and in a slightly moderate growth in exports, and seeing a positive development horizon in the capital market, the Bank has defined the following sectors and/or areas of operation having preference in the allocation of credit:

- Preference to financing activities of corporations in the following areas;
- Industrial operations - electronics (principally in the industrial electronic equipment, chips and semiconductor sectors), chemicals, medical equipment, pharmaceuticals, defense industries, paper, food and beverages;
- Commercial operations - large corporations engaged in oil, gas and commodities trading, importers of motor vehicles, large food and electrical appliances marketing chains;
- Services - communications companies, business services, public transport, motor vehicle leasing and rental companies with a relatively low leverage finance operating within the framework of a financially sound group;
- Current financing of large capital market operators, where the credit granted is secured by solid financial assets;

- Medium and Long-term finance of exporters and/or their customers in respect of complex foreign trade transactions, secured by insurance policies issued by insurance companies having a high international investment rating;
- Increasing the scope of operation with medium sized borrower groups having financial stability and growth potential, with a view of reducing the concentration of the credit portfolio;
- Granting short-term credit to large and financially sound corporations by means of discounting bills and/or against supplier invoices;
- Completion of the move for the reorganization of the service layouts;
- Expanding business activity with medium and small groups of borrowers of financial soundness and growth potential with a view of reducing the concentration of the credit portfolio;
- Expanding business activity with operating companies having growth potential and reasonable profitability, owned by holding corporations financed by the Bank, with a view of increasing the yield component of related activity.

The above said is considered a forward looking statement. The above reflects the evaluation of the Bank's management keeping in mind the information available to it at date of preparation of the financial statements, with respect to the state of the economy and of the global economy, as discussed above in this Section and in "Main developments in Israel and around the world in 2010". The foregoing may not materialize in case of a significant decrease in demand from overseas due to a noticeable decrease in the recovery and growth rates in certain overseas markets, a significant decrease in local demand due to deterioration of the security-political situation, a decrease in available financing resources on overseas and domestic financial markets, significant volatility in interest rates and exchange rates around the world and in the global economy, and other changes in macro-economic conditions, which are not under the Bank's control.

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## LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SEGMENT

The Bank operates within the framework of laws, regulations and regulatory directives applicable to the banking sector in Israel as promulgated by various supervisory bodies, viz., the Supervisor of Banks, the Commissioner of the Capital Market, Insurance and Savings of the Ministry of Finance, the Commissioner of Restrictive Trade Practices, the Israel Securities Authority etc. The principal restrictions applicable to this segment are briefly described hereunder.

**Limitations on indebtedness of a single borrower, a group of borrowers and all the six large borrower groups.** The Proper Bank Management directives contain restrictions with respect to the extent of the indebtedness allowed to any single borrower or group of borrowers, and the extent of the total indebtedness allowed to the bank's six largest borrower groups. These restrictions may have adverse implications on the manner and scope of the Bank's business segment operations insofar as they relate to these customers.

The Bank computes the limitation on groups of borrowers at the rate of 25% of the Bank's equity while the limitation on the total indebtedness of the six largest borrowers and groups of borrowers will be computed at the rate of 150% of the Bank's equity, this in accordance with the approval of the Supervisor of Banks.

As of December 31, 2009 no deviations existed to the limitations regarding a single borrower, groups of borrowers and the six largest groups of borrowers, as set in the Supervisor's directives.

**The limitation on "related parties".** Proper Banking Management Directive No. 312 imposes a restriction on the granting of credit to all "persons related to the bank", as defined in the Directive, so that it would not exceed 10% of the bank's equity. The indebtedness of each component of the controlling interest shall not exceed the product of multiplying his proportionate share in the controlling interest by 10% of the bank's equity.

In September 2006, the Bank received the Supervisor of Banks' guideline of in this matter, according to which for the purpose of the said Directive, the credit restriction relating to the individuals making up the group will be as follows: Mr. Edgar M. Bronfman - 3.86% of the Bank's equity,

Mr. Matthew Bronfman - 0.78% of the Bank's equity, Mr. Adam R. Bronfman - 0.39% of the Bank's equity, Ms. Holly B. Lev - 0.39% of the Bank's equity, Mr. Michael Rubinoff - 0.2% of the Bank's equity, Mr. Philip Milstein - 0.39% of the Bank's equity and Mr. Rubin Schron - 4.0% of the Bank's equity.

As of December 31, 2009, there were no deviations from the said limitations.

**Intensifying supervision.** Following the economic slowdown, the Bank of Israel has approached the banking corporations requiring them to examine their credit portfolio, focusing on transactions for the finance of acquisition of means of control, credit to customers exposed to the crisis, and more. The Bank has performed the examination as required, partly under the supervision of the Bank's credit controller, and no exceptional findings have come to light.

**Amendment No. 44 of the Securities Law.** An amendment published on January 12, 2011, determined that in cases where a company, being a reporting corporation, becomes insolvent or cannot meet its obligations, the bonds held by the controlling shareholders of the company will be redeemed only after the bonds held by all other bondholders have been redeemed.

This means that the right of the controlling shareholders to receive payment by power of their ownership of bonds issued by the corporation under their control, in circumstances where such corporation finds itself in difficulties, is impaired and turns into a deferred right. In such cases a controlling shareholder will be entitled to a payment by power of bonds issued by the corporation under his control only after (and actually only subject to) all other bondholders have been redeemed in full, unless otherwise explicitly determined within the framework of a compromise agreement or arrangement approved by a special resolution of a meeting of bondholders of the same Series, or within the framework of a compromise or arrangement approved in accordance with Section 350 of the Companies Law, or where the controlling shareholder is holding the bonds since their initial issuance.

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## SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

**Income from financing operations** amounted to NIS 1,025 million in 2010, compared to NIS 1,097 million in 2009, a decrease of 6.56%. The said decrease stems from a decline of 6.4% in the average credit portfolio, resulting, among other things, from the impact of the decline in the exchange rate of the U.S. dollar as well as from the increasing competition among the large banks and from the decline in the risk premium due to the improvement in economic conditions.

**Net income** of the segment in 2010 amounted to NIS 279 million compared with NIS 324 million in 2009, a decrease of 13.89%.

**The return on equity**, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 7.3% in 2010, compared with 8.7% in 2009.

**Provision for doubtful debts** in this segment amounted in 2010 to NIS 221 million compared with NIS 293 million in 2009, a decrease of 24.5%.

Following are the principal data relating to the operations of the corporate banking segment:

	Domestic operations				International operations				Total	Total
	Banking and finance	Credit cards	Capital market	Construction and real estate	Total	Banking and finance	Construction and real estate	Total		
For the year ended December 31, 2010										
in NIS millions										
Income from financing activities before provision for doubtful debts										
- From external sources	78	11	2	252	343	408	9	417	760	
- Intersegmental	453	-	-	69	522	(257)	-	(257)	265	
<b>Total income from financial activity</b>	<b>531</b>	<b>11</b>	<b>2</b>	<b>321</b>	<b>865</b>	<b>151</b>	<b>9</b>	<b>160</b>	<b>1,025</b>	
Operating and other income	84	49	34	27	194	66	1	67	261	
<b>Total Income</b>	<b>615</b>	<b>60</b>	<b>36</b>	<b>348</b>	<b>1,059</b>	<b>217</b>	<b>10</b>	<b>227</b>	<b>1,286</b>	
Provision for doubtful debts	44	-	(1)	38	81	87	53	140	221	
Operating and other expenses	338	60	18	69	485	101	7	108	593	
Operating Income (loss) before taxes	233	-	19	241	493	29	(50)	(21)	472	
Provision for taxes on operating income	79	1	7	84	171	38	(16)	22	193	
<b>Net (loss) income</b>	<b>154</b>	<b>(1)</b>	<b>12</b>	<b>157</b>	<b>322</b>	<b>(9)</b>	<b>(34)</b>	<b>(43)</b>	<b>279</b>	
Return on equity (percentage)	8.6	(3.8)	227.4	12.1	10.3	(1.6)	(55.4)	(6.6)	7.3	
Average Assets	24,733	447	18	14,080	39,278	5,106	875	5,981	45,259	
Average Liabilities	17,057	1,298	2	1,785	20,142	1,496	-	1,496	21,638	
Average Risk-assets	25,566	519	74	18,582	44,741	8,542	875	9,417	54,158	
Average assets of provident and mutual funds	-	-	230	-	230	-	-	-	230	
Average customers' securities	-	-	80,484	-	80,484	-	-	-	80,484	
Average other assets under management	-	-	182	-	182	-	-	-	182	
Components of income from financial activities:										
Margin from credit activity	459	11	-	269	739	124	9	133	872	
Margin from deposits activity	35	-	-	9	44	27	-	27	71	
other	37	-	2	43	82	-	-	-	82	
<b>Income from financing activities before provision for doubtful debts</b>	<b>531</b>	<b>11</b>	<b>2</b>	<b>321</b>	<b>865</b>	<b>151</b>	<b>9</b>	<b>160</b>	<b>1,025</b>	

Following are the principal data relating to the operations of the corporate banking segment (continued):

	Domestic operations				International operations				
	Banking and finance	Credit cards	Capital market	Construction and real estate	Total	Banking and finance	Construction and real estate	Total	Total
For the year ended December 31, 2009									
in NIS millions									
Income from financing activities before provision for doubtful debts									
- From external sources	*988	11	5	705	1,709	176	20	196	1,905
- Intersegmental	(413)	-	-	(383)	(796)	(12)	-	(12)	(808)
<b>Total income from financial activity</b>	<b>575</b>	<b>11</b>	<b>5</b>	<b>322</b>	<b>913</b>	<b>164</b>	<b>20</b>	<b>184</b>	<b>1,097</b>
Operating and other income	*241	*104	27	23	395	26	3	29	424
<b>Total Income</b>	<b>816</b>	<b>115</b>	<b>32</b>	<b>345</b>	<b>1,308</b>	<b>190</b>	<b>23</b>	<b>213</b>	<b>1,521</b>
Provision for doubtful debts	131	-	-	98	229	64	-	64	293
Operating and other expenses	385	72	17	79	553	140	10	150	703
Operating income (loss) before taxes	300	43	15	168	526	(14)	13	(1)	525
Provision for taxes on operating income	*102	*14	6	59	181	10	1	11	192
<b>Net income</b>	<b>*198</b>	<b>20</b>	<b>9</b>	<b>109</b>	<b>336</b>	<b>(24)</b>	<b>12</b>	<b>(12)</b>	<b>324</b>
Return on equity (percentage)	10.1	270.3	-	9.4	10.7	*(4.8)	21.5	(2.1)	8.7
Average Assets	27,996	422	14	13,136	41,568	5,904	880	6,784	48,352
Average Liabilities	19,255	1,508	2	1,894	22,659	1,993	-	1,993	24,652
Average Risk-assets	30,240	113	12	18,024	48,389	*7,893	880	8,773	57,162
Average assets of provident and mutual funds	-	-	426	-	426	-	-	-	426
Average customers' securities	-	-	64,172	-	64,172	-	-	-	64,172
Average other assets under management	-	-	141	-	141	-	-	-	141
Components of income from financial activities:									
Margin from credit activity	491	11	2	278	782	137	19	156	938
Margin from deposits activity	*46	-	-	6	52	27	-	27	79
other	38	-	3	38	79	-	1	1	80
<b>Income (loss) from financing activities before provision for doubtful debts</b>	<b>575</b>	<b>11</b>	<b>5</b>	<b>322</b>	<b>913</b>	<b>164</b>	<b>20</b>	<b>184</b>	<b>1,097</b>

\* Reclassified.

## SERVICE TO SEGMENT CUSTOMERS

The business segment enjoys professional banking services provided by the Corporate Banking Division having an expertise in the comprehensive financial guidance (One Stop Shop), including an in-depth examination of the company's needs and modification of unique financial solutions. Customers are provided with personal, professional and quality service that relates to all their financial needs by offering customized various banking products in the credit, exchange-rate hedging, international trade, settlement

through the use of credit cards, financing, specialist capital market investments, etc.

The rolling finance arrangements for the big companies are implemented through **business managers** in the corporate company department of the Corporate Banking Division. The teams are allocated to customers by reference to the field of business activity in which the companies are engaged.

The teams include a business manager, a business banker, economists and credit officers. Such a team provides the banking support for all the financial needs of the business customer.

The various banking services are provided through the branches.

**The Capital Market Department.** Within the framework of expanding the operations basket with the business customer and the focusing on activity that does not require capital, it was decided in 2010 on the establishment of a capital market department within the Corporate Banking Division. The aim of the department is to expand the services provided by the Bank with respect to capital market activity, to the large corporations, institutional bodies and capital market operators. The department engages in the allotment of credit to capital market operators, including the rendering of related services (brokerage, investment consultancy and administration), providing initiated consulting services to corporations, and the comprehensive handling of institutional bodies.

**The Diamond Exchange Branch** serves diamond industry customers. The branch specializes in accounts of diamond merchants as well as in all the special services required by the diamond industry.

**The Bank's approved enterprises unit**, which operates within the framework of the construction and real estate department, works with those customers entitled to benefits from the State by providing finance for the acquisition or construction of equipment and buildings, and for the establishment or expansion of tourist and industrial projects, by virtue of the provisions of the Law for the Encouragement of Capital Investments.

**The foreign trade department** serves customers engaged in international trade (for further information, see below).

Some of the segment's customers utilize the services of the Bank's trading desk (see below, 'Finance management segment') and the Bank's overseas offices (see below, 'International operations segment').

The services of the **Tel Aviv Main Branch** are also at the disposal of the customers. The branch focuses on the Bank's large business customers and on providing services to financial and institutional entities, including custodian services to foreign institutions.

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## FOREIGN TRADE OPERATIONS

**General.** The foreign trade department operates within the framework of the Bank's Corporate Banking Division, and offers a range of services to customers from the various business segments engaged in international trade.

**Scale of operations.** The recovery of the Israeli economy, which began in the fourth quarter of 2009, continued in 2010, resulting in a significant growth in export and import activities in the market.

According to data of the Central Bureau of Statistics, the import of goods (excluding ships, aircraft and diamonds) increased at the rate of 21.0%, compared to 2009, while the export of goods (excluding ships, aircraft and diamonds) increased at the rate of 15.0% as compared with 2009.

The business activity of the foreign trade department coordinates in each department all the services in the foreign trade field that the customer requires (import, export, finance, financial instruments, etc.). The personal and direct relations with the customer are particularly emphasized alongside the current communication of the customer with his business manager at the Bank, with the view of intensifying the activity with customers.

In 2010 the Bank continued expanding its business development activities in accordance with the devised plan, an initiated activity for the identification of potential customers was carried out. Concurrently, activity with existing customers was intensified, while providing customers with a professional and personal service.

**Improvement of service.** The Bank continues its efforts to improve the quality of service to customers, and in this framework extended the business hours in a manner that provides expedient service during busy hours, in accordance with urgency, even

after accepted business hours.

**Technological improvements.** The year 2010 was characterized by the success of the marketing efforts in increasing the pool of customers using foreign trade services on the Internet. The Internet system allows customers to make direct payments for imports, to open import documentary credits and to make payments in respect of import documents for collection.

**Mercantile Discount Bank.** A central unit at the Bank's Head Office was established in February 2011, to take charge of foreign trade operations, subject to the Corporate Banking Division of this bank.

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## DEVELOPMENTS IN THE SECTOR'S MARKETS AND IN CUSTOMER CHARACTERIZATION

The large customers and the large borrower groups in the economy form a substantial part of the Bank's corporate customer portfolio. The increase in recent years in the volume of mergers and acquisitions activity in the market contributed to the increase in the weight of large borrowers and large borrower groups in the activity of the corporate segment at the Bank.

In the years preceding the crisis, many customers of this segment expanded the volume of their operations outside Israel, so that credit provided to such customers served mainly as equity invested in expanding such operations. As part of the lessons learned from the financial crisis, the Bank significantly reduced the credit granted to finance the overseas operations of customers, which is generally secured by reasonable domestic collateral.

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## TECHNOLOGICAL CHANGES THAT MAY HAVE A MATERIAL IMPACT ON THE SEGMENT

The information systems serving this segment are designed to support procedures of analyzing customer needs and control and marketing processes.

The corporate banking segment is engaged currently in updating and upgrading its information systems that are utilized to analyze and to measure various risks (mainly credit risks) and to monitor and to control customer activity in "real time".

The Bank focuses on improving the systems for measuring customer profitability and for reliable assessment of the customer's contribution to profitability.

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## CRITICAL SUCCESS FACTORS IN THE SEGMENT

- Committed and long-term customer relationships, quality service, prompt response to credit requests and to the overall related services (foreign trade operations, security investment, derivative financial instruments, banking services to corporate executives and owners, etc.);
- An ability to support and stand by the customer also in periods of slowdown and economic crisis;
- Efficient management of the credit portfolio from the aspects of measurement, costing and sophisticated risk management "in real time", while maintaining proper credit control systems for identifying and minimizing risks while taking into account the overall indebtedness of the customer, including in the off-banking market;
- The professional training of quality and proficient manpower;
- Improvement of the technical ability to provide services;
- Relations with large banks in Israel and abroad.

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## ENTRY AND EXIT BARRIERS OF THE SEGMENT

Customers of the segment transact business concurrently with several other banks, so that The relative advantage of the segment is based upon long-term relationships with the customers, including continued satisfaction with the quality of service and providing prompt and suitable solutions to complex financing needs and support to customers during changes in economic conditions.

A large number of large corporations have adopted a leverage policy which includes the use of bank financing resources together with use of off-banking means of finance.

The ability of corporations to raise credit from off-banking financing resources improved during 2010, principally on the part of large and financially sound customers, a fact which reduced their dependency on banking industry finance.

Entry and exit barriers may arise as a result of the need for the appropriate allocation of capital and compliance with regulatory limitations of the Bank of Israel, which impact the manner and volume of activity vis-à-vis borrowers and groups of borrowers.

The long-term resources available to the Bank for credit financing are limited in relation to the short and mid term resources. Accordingly, cooperation with institutional investors is required for financing long-term projects in the income generating real-estate and infrastructure fields and/or by way of the sale of a part of the long-term bank credit.

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## **SUBSTITUTES FOR PRODUCTS AND SERVICES OF THE SEGMENT AND CHANGES THEREIN**

As a substitute for bank credit to customers of the business segment, alternative financing products offered by off-banking financial institutions in general and institutional entities in particular have been developed.

These bank credit substitutes include the raising of finance by way of the issue of shares, bonds and other securities on the capital markets in Israel and abroad, including direct credit offered by such entities.

Starting with the second half of 2009, against the background of the improvement of business activity of corporations operating in the domestic and foreign markets, the availability of a part of the financially sound large customers to off-banking financing resources has increased.

Wherever the possibility to raise funds on the capital market exists, off-banking finance serves as an alternative financing resource, primarily for the long and medium term credit products, thus contributing to the reduction in the volume of this kind of credit in the credit portfolio reflecting the activity of this segment.

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## **COMPETITION IN THE SEGMENT AND CHANGES THEREIN**

The business segment is exposed to ever-increasing competition from the other four large banking groups as well as from foreign banks that operate in Israel (HSBC, Citigroup, BNP). It should be noted that competition on the part of the foreign banks has declined with the development of the world financial crisis.

The level of competition on the part of institutional bodies also increased in recent years, mainly insurance companies and pension funds.

The financial crisis, which began in the second half of 2008, resulted in the termination of a record period of fundraising from off-banking resources that provided an alternative to bank credit, and also caused a significant decline in its volume. However, since the second half of 2009, the capital market has shown a continued recovery, and a considerable number of corporations reverted to raising off-banking resources.

The process of declining financial margins and operating commissions, which had begun in the second half of 2009, continued during 2010, this following the reduced credit risk level of a part of the customers, the improvement in the capital adequacy of banks, and the intensified competition between the two large banks in the country with respect to leading large financing transactions in the segment, particularly involving the finance of acquisition of means of control.

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## **MARKETING AND DISTRIBUTION**

Activity of the corporate banking segment in marketing credit and related services to existing and new customers is implemented principally by business managers engaged in the adaptation of financing solutions to the various transactions. Identification and analysis of comprehensive banking needs of customers and in appropriate adaptation of the Bank's products to these customers'

needs and requirements, as well as in the "real-time" provision of such services.

The Bank's products are also marketed and distributed relative to owners, executives and employees of the corporations.

Furthermore, the "Business +" website was launched in 2010, being a designated site for business customers, which presents comprehensive data regarding the accounts of the business and allows effecting transactions at lower rates of commission.

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## DEALING WITH COMPETITION

The high level of competition in the segment is reflected in the quality and sophistication of the service, prompt reaction and the cost of credit and commissions. The segment's main tools in facing competition include the provision of personal, professional and quality service and the establishment of a long-term relationship with customers, while acquiring an overall understanding of their financial needs.

The recent crisis increased the awareness of the corporate customer to the fact that it is beneficial for him to transact business with more than one bank, in view of the desire and necessity not to be dependent on financing facilities of only one bank. This increased awareness is advantageous to the Bank when attracting new customers.

The Division performs from time to time customer satisfaction surveys, with a view of constantly improving the quality of service provided to them.

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## PRODUCTS AND SERVICES

The services offered include current financing according to customer needs, including among other things, foreign trade activity and the trading desk, financing of investments for maintaining and expanding activity, the financing of acquisitions and mergers, granting credit to capital market operators, participating in credit and/or risk offered by the large local banks or foreign financial institutions extending credit to Israeli corporations operating abroad.

In addition, these include related services such as deposit accepting and investment activities, derivative financial instrument activities, granting financial guarantees, advances, execution and so forth.

The demand for credit intended for the financing of mergers and acquisitions increased during the fourth quarter of 2009, against the background of the rise in the number of such transactions in the market, particularly in the communications field.

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## MIDDLE MARKET BANKING SEGMENT

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### SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

**Income from financing operations** amounted in 2010 to NIS 656 million, compared to NIS 658 million in 2009, a decrease of 0.3%.

**The net income** of the segment in 2010 amounted to NIS 117 million compared with NIS 33 million in 2009, an increase of 254.55%. **The return on equity** in 2010, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 7.5% compared with 2.4% in 2009.

**Provision for doubtful debts** in this segment amounted in 2010 to NIS 182 million, compared with NIS 219 million in 2009, a decrease of 16.89%. The decrease in the provision for doubtful debts stemmed from the hotel, communications, computer services and the construction and real estate sectors.

Following are the principal data relating to the operations of the middle market banking segment:

	Domestic operations					International operations					
	Banking and finance	Credit cards	Capital market	Construction		Total	Capital market	Construction		Total	Total
				and real estate	Mortgage			and real estate	Total		
For the year ended December 31, 2010											
in NIS millions											
Income from financing activities before provision for doubtful debts											
- From external sources	127	4	1	67	-	199	445	120	565	764	
- Intersegmental	129	-	-	18	-	147	(225)	(30)	(255)	(108)	
<b>Total income from financial activity</b>	<b>256</b>	<b>4</b>	<b>1</b>	<b>85</b>	<b>-</b>	<b>346</b>	<b>220</b>	<b>90</b>	<b>310</b>	<b>656</b>	
Operating and other income	90	16	18	12	-	136	56	9	65	201	
<b>Total Income</b>	<b>346</b>	<b>20</b>	<b>19</b>	<b>97</b>	<b>-</b>	<b>482</b>	<b>276</b>	<b>99</b>	<b>375</b>	<b>857</b>	
Provision for doubtful debts	96	-	-	(5)	-	91	59	32	91	182	
Operating and other expenses	284	20	11	27	-	342	152	30	182	524	
Operating Income (loss) before taxes	(34)	-	8	75	-	49	65	37	102	151	
Provision for taxes on operating income	(13)	-	2	27	-	16	19	2	21	37	
<b>Net (loss) income</b>	<b>(21)</b>	<b>-</b>	<b>9</b>	<b>48</b>	<b>-</b>	<b>36</b>	<b>45</b>	<b>36</b>	<b>81</b>	<b>117</b>	
Return on equity (percentage)	(3.1)	(1.4)	-	21.2	1.4	4.0	10.5	17.8	12.7	7.5	
Average Assets	7,694	144	1	2,521	179	10,539	5,270	2,395	7,665	18,204	
Average Liabilities	4,926	1,441	-	699	-	7,066	2,898	354	3,252	10,318	
Average Risk-assets	9,400	253	33	3,305	233	13,224	6,323	2,751	9,074	22,298	
Average assets of provident and mutual funds	-	-	16	-	-	16	-	-	-	16	
Average customers' securities	-	-	8,541	-	-	8,541	-	-	-	8,541	
Average other assets under management	957	-	404	-	-	1,361	-	-	-	1,361	
Components of income from financial activities:											
Margin from credit activity	199	4	-	68	-	271	179	83	262	533	
Margin from deposits activity	26	-	-	3	-	29	41	7	48	77	
other	31	-	1	14	-	46	-	-	-	46	
<b>Income from financing activities before provision for doubtful debts</b>	<b>256</b>	<b>4</b>	<b>1</b>	<b>85</b>	<b>-</b>	<b>346</b>	<b>220</b>	<b>90</b>	<b>310</b>	<b>656</b>	

Following are the principal data relating to the operations of the middle market banking segment (continued):

	Domestic operations					International operations				
	Banking and finance	Credit cards	Capital market	Construction and real estate	Mortgage	Total	Capital market	Construction and real estate	Total	Total
For the year ended December 31, 2009										
in NIS millions										
Income from financing activities before provision for doubtful debts										
- From external sources	*157	3	1	155	3	319	216	88	304	623
- Intersegmental	106	-	-	(73)	(2)	31	2	2	4	35
Total income from financial activity	263	3	1	82	1	350	218	90	308	658
Operating and other income	105	33	19	13	1	171	29	29	58	229
<b>Total Income</b>	368	36	20	95	2	521	247	119	366	887
Provision for doubtful debts	104	-	-	17	-	121	42	56	98	219
Operating and other expenses	293	23	12	25	-	353	182	61	243	596
Operating income (loss) before taxes	*(29)	13	8	53	2	47	23	2	25	72
Provision for taxes on operating income	(14)	4	3	*20	1	14	15	7	22	36
<b>Net income</b>	*(15)	6	5	*33	1	30	8	(5)	3	33
Return on equity (percentage)	*(3.5)	89.8	-	16.4	13.6	4.1	*1.7	(2.4)	*0.6	2.4
Average Assets	8,293	138	1	2,645	123	11,200	*5,464	2,685	8,149	19,349
Average Liabilities	5,180	455	-	618	-	6,253	3,631	595	4,226	10,479
Average Risk-assets	7,444	109	1	3,082	123	10,759	*7,812	2,757	*10,569	21,328
Average assets of provident and mutual funds	-	-	83	-	-	83	-	-	-	83
Average customers' securities	-	-	8,014	-	-	8,014	-	-	-	8,014
Average other assets under management	839	-	679	-	-	1,518	-	-	-	1,518
Components of income from financial activities:										
Margin from credit activity	212	3	-	68	1	284	189	82	271	555
Margin from deposits activity	*22	-	-	3	-	25	29	8	37	62
other	29	-	1	11	-	41	-	-	-	41
<b>Income (loss) from financing activities before provision for doubtful debts</b>	263	3	1	82	1	350	218	90	308	658

\* Reclassified.

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## SERVICE TO SEGMENT CUSTOMERS

The commercial banking segment enjoys professional banking services provided through the Commercial Department in the Corporate Banking Division. Customers are provided with personal, professional and quality service that relates to all their financial needs by offering customized various banking products in credit, exchange-rate hedging, international trade, settlement through the use of credit cards, financing, specialist capital market investments, etc. Concurrently, solutions are also provided for meeting the financial needs of the owners of companies, and their executives and staff, who thus benefit from arrangements that afford them the status of preferred customers.

The products and services are adapted to the business requirements of customers and also include, alongside the varied credit products foreign trade services, risk hedging by way of financial instruments and investment services in various channels: deposits, securities and the handling of business and private accounts.

Customer service is provided at **business centers** situated in the Dan, Sharon, Tel Aviv, Southern, Jerusalem and Haifa as well as by means of the Tel Aviv business section at the Tel Aviv main branch.

The service provided by the centers is integrative, provided by teams that include business bankers, economists, investment advisors and credit officers. In order to adapt the service to the business customer, which are located at the business centers, while assisted by the branch layout (within the framework of the reorganization of the service layouts, the credit centers and business centers will be merged into one service layout of six business centers countrywide).

**The foreign trade department** serves customers engaged in international trade. (For further information, see above, "Corporate Banking Segment").

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## DEVELOPMENTS IN THE SEGMENT'S MARKETS

Customers of this segment are generally companies having a medium volume of operations, most of whose activity is in the local market and their exposure level to various layers of the crisis in the international markets from the financial and non-financial aspects is relatively higher than that of large customers.

The business activities of customers of this segment were stabilized in 2010 compared to the beginning of 2009. The accessibility of corporations in this segment to off-banking finance through bond issues was low.

Following are the main developments during 2010:

- Stability in the volume of demand on the domestic and overseas markets, on the background of the recovery in domestic private consumption and in volume of global trade;
- A moderate expansion in the volume of activity of customers in this segment, which was reflected in a moderate increase in inventory and investment levels, while maintaining stability of operating profit margins;
- A moderate growth in demand for credit stemming from expansion in the activity of corporations compared to 2009.

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## PRIVATE BANKING SEGMENT

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### STRATEGIC EMPHASES

In the service layout of the private banking emphasis is placed on initiated overall banking service, and specialized, to wealthy customers, while being committed to discretion and to a rapid response to the customers' needs, both in the field of investments and in the field of credit.

Providing service both to Israelis and to foreign residents in one layout provides customers with an advantage of high accessibility to the global arena. This advantage is also enhanced by the synergy between the Bank's infrastructure in the fields of information and operations, which are designed for the needs of this unique segment of customers.

Another strategic basis can be found in the private banking services provided to customers, without them having to transfer their accounts for this purpose. This mode of operation intensifies the ties between the customer and the Bank without severing the

warm and humane ties that accompanied him prior to his attachment to the private banking layout.

Within the framework of the preparation by the Bank for providing an appropriate service experience modified to the needs of customers having considerable financial wealth in the private banking profile - Israeli customers having at the Bank financial wealth of US\$1 million and over, and foreign residents having financial wealth of US\$0.5 million and over (hereinafter: "private banking profile") – the Bank acts since 2009 towards the repositioning of the private banking centers. In this framework, customers meeting the private banking profile will be treated by the private banking centers. Retail customers who do not meet the said profile, have been transferred to the household segment.

In the course of 2009, private banking centers were opened in Tel Aviv and Haifa in new premises. A new center was opened on February 15, 2011 in Herzliyah, intended to serve mostly Israeli customers, and in April 2011, a new center is expected to open in the Mamilla Quarter in Jerusalem.

Concurrently, the existing centers operating in Jerusalem and in Nataniyah, specializing in retail foreign residents customers, are being transferred to the responsibility of the retail segment, while those of their customers belonging to the private banking profile are being attached to the new private banking centers. At the end of the said move, the Bank will provide four private banking centers designed to service both Israeli and foreign resident customers having high financial wealth meeting the private banking profile.

The private banking centers offer, among other things, comprehensive banking solutions, while focusing on investment products and on credit required for the finance of the varied investment channels of such customers.

In the course of 2011, the department will act towards intensifying operations with Israeli customers of a private banking profile.

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## SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

**Net income** of the segment in 2010 amounted to NIS 56 million compared with NIS 32 million in 2009, an increase of 75%.

Disregarding the gains from extraordinary operations, profit amounted to NIS 47 million, compared with NIS 32 million in 2009, an increase of 46.9%.

**The return on equity**, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 17.4% in 2010 compared with 15% in 2009.

Following are the principal data relating to the operations of the private banking segment:

	Domestic operations			International operations			Total
	Banking and finance	Capital market	Total	Banking and finance	Capital market	Total	
For the year ended December 31, 2010							
in NIS millions							
Income (loss) from financing activities before provision for doubtful debts							
- From external sources	222	1	223	(443)	1	(442)	(219)
- Intersegmental	(90)	-	(90)	644	-	644	554
Total income from financial activity	132	1	133	201	1	202	335
Operating and other income	49	35	84	85	57	142	226
<b>Total Income</b>	181	36	217	286	58	344	561
Provision for doubtful debts	1	-	1	10	-	10	11
Operating and other expenses	94	24	118	295	51	346	464
Operating Income (loss) before taxes	86	12	98	(19)	7	(12)	86
Provision for taxes on operating income	30	5	35	3	1	4	39
<b>Net (loss) income</b>	56	16	72	(22)	6	(16)	56
Return on equity (percentage)	41.0	139.7	48.8	(13.2)	-	(9.5)	17.4
Average Assets	1,985	7	1,992	4,591	-	4,591	6,583
Average Liabilities	18,597	-	18,597	18,006	-	18,006	36,603
Average Risk-assets	2,266	238	2,505	2,115	-	2,115	4,620
Average assets of provident and mutual funds	-	187	187	-	-	-	187
Average customers' securities	-	11,834	11,834	-	10,999	10,999	22,833
Average other assets under management	-	2,088	2,088	99	-	99	2,187
Components of income from financial activities:							
Margin from credit activity	28	-	28	87	1	88	116
Margin from deposits activity	113	-	113	114	-	114	227
other	(9)	1	(8)	-	-	-	(8)
<b>Income from financing activities before provision for doubtful debts</b>	132	1	133	201	1	202	335

Following are the principal data relating to the operations of the private banking segment (continued):

	Domestic operations			International operations			Total
	Banking and finance	Capital market	Total	Banking and finance	Capital market	Total	
For the year ended December 31, 2009							
in NIS millions							
Income from financing activities before provision for doubtful debts							
- From external sources	*122	1	123	140	-	140	263
- Intersegmental	13	-	13	86	-	86	99
Total income from financial activity	135	1	136	226	-	226	362
Operating and other income	52	41	93	43	51	94	187
<b>Total Income</b>	187	42	229	269	51	320	549
Provision for doubtful debts	-	-	-	15	-	15	15
Operating and other expenses	*110	28	138	266	40	306	444
Operating income (loss) before taxes	77	14	91	(12)	11	(1)	90
Provision for taxes on operating income	*29	4	33	21	4	25	58
<b>Net (loss) income</b>	*48	10	58	(33)	7	(26)	32
Return on equity (percentage)	*70.3	-	84.2	(23.3)	-	(18.7)	15.0
Average Assets	*2,288	6	2,294	4,184	-	4,184	6,478
Average Liabilities	*20,045	-	20,045	17,685	-	17,685	37,730
Average Risk-assets	1,198	6	1,204	2,073	-	2,073	3,277
Average assets of provident and mutual funds	-	308	308	-	-	-	308
Average customers' securities	-	9,041	9,041	-	9,677	9,677	18,718
Average other assets under management	-	1,284	1,284	135	-	135	1,419
Components of income from financial activities:							
Margin from credit activity	26	-	26	89	-	89	115
Margin from deposits activity	*122	-	122	137	-	137	259
other	(13)	1	(12)	-	-	-	(12)
<b>Income (loss) from financing activities before provision for doubtful debts</b>	135	1	136	226	-	226	362

\* Reclassified.

## SERVICE TO CUSTOMERS

Private banking customers are offered an "enveloping" service package, which commits the Bank's and the Group's resources to providing an optimal response to customers' needs alongside a commitment towards taking the initiative in dealings with them. Customers of this sector enjoy an array of banking services at the highest professional level in four private banking centers, in which consultants, experienced in the field of financial investments in Israel and abroad, pension consultants as well as experienced bankers in the fields of credit and general banking are at their disposal. Most of the staff has a command of foreign languages compatible with the language of the customer they serve. In addition, customers benefit from direct access to dealing rooms, direct banking via the Internet, as well as complementary services by the Bank's subsidiaries: trusteeship family office and investment

banking, compatible with the needs of this segment's customers.

**Business development department in private banking.** The department assists in developing business with customers of this segment both in Israel and abroad. The department also contributes to the Bank's involvement with Jewish communities abroad, while maintaining close contacts with organizations operating there.

The planning and business development unit acts with a view of providing the private banking customers with valuable suggestions in the products area and the marketing surroundings.

The compliance unit, which operates as part of the private banking department, is engaged in risk control with respect to money laundering prohibition, consumer instructions and operational risks, as a derivative of the activity of the private banking segment.

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## DEVELOPMENT IN THE SEGMENT'S MARKETS AND COMPETITION

The process of increased competition in the private banking segment continued in 2010. This was reflected both in price and commission competition and in the differentiation of the private banking layouts of Israeli banks, in accordance with the structure of the segment in each bank. Concurrently, the marketing and service efforts of foreign banks to the private banking sector have intensified, including those of Israeli banks operating abroad, and of insurance companies and investment houses, which approach the same target population.

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## MARKETING AND DISTRIBUTION

Most of the marketing efforts as regards private banking are based on the referral of customers. Marketing an "enveloping" service package is carried out by means of personal meetings as well as at focused conventions for private banking customers. In addition, the Bank is active in Jewish communities around the world in providing added value and contribution to community life while creating image differentiation. Furthermore, as preferred customers, private banking customers enjoy the Bank's cultural and artistic activities in cooperation with the Discount Museum.

For details as to the legislation regarding bank commissions and its implications, see above.

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## FINANCIAL MANAGEMENT SEGMENT

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### MAIN DEVELOPMENT IN THE SEGMENT

**Developments in the "nostro" portfolio.** For details regarding the Bank's "nostro" portfolio and developments therein, including particulars concerning the impairment of available-for-sale securities and concerning the Bank's investments in asset-backed securities, see above "Securities" under "Development of assets and liabilities" and Note 3 to the financial statements.

**Banks within the Palestinian Authority.** For details regarding the cessation of representation services and clearing transfers from the Gaza Strip, see "Prohibition of money laundering and prohibition of financing of terror" under "Legislation and supervision" hereunder.

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### SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

**The income of the segment,** excluding the activity of the non-financial companies sub-segment, in 2010 amounted to NIS 93 million compared with NIS 117 million in 2009.

**Total revenues** amounted in 2010 to NIS 457 million, of which NIS 170 million from domestic activity, compared with NIS 636 million in 2009, of which NIS 317 million from domestic activity, and they include three major components:

1. Profits from the Bank's "Nostro" operations (primarily from financial derivatives) in the amount of NIS 215 million, of which NIS 195 million from earnings on the sale of securities and from adjustments to fair value of trading securities, compared with NIS 496 million "Nostro" earnings in 2009, of which NIS 325 million from gains on sale of securities and from adjustments to

the fair value of trading securities.

2. Net loss, from asset and liability management (management of positions and trading and brokerage in currencies and financial derivatives) in the amount of NIS 45 million in 2010, compared with NIS 179 million in 2009.
3. Income on international operations in the amount of NIS 287 million, compared to a loss in the amount of NIS 319 million in 2009.

**The return on equity** in 2010, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, reached a negative rate of 5.8%, compared with a rate of 7.7% in 2009.

Following are the principal data relating to the operations of the financial management segment:

	Domestic Operations	International Banking	Total	Domestic Operations	International Banking	Total
For the year ended December 31						
	2010			2009		
in NIS millions						
Income from financing activities before provision for doubtful debts	147	365	512	*241	330	571
Operating and other income	23	(78)	(55)	76	(11)	65
<b>Total Income</b>	170	287	457	317	319	636
Provision for doubtful debts	(1)	3	2	-	31	31
Operating and other expenses	651	80	731	581	75	656
Operating Income (loss) before taxes	(480)	204	(276)	(264)	213	(51)
<b>Net income</b>	(176)	83	(93)	*(57)	174	117
Return on equity (percentage)	(14.3)	22.5	(5.8)	*(5.1)	*43.4	7.7
Average Assets	51,037	16,159	67,196	48,882	18,619	67,501
Average Liabilities	22,131	10,156	32,287	*14,160	12,217	26,377
Average Risk-assets	8,295	5,180	13,475	*8,857	*6,194	15,051

\* Reclassified.

## DEALING ROOM

The dealing room is engaged in four principal areas of activity: trade in currencies, trade in interest rates, trade in Israeli and foreign securities and management of liquidity in Israeli currency and in foreign currency. The dealing room develops and "constructs" the various transactions in accordance with customer needs and, inter alia, develops structured products based on currencies, interest rates and share quotations. The dealing room is available to customers and to the Bank's branches and provides personal and professional service in the global money and capital markets in the implementation of special transactions in foreign exchange, interest rates and securities. Dealing room customers include local and foreign banks, corporations, Private customers having a large volume of activity and institutional entities. Dealers and professional traders Advanced technology and computer systems, enable the dealing room to provide customers with timely professional service.

Combining the four said areas of operation, allows customers to obtain all commercial services under one station providing a uniform standard of service and of professional level.

## FOREIGN CURRENCY AND INTEREST RATE TRADING

The main transactions provided to customers by way of the customer desk at the dealing room, are: future contracts and currency, interest and index options (including exotic options), swap transactions and fixed and variable interest rate swap transactions.

### Trading in securities

Following are details concerning fields of activity in securities trading;

**Trading in foreign securities.** The foreign securities desk is active in a large variety of equity and financial markets worldwide, utilizing complex financial instruments and offering a wide range of instruments: trading in shares on foreign markets, trading in options, in Government bonds and in corporate bonds and debentures, mutual funds and hedge funds, and in arbitration activity.

**Israeli securities.** The Israeli securities desk engages in the trading in bonds, shares, options and convertibles traded on the Stock Exchange. In addition, the desk provides brokerage services for marketable and non-marketable securities, executes sophisticated transactions in bonds, submits orders for the purchase of securities marketable and non-marketable and executes short sales of securities alongside the lending of securities. The staff of the dealing room maintains direct communication with institutional investors, large corporations and hedge market players active in daily trading activity.

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## LIQUIDITY AND DEPOSITS

The liquidity desk engages in managing the Bank's short-term liquidity (up to one month), both in shekel and foreign currency terms, through the open tenders of the Bank of Israel, deposits and loans. The desk supplies interest rate quotations for deposits in foreign currency and in shekels by large customers ("super jumbo"), and looks after satisfying the Bank's needs (loans and transfers) with respect to any currency and at any point of time, including investment of surplus funds.

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## RISK AND LIABILITY MANAGEMENT

Following is information about operating segments in asset and liability management:

**General.** Following are details concerning fields of operation regarding asset and liability management:

The main areas of activity in the management of assets and liabilities are the management of capital, liquidity, exposure to base and interest risks inherent in the balance sheet, management of the available-for-sale securities portfolio, management of the financial spread and determination of transfer prices.

**Capital management.** The capital management process includes the determination of capital ratio targets, formation of a framework for growth in business activity that will enable reaching the Bank's capital targets, distribution of the business activity among the Group's companies and the monitoring of current operations. Several factors in the Bank and in the Group participate in this process. In addition, the asset and liability management group is responsible for the raising of funds on the capital market. **Liquidity management.** The liquidity risk management at the Bank by means of an internal model, from which the volume of liquid assets required to withstand stress scenarios is derived. Ongoing analysis of trend in the mix and volume of the Bank's deposits and credit.

**Linkage base and interest rate exposure management.** Evaluating market risk exposure in the Bank's balance sheet by means of a designated computer system, which downloads information from all operational systems at the Bank. The asset and liability management committee, headed by the Bank's CEO, makes decisions regarding the levels of exposure to interest rate risk at the various linkage segments within the framework of limits determined by the Board of Directors regarding the risk propensity. The asset and liability management increases or reduces the risks in accordance with the decisions of the assets and liability management committee by managing the available-for-sale portfolio and by off-balance sheet transactions.

**Transfer prices and management of the marginal financial spread.** The asset and liability management group provides on a daily basis to the business divisions, the internal transfer prices of the Bank for credit and deposits. The prices are updated at daily intervals in accordance with developments in the money and capital markets.

The transfer prices serve as a basis for computing the profitability of all credit and deposit transactions made at the Bank. The asset and liability management group determines the targets of the marginal spread for deposits and credit and monitors them on an ongoing basis.

## GROUP MANAGEMENT

In 2007, the Bank began implementing in Tel Aviv the "Global treasury" strategy, among the aims of which was the promotion of management with a group overview with respect to the dealing rooms and to asset and liability management in all Group companies.

**In the asset and liability management field**, the Bank implemented during the last two years a process of group management as regards liquidity, the planning and management of the capital and the raising of capital.

Within the framework of the process for the management of the Group's capital, the Bank established a three-year plan for capital management, for the years 2011-2013, which allocates capital in a centralized manner, to the business units and subsidiaries of the Bank, on a Group risk assets basis. The risk assets framework is computed so that it will enable the Bank to reach the capital targets determined by the Board of Directors for various scenarios.

**In the dealing rooms field** the Bank promoted during the last two years cooperation between the various dealing rooms of the subsidiaries, and has begun the implementation of a strategic plan for improving efficiency and increasing profitability supported by such cooperation. Within the framework of this plan, the Bank strives to establish a joint group platform for financial management, risk management, controls and business targets to be used by dealing rooms in the Group, and which will enable the Group to provide comprehensive professional service modified to the needs of the Group and its customers.

The subsidiaries and overseas extension desk at the dealing room is entrusted with the implementation of this plan, with the existence of complete transparency between the subsidiaries in everything relating to the operation of the foreign currency dealing rooms, and with the current and mutual cooperation between the parent company and the subsidiaries.

**Organizational changes in the financial management segment of Mercantile Discount Bank.** Within the framework of the change in the organizational structure of Mercantile Discount Bank, as approved by its Board of Directors in January 2010, the following changes, among other things, have been determined:

- All dealing rooms are subject to the Financial and Customer Asset Management Division (to take effect until the end of the first quarter of 2011);
- Responsibility for the management of the "Nostro" investments was transferred to the Financial and Customer Asset Management Division (with effect as from October 2010).

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## COMPETITION

The financial management segment includes, as stated, the Group's activity in the dealing rooms. This area is typified by a high level of competition. The principal competitors in are the four large local banking groups. Additional competitive entities in this market are foreign banks, which have opened dealing rooms in Israel (Citibank, Deutsche Bank, HSBC, Barclays, BNP), and other financial corporations engaged in foreign currency and the Shekel interest markets, the involvement of which in these markets have grown significantly in recent years.

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## BUSINESS STRATEGY AND TARGETS

The strategic plan of the finance division for the coming years includes the continued absorption of the global treasury strategy with a view of professionally concentrating the activity in assets and liabilities and activity of dealing rooms of the comprehensive Group (in Israel, New York, London and Switzerland). The Bank intends to focus mainly on the management of capital, of liquidity, of exposure to linkage bases and interest rate, on the management of the "Nostro" securities portfolio, on computer systems as well as on the integration of joint standards for risk management and implementation of controls, including by means of market and credit risk management systems, in cooperation with the Bank. During 2011 the Bank intends to intensify cooperation in the area of asset and liability management and in the activity of the dealing rooms of Group companies, both at the business and technological levels.

The above forward-looking statement is based on the Bank's plans as of publication of the financial report. The plan may not materialize, inter alia, as a result of implementation, technological and regulatory difficulties.

## NON-FINANCIAL COMPANIES SUB-SEGMENT

### LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SUB SEGMENT

The Bank operates within the framework of laws, regulations and regulatory directives applicable to the banking sector in Israel as promulgated by various supervisory bodies, viz., the Supervisor of Banks, the Commissioner of the Capital Market, Insurance and Savings at the Finance Ministry, The Commissioner of the Antitrust Authority, the Securities Authority etc. The principal restrictions applicable to this sub segment are briefly described hereunder.

Section 23 A of the Banking (Licensing) Law, specifies that the amount of any means of control held by a banking corporation in non-financial corporations shall not exceed the following proportions of the capital of the banking corporation, as shall be determined for this purpose in rules prescribed by the Governor, after consultation with the Advisory Committee and with the approval of the Minister of Finance -

- (1) Up to fifteen per cent of its capital - in any non-financial corporation;
- (2) Up to a further five per cent of its capital - provided that it does not hold in corporation more than five per cent of a certain class of means of control and it is not entitled to appoint a director;
- (3) Up to a further five per cent of its capital - in non-financial corporations which are foreign corporations that do not conduct any material and continuing business operations in Israel.

As of December 31, 2010, the amount of the Bank's investment in non-financial corporations was less than the amount of the above restriction.

**The Banking Law (Licensing) (Amendment No. 15), 2010.** An amendment to the Banking Law (Licensing) was published in March 2010, regarding the restriction according to which a banking corporation may not have an interest in more than one non-financial holding company. According to the Amendment, the restriction shall be changed as follows:

- In addition to the permitted holdings in one non-financial corporation, a banking corporation may have additional interests, either direct or indirect, in other non-financial holding corporations at a rate of up to 1% of a certain class of means of control;
- A banking corporation is permitted to hold more than 1% of a certain class of means of control of one insurer only, whose equity exceeds NIS 2 billion;
- The term "operating indirectly" (used in the definition of a non-financial holding company) shall be defined so that a corporation will be considered as operating indirectly in an economic sector, if it holds an interest of 5% or over in a certain class of means of control of a corporation active in that economic sector.

The said Amendment does not have a material effect on the Bank's business.

### SCALE OF OPERATIONS AND NET INCOME OF THE SUB SEGMENT

**The loss** of the sub segment in 2010 amounted to NIS 2 million, compared with a loss of NIS 4 million in 2009.

**The return on equity**, calculated on the capital allocated to the sub-segment on the basis of the average balance of sub segment risk assets reached a negative rate of 4.2% in 2010, compared with 9.0% in 2009.

Following are the principal data relating to the operations in the non-financial company segment:

	For the year ended December 31	
	2010	2009
	In NIS millions	
Income from financing activities before provision for doubtful debts	(4)	(2)
Operating and other income	(7)	33
<b>Total Income</b>	(11)	31
Operating and other expenses	4	4
Operating Income (loss) before taxes	(15)	27
Bank's share in operating income of affiliated	4	(7)
<b>Net income</b>	(2)	(4)
<b>Return on equity (percentage)</b>	(4.2)	(9.0)
Average Assets	624	749
Average Liabilities	721	745
Average Risk-assets	1,094	749

## PRINCIPAL AREAS OF OPERATION IN SEGMENT

The investments of the Discount Group in non-financial companies are divided into two principal categories, as under:

- **Investment in private equity funds and in venture capital funds.** The activity in this field is made primarily through the subsidiary DCFI, directly by the Bank itself and through the subsidiary of Mercantile Discount Bank;
- **Investments in companies.** The principal investment in this field is the investment in two companies controlled by Mayer Cars and Trucks Co. Ltd. (see below).

Within the framework of the new strategic plan for the years 2011-2013, a policy regarding non-financial investments will, among other things, be determined, replacing the policy determined in 2007.

## INVESTMENTS OF THE GROUP IN PRIVATE EQUITY FUNDS AND IN VENTURE CAPITAL FUNDS

In the field of venture capital funds and private equity funds, the subsidiary DCFI participates in several funds, including:

Name of fund	Size of fund (In US\$ millions)*	Investment commitment	Balance of		Additional information and remarks
			Invested	commitment	
			For the year ended December 31, 2010*		
First Israel Mezzanine Fund (FIMI)	91	16	13.1	-	The Fund completed the realization of its remaining investment portfolio and started liquidation proceedings in accordance with the partnership agreement.
Vertex Israel II Fund	160	15	15	-	
Vertex Israel III Fund	174	13.5	11.3	2.2	
Vitalife Fund	50.3	10	9.6	0.4	Israel Discount Capital Markets and Investments has initiated the establishment of the fund, which specializes in investments in the bio-science field.
FIMI Opportunity II	293	50	44.3	5.7	

Name of fund	Size of fund	Investment commitment	Invested	Balance of commitment	Additional information and remarks
	(In US\$ millions)*		For the year ended December 31, 2010*		
FITE - First Israel Turnaround Enterprise	129	12.5	3.1	-	The outstanding commitment for investment in the Fund has been transferred to FIMI Opportunity IV Fund, which began operations at the beginning of 2008 (see below).
FIMI Opportunity IV	509	50	14	3.6	The commitment for investment in the fund includes the balance of the commitment transferred from the FITE Fund.
Golden Gate Bridge Fund	6	2	1.7	-	The fund engages in providing bridge financing for hi-tech start-up companies. The fund completed its investments and no further investments are expected.
Plenus Venture Lending II	55	5	4.2	0.8	Engages in the granting of bridging loans and credit facilities to technology companies.
Stage One Venture Capital fund	46	17.8	16.9	0.9	The fund was established together with Bezeq and others and is engaged in investments in the field of communications and information technology.
Alon Fund	30	2	2	-	Of the Gaon Financial Management Group, which invests in late stage technology companies.
Fortissimo Capital Fund	78	5	4.3	0.7	
Edmond de Rothschild Euroopportunities	Euro 100 million	Euro 11.3 million	Euro 10 million	Euro 1.3 million	Of the Rothschild Group.
Apax VII	Euro 11 billion	Euro 7.4 million	Euro 5 million	Euro 2.4 million	A European private equity fund in the Apax Group, and is expected to operate mainly in Europe.
Plenus III	120	15	9.7	5.3	A venture lending fund of the Dovrat Group, and is engaged in granting loans and credit facilities to technology companies.
Brack Capital Group real estate fund	110	5	3.7	1.3	At inception directed its investments towards real estate projects in India and China. Following the global crisis, the fund has changed its investment policy and now focuses on investments in the USA and Canada.
European real estate fund	Euro 416 million	Euro 10 million	Euro 7.2 million	Euro 2.8 million	Managed by the French AXA group.
Fortissimo Fund II	109.9	20	5	15	"Turn around" fund for technology based developed companies.
Carmel Software Fund	171	0.5	0.5	-	

\* The amounts are presented in U.S. dollars, unless otherwise stated.

The outstanding balance of DCMI's investments in venture capital funds, companies and in private equity funds amounted on December 31, 2010 to US\$173.8 million. As of that date, the balance of DCMI's investment commitments amounted to US\$155.4 million.

**Additional investment in funds.** In addition to the investment in funds through DCMI, the Bank has made a direct investment in an additional fund:

**FIMI Opportunity Fund I.** The size of this fund is US\$114 million. The Bank's share in the fund is due to reach US\$22.7 million, of which US\$18.6 million had been invested by December 31, 2010.

Furthermore, Mercantile Discount Bank is committed to investments in five venture capital funds. As of December 31, 2010, the investment of Mercantile Discount Bank in these funds amounted to US\$\_\_\_ million. As of December 31, 2010, the maximum commitment for the future investments in these funds amended to US\$2 million.

## INVESTMENTS IN CORPORATIONS

As part of investments in corporations several investments in several companies were made, including:

**Investment in activities abroad.** In September 2007 agreements were signed for investments in two companies under the ownership of Mayer Motor and Cars and Trucks Co. Ltd. (hereinafter: "the Mayer Group") according to which DCMI has undertaken to invest an amount of up to Euro 40 million in Mayer (Keshet) Real Estate Ltd. (hereinafter: "Mayer Real Estate") and an amount of up to Euro 30 million in Mayer Europe Ltd. (hereinafter: "Mayer Europe"). The Bank's said commitment subject to the commitment of the Mayer Group to make a parallel investment an amount of up to Euro 160 million in Mayer Real Estate and an amount of up to Euro 120 million in Mayer Europe. Until December 31, 2010, DCMI invested Euro 18 million in Mayer Real Estate Ltd. and an amount of Euro 1.4 million in Mayer Europe.

Mayer Real Estate is a holding company established at the beginning of 2007, centralizing the entrepreneurial real estate activities of the Mayer Group in Israel and abroad, including the hotel field. Mayer Europe is a holding company established in 2006, centralizing the leasing, trading, rental and import activities of new and used private vehicles of Mayer Group in European countries.

The investment in the said companies entitles DCMI to an equity interest of 20% and to the right to appoint one of five Directors in each of these companies.

Most of the investment in Mayer Real Estate is in respect of the holding in Habas Star, the main holding of which is a Dutch REIT owning income producing real estate in Western Europe.

Starting with the third quarter of 2008, Mayer Europe has made no investments and its operation in Hungary, being its only operation until now, is in the midst of realizing assets and a "run off" process. In

**Investment in "KFS".** On December 30, 2007, DCMI Kardan Financial Services BV (hereinafter: "KFS") and Kardan NV (hereinafter: "Kardan") entered into an agreement according to which DCMI will acquire by way of an issue of shares 11.01% of the issued and paid share capital of KFS at date of issue (and 11% of the issued and paid share capital of KFS fully diluted), in consideration of Euro 55.6 million. The original investment in KFS amounted to NIS 316 million. The Bank provided KFS with a credit facility of up to Euro 225 million. The credit is provided in installments, for various periods and subject to compliance with certain conditions as determined in the agreement between the parties. A significant part of the credit was secured by collateral that is not related to the activities of KFS or to the areas in which it operates.

On March 30, 2009, DCMI signed an agreement for the sale to Karden of all of its holdings in the shares of KFS in consideration for Euro 38.5 million. For details regarding the sale by DCMI of its investment in KFS and the option agreement for the purchase of KFS shares, see Note 19(c)(20) to the financial statements.

In 2008-2009, the Bank recorded provisions for impairment and loss in respect of the regulation of the investment in KFS, in the amount of NIS 103 million.

**Investment in "Menif" - Financial Services Ltd. ("Menif").** Menif engages in complementing equity capital of building contractors as required by banks financing building projects in a closed project format. Complementing the equity capital is effected by way of providing guarantees in favor of the project in consideration of income participating interest in profits. DCMI owns approximately 19.6% of the equity of Menif. DCMI's board of directors has approved a commitment of guarantees for projects up to an amount of US\$17.3 million. As of December 31, 2010, guaranties have been provided in the amount of NIS 51.3 million.

**Investment in Europort Ltd.** In March and April 2007, Discount Israel Capital Markets and Investments Ltd acquired 13.34% of Europort Ltd., in consideration for US\$2 million. Europort was expected to engage in initiation of income generating real estate projects. On December 31, 2010, DCMI held a 10.67% interest in Europort Ltd.

**Realization of investments.** For details of the realization of investments in 2009 in HOT, Bezeq and Harel, which had been in the Bank's possession, see Note 25 to the financial statements.

## FURTHER DETAILS AS TO ACTIVITY IN CERTAIN PRODUCTS

### CREDIT CARD OPERATIONS

#### STRUCTURE OF THE FIELD OF OPERATION

In recent years, the credit card serves as one of the principal means of payment in the market. The credit card is issued to the customer by the credit card company and the customer uses it for payment, as an alternative for cash or checks. The credit card company issues credit cards of two types: most of the cards are being issued to customers of banks, for the customers of such banks (hereinafter: "banks included in the arrangement"). The remaining cards are being issued directly by the credit card companies to customers, not by way of banks (hereinafter: "off-banking credit cards").

As estimated by ICC, 80% of the adult population of Israel uses credit cards as a means of payment, the Israeli consumer holding an average of 2.1 cards in his possession. ICC estimates the number of cards in Israel at December 31, 2010 was 6.75 million. Furthermore, some 70 thousand trading houses and marketing chains in Israel allow purchases using credit cards.

Use of credit cards is made possible by a contractual network covering four factors: an issuer, a clearing agent, a trader and a customer (the credit card holder), all of which are bound by separate and independent agreements (direct or indirect agreements, by virtue of the issuer and the clearing agent being members of an international organization that provides the franchise in respect of the credit card brand name). These contractual engagements provide the infrastructure for communicating the relevant data for settling the payments relating to transactions paid by credit cards.

As stated, the credit card system is composed of four factors: **Issuer** - the entity issuing credit cards to its customers; **Customer** - the holder of a credit card; **Trader** - the entity accepting a credit card; **Clearing agent** - the financial institution through which the trader receives payment.

The trader enters into an agreement with the clearing agent. In this framework, the clearing agent, in consideration for a commission, undertakes to credit the trader related to it, in a manner secured in advance, with the consideration due to the trader for the transactions made with him by the customers holding the credit card of the brand that is being cleared. The commission collected by the clearing agent in respect of clearing services to the trader is the "**Trader commission**". The clearing agent, on his part, pays the issuer an issuance commission called "**Cross commission**". This commission is embedded in the trader commission collected by the clearing agent. Namely, the trader commission is composed of the clearing commission and the issuer commission.

#### THE OPERATIONS OF ICC

ICC operates in two sectors of activity in the credit card market, constituting together the core activity of a credit card company: (a) issuance of credit cards; and (b) clearing of credit card transactions. In addition, ICC serves as a clearing agent with respect to international electronic trading transactions.

ICC (directly and through Diners Club, a company under its control) issues, markets and operates credit cards of the "VISA", "Diners" and "MasterCard" types, valid in Israel and abroad, and also has joint issue agreements with banks that participate in the arrangement.

In the issuance field, ICC issues (directly and through Diners Club, a company under its control) credit cards under two routes: (a) issuance of cards to customers of banks in the arrangement with which ICC has agreements for co-issuance or distribution agreements (above and hereunder: "co-issuance"). As regards these cards, ICC issues and manages the card, bears the costs of management of the card and of theft and forgery damage. The banks provide the credit facilities to the customer and bear the credit risk involved with the card; (b) issuance of cards directly by ICC, mostly through clubs and unique organizations (hereinafter:

"off-banking cards"). As regards to these cards ICC provides to the customer the credit facilities and bears the overall risk relating to transactions made by use of the card.

ICC issues a variety of credit cards in addition to the deferred charge card, which at present is the most common credit card in Israel, among which the following cards may be mentioned:

- (1) "Active" - a rolling credit card enabling the customer, subsequent to effecting the transaction, to choose when to make payment, within the limits of the credit facility granted to him;
- (2) A VISA credit card, which is a virtual credit card ("a credit card without a card") which had been developed jointly with VISA International. Within this framework, the customer contacts ICC receiving a personal number and a code, with which he is entitled to transact business (in an amount not exceeding the predetermined limit) without having to use an actual plastic card.

Clearing operations include the clearing of credit card transactions made in Israel, by way of "Point of Sale" appliances (POS appliances) located at trading houses.

In addition, ICC offers trading houses credit and related services, which include, among other things: discounting of credit card transaction vouchers, advance payments for transactions effected, the granting of advances on account of future payments to trading houses with which the company is engaged in clearing agreements and factoring activity.

With respect to the clearing of international electronic trading transactions, ICC serves as a clearing agent since 2003. ICC has an appropriate clearing license from VISA, MasterCard and Diners. Within the framework of this operation, ICC is mainly engaged in the clearing of Internet website transactions effected on behalf of overseas trading houses which operate these websites. The transactions are document free. Operations in this field are based on a global trend of a steep rise in transactions effected on the Internet. (For details regarding developments in respect of clearing of international trading transactions, see note 33 A to the financial statements).

Following are quantitative data regarding the activity of ICC:

Number of valid cards <sup>(3)</sup>	As of December 31,			
	2010		2009	
	The total number of cards	Of which: active cards	The total number of cards <sup>(5)</sup>	Of which: active cards <sup>(5)</sup>
	in thousands			
Bank cards <sup>(1)</sup>	1,107	942	1,043	892
Off-banking cards <sup>(2)</sup>	548	431	524	421
<b>Total</b>	<b>1,655</b>	<b>1,373</b>	<b>1,567</b>	<b>1,313</b>

Notes:

- (1) "Bank card" - A credit card issued jointly with the banks in the arrangement and under their responsibility.
- (2) "Off-banking card" - A credit card issued by ICC, separately from the banks.
- (3) "Valid card" - A valid credit card which is not blocked.
- (4) "Transactions turnover" - Includes transactions made using the credit card and debits in respect of transactions payable in installments, less the credits made to the banks or their customers in respect of the use of credit cards during the same period and commissions collected for the banks or for ICC. The transaction turnover does not include withdrawals of cash through the automatic teller machines in Israel.
- (5) "Active card" - a credit card through which at least one transaction was made in the last quarter.

Transactions turnover <sup>(4)</sup>	For the year ended December 31,	
	2010	2009
	in NIS millions	
Bank cards	37,414	34,415
Off-banking cards	8,882	8,523
<b>Total</b>	<b>46,296</b>	<b>42,938</b>

## Notes:

- (1) "Bank card" - A credit card issued jointly with the banks in the arrangement and under their responsibility.
- (2) "Off-banking card" - A credit card issued by ICC, separately from the banks.
- (3) "Valid card" - A valid credit card which is not blocked.
- (4) "Transactions turnover" - Includes transactions made using the credit card and debits in respect of transactions payable in installments, less the credits made to the banks or their customers in respect of the use of credit cards during the same period and commissions collected for the banks or for ICC. The transaction turnover does not include withdrawals of cash through the automatic teller machines in Israel.
- (5) "Active card" - a credit card through which at least one transaction was made in the last quarter.

Based on data produced by the banking industry as of December 31, 2010, as published by the Bank of Israel, the share of ICC credit cards out of the total of credit cards in Israel is 29%.

## SCALE OF OPERATIONS AND NET INCOME

**General.** The volume of credit card transactions increases annually. The increase in the use of credit card derives both from an increase in the volume of transactions (as a result of population growth and the existence of a younger population that is accustomed to using credit cards as part of its consumer culture) and from an increase relative to transactions paid for through other means.

Income from credit card clearing operations is attributed to the corporate banking segment, the small business segment and to the middle market segment.

**Net income** from the operations in 2010 amounted to NIS 161 million, compared with NIS 197 million in 2009, a decrease of 18.27%.

**The return on equity** was 18.5% in 2010, calculated on the capital allocated to the operations on the basis of the average balance of the operations risk assets, compared with 44.2% in 2009.

**Provision for doubtful debts** amounted in 2010 to NIS 26 million, compared with NIS 77 in 2009, an increase of 66.23%.

Following are the principal data relating to the credit cards operations:

Domestic operations					
	Households	Small Businesses	Corporate Banking	Middle Market Banking	Total
For the year ended December 31, 2010					
In NIS millions					
Income from financing activities before provision for doubtful debts					
- From external sources	283	13	11	4	311
- Intersegmental	(51)	1	-	-	(50)
Total income from financial activity	232	14	11	4	261
Operating and other income	787	60	49	16	912
<b>Total Income</b>	1,019	74	60	20	1,173
Provision for doubtful debts	26	-	-	-	26
Operating and other expenses	655	65	60	20	800
Operating Income before taxes	338	9	-	-	347
Provision for taxes on operating income	114	4	1	-	119
<b>Net (loss) income</b>	157	5	(1)	-	161
Return on equity (percentage)	20.6	10.0	(3.8)	(1.4)	18.5
Average Assets	7,858	324	447	144	8,773
Average Liabilities	748	905	1,298	1,441	4,392
Average Risk-assets	10,880	753	519	253	12,405
Components of income from financial activities:					
Margin from credit activity	238	14	11	4	267
<b>Income (loss) from financing activities before provision for doubtful debts</b>	232	14	11	4	261

Following are the principal data relating to the credit cards operations (continued):

	Domestic operations				Total
	Households	Small Businesses	Corporate Banking	Middle Market Banking	
For the year ended December 31, 2009					
In NIS millions					
Income from financing activities before provision for doubtful debts					
- From external sources	275	15	11	3	304
- Intersegmental	(59)	-	-	-	(59)
Total income from financial activity	216	15	11	3	245
Operating and other income	767	93	*104	33	997
<b>Total Income</b>	983	108	115	36	1,242
Provision for doubtful debts	77	-	-	-	77
Operating and other expenses	605	66	72	23	766
Operating Income before taxes	301	42	*43	13	399
Provision for taxes on operating income	*99	14	*14	4	131
<b>Net income</b>	*149	22	20	6	197
Return on equity (percentage)	36.5	99.7	270.3	89.8	44.2
Average Assets	7,682	305	422	138	8,547
Average Liabilities	1,396	1,064	1,508	455	4,423
Average Risk-assets	6,301	335	113	109	6,858
Components of income from financial activities:					
Margin from credit activity	216	15	11	3	245
<b>Income (loss) from financing activities before provision for doubtful debts</b>	216	15	11	3	245

\* Reclassified.

## PUBLIC SHARE ISSUE BY VISA INTERNATIONAL

VISA International decided in 2007 on a structural change and the offer of its shares to the public. The public offering of shares on the Stock Exchange in the United States was effected in the first quarter of 2008. ICC is a member of the VISA Europe organization, which remained a not-for-profit organization. VISA Europe received part of the proceeds of the share issue of VISA International as well as blocked shares of Visa International. VISA Europe has distributed the proceeds to member companies of the organization, including the Bank and ICC. Accordingly the Bank received a cash amount of approximately US\$4.4 million as well as 54.6 thousand shares of Visa Inc. On the said date ICC received a cash amount of US\$16 million as well as 201 thousand shares. Income in a total amount of NIS 110 million, as above, was recognized in 2008. The said shares were locked-up (part of which were released in 2010 and the balance in March 2011).

For details regarding gains on realization of a part the VISA shares, see Note 25 A to the financial statements.

## REGULATIONS, LEGISLATION AND ARRANGEMENTS

**General.** The activities of ICC are regularized under the Credit Card Law, 1986 and various rules under the general law also apply to it. In addition, due to the fact that ICC is a subsidiary of a banking corporation, it is defined also as an "auxiliary corporation" under the Banking Law (Licensing), 1981, and as such, a set of Laws, Regulations and Orders under the banking laws also apply to it including various directives issued by the Supervisor of Banks.

Likewise, ICC is bound to operate in accordance with the rules of the international organizations of which it is a member (VISA International organization, MasterCard Worldwide organization and Diners Club International). These rules are updated from time to time and determine international standards.

In addition, clearing operations outside Israel of international trade transactions may be subject to foreign legislation and regulations.

**The Commissioner of the Antitrust Authority.** The Commissioner of the Antitrust Authority is involved extensively in the field of credit card activity. For details as to the arrangements between the credit card companies and the three way agreement for cross clearing, which was submitted for approval of the Antitrust Tribunal, see Note 33 C 1 to the financial statements.

**Prohibition of money laundering and the financing of terror.** In December 2006 an amendment to the Prohibition of Money Laundering Order (Obligation for identification, reporting and maintenance of records by banking corporations for the prevention of money laundering and the financing of terror) was published. The amendment also applied to credit card companies' obligations for identification, maintenance of records and reporting to the Prohibition of Money Laundering Authority in all matters concerning credit card holders and businesses with whom the companies have clearing agreements. ICC has prepared to act in accordance with the requirements of the amended Order. As from September 2007, the Order has come into effect in stages when, as of March 12, 2009, the transitional periods determined by the Order came to an end and all the provisions of the Amendment came into effect. In complying with the Order, ICC is, among other things, obligated to employ extensive means in familiarizing itself with the customer in the process of attracting new customers.

**Amendment of Proper Banking Management Directive No. 411 - Credit Card Companies.** An amendment to Directive No. 411 applying to credit card companies was published on January 12, 2011, within the framework of which, the Supervisor of Banks intends to regularize the management of risks involved in conducting illegal transactions by means of credit cards.

The amendment states that the board of directors of a credit card company is required to formulate a policy for the implementation of the directives of the Supervisor regarding this matter. The policy will refer, among other things, to limitations on the volume of issuance and clearing operations of the company in markets outside Israel, as well as to engagement with trading houses active in risk abundant businesses.

On the issuance side - a credit card company is prohibited from approving a transaction made by means of a charge card issued by it, where suspicion exists that it comprises a gambling, lottery or a prohibited game transaction and where it is feared that the service acquired through the charge card is illegal in the country in which it had been rendered, or where the payment was made through a charge card held by an Israeli resident customer or by a foreign customer staying in Israel.

On the clearing side - it has been determined that a credit card company may engage in an agreement for the clearing of no document transactions with trading houses (in Israel or abroad), this only if according to information at hand the line of business of such trading houses is not in contravention of the law. Furthermore, credit card companies are prohibited from engaging with trading houses outside Israel active in risk abundant businesses, unless a legal opinion had been obtained according to which their line of business is not in contravention of the law, and which refers to the law applying to the parties to the transaction at all centers of their operations, and that all required measures had been taken in order to verify that such trading houses do not engage in no document transactions with customers who reside in countries that do not allow such transactions. It has also been determined that a credit card company has to apply the above mentioned requirements at least with respect to OECD member countries. In addition, a duty was imposed to monitor on a periodic basis compliance of the trading house with the duties imposed on it and to determine procedures that will assure that the company fulfills the requirements in this respect during the whole of the engagement period with the trading houses as stated.

ICC has adopted that part of the Directive that became effective, and is preparing for the implementation of the remaining parts of the Directive.

For details regarding an additional amendment to Proper Banking Management Directive relating to the entire banking sector, see under on "Legislation and supervision" below.

**Proper Banking Management.** In 2005 the Supervisor of Banks issued Proper Banking Management Directive No. 470, the purpose of which is regulating the charge card operations of credit card companies both in the field of risk management and in various consumer fields. In the risk management field, the Supervisor applied to the credit card companies additional Proper Banking Management Directives, such as "the board of directors", "risk management", "fraud and embezzlement by employees", "banking insurance" and so forth. In the consumer field the instruction relates to several principal issues, including: rules for the issue of credit cards, their delivery, their renewal and cancellation, the information provided as part of the monthly statement, rules regarding point/stars drives, rules regarding the conversion of transaction in foreign currency into Shekels, and so forth.

**Reporting to the public by credit card companies.** The Supervisor of Banks has applied similar reporting requirements to those applied to banks to credit card companies, including a Directors' Report, Management Review and declarations as to disclosures in the financial statements.

**Amendment of Proper Banking Management Directive No. 432.** At the end of March 2010, the Supervisor of Banks published an amendment to Proper Banking Management Directive No. 432, in the matter of "Charge cards". The amendment is intended to facilitate the transfer of customer accounts from one bank to another and will also enable customers to transfer their standing orders or continuing charge card transactions from the existing credit card to the new one. The amendment is intended to create a mechanism for the transfer of the charges, and for transferring the responsibility for such transfer of operations from the customer to the transferor issuer. The Directive also applies to the transfer of operations in continuing charge cards transactions, which are not incidental to the transition from one bank to another. The amendment became effective on December 1, 2010. At this stage, it is not possible to assess the impact of the amendment on ICC.

**Credit Data Service Regulations (Amendment), 2009.** An amendment of the Regulations imposing a duty of ICC to provide information to entities having a credit data service license. In this framework, ICC will be required to establish a reporting layout regarding credit data with respect to its customers, including positive information regarding its customers.

**A committee for the examination of market failures in the credit card field.** In February 2007, the report of the inter-ministerial committee, headed by the Accountant General at the Ministry of Finance, which dealt with the examination of market failures in the credit card field in Israel, was published. The committee recommended that the clearing market should be regularized by way of the Banking Law (Licensing). According to the recommendations of the committee, engaging in clearing would require a license from the Governor of Bank of Israel (existing clearing agents shall be entitled to a license); The Supervisor of Banks shall be entitled to require mutual clearing between the three existing credit card companies and between them and any new company in this field, and to require a large issuer to allow any clearing agent to clear its cards; the Supervisor of Banks shall be authorized to supervise clearing agents and to issue directives as to their operation, including the recommendation to the price committee, established under the Supervision of Commodities and Services Law, as to the maximum cross commissions, and to determine instructions requiring a clearing agent to enter into agreements with discount companies and not to discriminate between them.

**The Banking Law (Licensing) (Encouragement of competition in the credit card market).** In the wake of the said Inter-ministerial Committee and a private Bill which followed it in March 2007, the Ministry of Finance issued in April 2008 a law memorandum of the Banking Law (Licensing) Amendment, the principal provisions thereof are:

- A requirement to obtain a license from the Governor of the Bank of Israel in order to perform the clearing of charge cards transactions;
- The Supervisor of Banks shall be authorized to determine that a clearing agent, who together with its subsidiaries and parent company, cleared at least 20% of the total amount of transactions or of the total number of transactions effected in Israel in a calendar year, shall be considered a "major clearing agent", and to compel such major clearing agent to enter into a cross

clearing agreement with credit card issuers for the clearing of cards issued by them;

- The Supervisor of Banks shall be authorized to determine that an issuer who, together with its subsidiaries and parent company, issued at least 10% of the number of credit cards issued in Israel in a calendar year, shall be considered a "major issuer", and to compel such major issuer to enter into a cross clearing agreement with clearing agents for the clearing of cards issued by it;
- The cross commission will be considered a controllable commission under the Banking Law (Service to customer);
- Various provisions of the Banking Ordinance shall apply to the holder of a clearing license.

The private Bill is not identical in its scope and details to the said Bill Memorandum, however its principles are similar. In June 2008, the private Bill passed its preliminary reading by the Knesset. The Ministry of Finance published towards the end of July 2010, a Bill for the encouragement of competition in the credit card market.

ICC and the Bank are of the opinion that at this stage it is not possible to evaluate the impact of the law, if passed, on the credit card activity.

In continuation to that stated above, the Banking Law (Licensing)(Amendment No. 17)(Clearing of transactions made by credit card), 2011, Bill was published on February 9, 2011. The Bill proposes to amend the Banking Law (Licensing), 1981, and to determine that the clearing of transactions made by charge cards would be effected only by a holder of a relevant license issued by the Governor of the Bank of Israel, that such clearing agents would be subject to the supervision of the Supervisor of Banks, and that the Bank of Israel would be authorized to intervene in the fixing of the cross commissions. The Bill also proposes that the Supervisor of Banks would be authorized to determine that a clearing agent, together with its subsidiaries and parent companies, which have cleared at least 20% of the amount of transactions or of the number of transactions made in Israel in a calendar year, would be considered a "major clearing agent", and as such would be compelled to engage with other issuers in cross clearing agreements for the clearing of its cards. It is also proposed that the Supervisor of Banks be authorized to determine that an issuer, together with its subsidiaries and parent companies, which have issued at least 10% of the number of credit cards issued in Israel in a calendar year, would be considered a "major issuer" and as such would be compelled to engage with other issuers in cross clearing agreements for the clearing of their cards. In addition, it is proposed to apply certain sections of the Banking Ordinance to whoever receives a clearing license. This, according to the explanatory notes, with a view of enabling the Supervisor to supervise a clearing agent and enforce the directives applying to him in accordance with the proposals of the Bill. The Bill passed its first reading by the Plenum of the Knesset on February 14, 2011, even before being approved as a draft by the relevant committee of the Knesset.

ICC informs that it is not possible to assess the effect of the proposed amendment.

**Legislation initiative for the separation of credit card companies from the Banks.** With the renewal of the activity of the Knesset, following the election of the 18th Knesset, and the establishment of the new Government, a private Bill was tabled once more, in April 2009, according to which a bank shall not be permitted to have an equity interest in a company that issues credit cards. The Supervisor of Banks has in the past opposed a legislation initiative of this type and the Government refrained from supporting such legislation. At this stage, it is not possible to assess whether proposals of this nature will be promoted by the Government and what the arrangements established in this area, if at all, will be.

**Legislation initiative regarding the amendment of the Credit Cards Law (Amendment - discontinuation of charges due to defect), 2009.** A private Bill was tabled before the Knesset in May 2009, which deals with the right of a credit card holder to instruct the credit card company to discontinue charging him due to a defect occurring in the basic transaction between the credit card holder and the trading house with which the transaction had been made.

**Penal Code Amendment Bill and the Charge Card Law Amendment Bill.** A private Bill for the amendment of the Penal Law (Prohibited games, restrictions and gambling on the Internet), 2010, has recently been tabled before the Knesset. The Bill includes a proposal for the amendment of the Charge Cards Law, according to which an issuer shall not be permitted to knowingly pay a supplier the consideration for transactions made by a customer constituting participation in prohibited games, including gaming on the Internet. Furthermore, a clearing agent shall not be permitted to knowingly transact business with a supplier engaged in

prohibited games, including on the Internet. According to the Bill, an issuer and/or a clearing agent who will violate the provisions of the law will be liable to a fine as stated in Section 61(a)(4) of the Penal Law. It should be noted that from the explanatory notes to the Bill, it could be deduced that the intention of the Bill is not to damage the international clearing business of ICC. It should be further noted that ICC operates today in line with the spirit of the said Bill.

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## TECHNOLOGICAL CHANGES

**Use of the "smart card".** As part of the effort to reduce misuse and forgery of credit cards, the international VISA organization and the MasterCard Worldwide organization are adopting various measures to improve the security of credit cards carrying their brand names. These organizations have directed their members to introduce the use of a credit card with special features that complicate its use and/or forgery by unauthorized factors (hereinafter: "the smart card"). As from January 1, 2005, (hereinafter: "date of transition"). In order to induce issuers and trading houses to convert to the use of "smart cards", the international organizations determined rules concerning the assignment of responsibility in the case of misuse of a credit card under certain circumstances, starting with the transition date. These rules state that in case of forgery/misuse of a card:

- (1) If a "smart card" has been cleared by a trading house where a "smart" clearing appliance is not installed, costs will be borne by the trading house;
- (2) Where a credit card which is not a "smart" card has been cleared by a trading house where a "smart" clearing appliance is installed, costs will be borne by the issuer.

In accordance with these directives, the Company commenced preparations for introduction of the smart card. The issuance aspect mainly includes upgrading of the technology acquired by the Company in the past and its adaptation for issuance of smart cards, and upgrading and/or acquisition and/or development of sophisticated POS instruments and their installation in various businesses with which ICC has clearing agreements. ICC is issuing "smart cards" on a current basis. ICC has not yet begun preparations with respect to clearing activities and it believes that such preparations require cooperation between all credit card companies for the installment of "smart" clearing appliances at trading houses.

**Upgrading of the information systems.** In 2010 ICC began the project of replacing its existing financial reporting system by an Oracle ERP system. The new system is expected to bring about, among other things, an improvement in the control capabilities in the various areas of the financial activity of ICC, shortening the purchase processes and improvement of control in this respect, improvement of budgetary control and higher compatibility with various compliance requirements.

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## CRITICAL SUCCESS FACTORS

- An operating network including technological information systems, teleprocessing and advanced infrastructures;
- A developed and effective risk management system.

The issuance field:

- Authorization to issue brand name credit cards under a franchise granted by the international organizations;
- Cooperation with banking corporations;
- Consummation of agreements for the establishment of consumer clubs;
- Ability to offer customers attractive credit products;
- The ability to borrow funds from financial institutions at attractive terms.

The clearing field:

- Cross clearing agreements between credit card companies in Israel;
- The ability to attract trading houses and maintain relations with them by an extensive marketing layout.

As regards the clearing of international electronic trading transactions:

- Establishing a layout of engagements with Internet payments service providers;
- Advanced monitoring and control capabilities;
- An effective and efficient layout of risk management.

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## OBSTACLES TO MARKET ENTRY

Principal entry barriers into the issuance field:

- Activity as an issuer requires the existence of an extensive, complex, costly operating system, with sophisticated information and communications systems, including information security systems, customer service, etc;
- A massive and ongoing investment is required for country-wide marketing, distribution and sales channels in order to compete in the issuance field, especially through a distribution chain for credit cards is required in accordance with agreements with banks and/or customer clubs;
- High financial stability is required for purposes of issuing resources for financial activity, i.e. ability to borrow extensive funds at more preferable conditions compared to conditions offered to "regular" customers;
- Maintenance of control of the issuer by banking corporations is required for purposes of recognition and membership in international organizations that manage leading international brand names;
- Ability to provide a guarantee by the controlling banking corporation (see Note 19(c)\_ to the financial statements);
- The existence of a recognized and efficient system for rating credit risks.

Principal entry barriers into the clearing field:

- Entry into the credit card clearing field involves, primarily, obtaining a license from the international organization to which the clearing activity is related. Receipt of such a license requires that the applicant have a banking connection and compliance with business and financial standards that will secure its activity, in addition to payment of membership fees to the international organization;
- An entity requesting entry into the clearing field should establish a communications network enabling on-line clearing of credit card transactions (or should acquire the services of Electronic Banking Services, which maintains such a system in Israel);
- The existence of a solid, credible information system for billing management.

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## ALTERNATIVE PRODUCTS

In addition to the classic alternatives to a credit card, e.g. checks, cash and bank transfers, additional instruments and services exist, constituting an advanced technology and which, in contrast to the above stated instruments and similarly to credit cards, are characterized by availability and convenience:

- Payment service through cellular phone;
- Internet transactions for transfer of funds without disclosing the credit card details of the customer/details of the customer's bank account;
- Alternative instruments to credit instruments are the many credit instruments offered on the market - whether by the banks or by other factors (private companies that offer off-banking credit, including the "grey market"). A very wide range of credit products having various characteristics, exist in the market, all of which serve as alternatives for one another. Notwithstanding, most of the customers purchase a credit product provided by the entity known to them (namely, their bank), therefore every customer sees various alternatives to products offered by ICC;
- An alternative product in the clearing channel is the check discounting service;
- Alternative products in the clearing field on the Internet are being developed all the time in view of the fact that the trade on the Internet is an activity being continuously developed.

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## CUSTOMERS

**The issuance field.** The majority of ICC customers in the credit card issuance field are customers holding credit cards issued in conjunction with the banks included in the arrangement (including the Bank and Mercantile Discount Bank). ICC is investing special effort to increase the part of off-banking credit cards and to issue off-banking credit cards through consumer clubs or special cards.

**The clearing field.** ICC customers in the clearing field are those traders that accept VISA, MasterCard or Diners credit cards. Additional customers in the clearing field are trading houses that look for advance payments services (the discounting of vouchers or invoices).

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## MARKETING AND DISTRIBUTION

**The issuance field.** The banks that are a party to the arrangement constitute ICC's "base recruiting level" for customers ordering credit cards through their banks. Consumer clubs serve as an additional "base recruiting level", through which ICC recruits off-banking customers through direct distribution. These clubs comprise unique customer groups who enjoy benefits tailored for them. In addition, ICC offers its customers attractive marketing campaigns in participation with leading trading houses in the Israeli market, and maintains several advertising and marketing channels through the Internet, television, direct mailing, etc.

**The clearing field.** The marketing operations in this field are directed towards the traders, with special emphasis on traders that have several points of sale (marketing chains generally utilize one clearing agent for all their branches). Sales representatives market clearing services to the traders. These sales representatives remain the contact persons for the traders also after the clearing agreements have been signed.

**In the field of clearing international electronic trading transactions** the engagement with traders around the world is made through a small number of "mediators" (Internet Payment Service Providers).

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## COMPETITION

**The structure of competition.** Competition in the field of credit card issuance is derived from the competition between the banks over customers. In addition, the competition is over the heart and pocket of the customer with the aim of convincing the customer to pay for the major part of his current consumption by means of the cards issued by ICC, and at the same time increasing the number of credit cards issued by it. In providing credit in the issuance channel, ICC competes with bank credit as well as with other entities providing off-banking credit. In the clearing field, competition is over traders to whom clearing services and complementing services are being provided.

**The issuance field.** Three credit card companies operate in Israel, all of which are owned or controlled by banks:

- **ICC** issues VISA credit cards and Diners credit cards (through Diners, exclusively). ICC also issues MasterCard credit cards.
- **IsraCard**, a group of private companies all of which are controlled by Bank Hapoalim Ltd., issues and clears Isracard (exclusively) and MasterCard, credit cards. IsraCard is a brand name owned by IsraCard, which issues credit cards under this brand name for use within Israel only. To the best of ICC's knowledge, as of date of the financial statements, the volume of operations of IsraCard in the issuance of VISA credit cards is rather limited compared with the volume of its operations in issuance of "MasterCard" credit cards, which constitutes most of its operation under this brand in Israel. American Express is issued by an affiliated company of IsraCard (exclusively).
- **LeumiCard**, a private company controlled by Bank Leumi (and which is also held by Kanit - Managing, Investments and Finance Ltd.) issues VISA and MasterCard credit cards.

**The clearing field.** The players in the field of credit card clearing includes:

- **ICC**, which clears VISA and MasterCard credit cards and Diners credit cards (through Diners, exclusively);
- **IsraCard**, which clears IsraCard (exclusively), "American Express" (exclusively), MasterCard and Visa;
- **LeumiCard**, which clears VISA and MasterCard credit cards.

In accordance with an agreement of October 30, 2006 between ICC, LeumiCard, IsraCard and the banking corporations controlling these companies, regarding the opening of the clearing market for VISA and MasterCard credit card by the three companies, the operational ability of ICC (and of LeumiCard) in respect of clearing MasterCard credit cards in Israel has increased. In June 2007 ICC began clearing MasterCard credit cards in Israel after activating the joint interface. Following the signing of the new agreement, Isracard joined the local agreement for cross clearing between ICC and LeumiCard with respect to the VISA brand name (for further details see below).

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## DEVELOPMENTS IN THE SEGMENT IN 2010

**Developments in the field of clearing of international electronic trading transactions and additional matters.** For details regarding developments in the field of clearing of international electronic trading transactions and additional matters, see Note 33 A to the financial statements. For details as to the merger between ICC and ICC International, see Note 33 A to the financial statements.

For details regarding material weaknesses in the internal control over financial reporting layout, as reported by ICC in its Annual Report for 2009, which have been rectified until December 31, 2010, including a material weakness regarding the control layout relating to the clearing of international electronic trade transactions, see below "Israel Credit Card Company Ltd." under "Main investee companies".

**Capital adequacy and corrective measures.** In a letter dated June 16, 2010, the Supervisor of Banks informed the Bank and ICC that following the materialization of risk events of recent months, ICC is requested to take immediate action in order to comply with capital adequacy requirements and to adopt corrective measures. For details see Note 33 \_\_ to the financial statements. ICC acted and is acting to implement in full the Supervisor's requirements.

**Agreement for joint issuance with Yahav Bank.** ICC and Yahav Bank signed an agreement on September 22, 2009, for the joint issuance of VISA, MasterCard and Diners Club credit cards. The agreement covers all operational arrangements and the granting of services to credit cards issued by ICC and distributed by Yahav Bank to its customers.

Until now, Yahav Bank has issued IsraCard credit cards only.

**Acquisition of factoring operations.** In April 2009, following the fulfillment of conditions precedent to the transaction, the transaction for the acquisition of the factoring operations of Psagot Factoring Finance was consummated. The purchased operations will be conducted under a new company (hereinafter: "ICC Factoring") jointly owned by ICC (75%) and a third party (25%). On November 30, 2010, ICC acquired the remaining shares in consideration for their par value only.

On December 31, 2010, the Board of Directors of ICC decided to transfer the factoring activity from ICC Factoring Ltd. to ICC. This transfer of operation would be effected by way of a merger in terms of the Companies Law, 1999. The object of this move is to extend the supervision and control over factoring operations. Completion of the merger is subject to obtaining all approvals required by the Companies Law and fulfillment of all conditions precedent included in the merger agreement.

**Standard for the protection of information relating to VISA card payments.** The International VISA Organization (hereinafter: "VISA") determined a standard for the protection of information regarding credit card payments (PCI DSS) in 2004, under which trading houses, companies operating electronic sales stations and credit cards companies must attain a series of milestones in the implementation and integration of the provisions of the standard. According to the VISA regulations, the Organization is authorized to impose monetary sanctions on Organization members who do not comply with the said milestones. In view of certain difficulties arising in the adjustment of the provisions of the standard to the credit card market in Israel, which caused a delay in the implementation timetable of the standard, discussions have been held in recent months with VISA regarding the

implications of the said delay. ICC together with other factors are endeavoring to solve the problem of adjustment of the standard to the Israeli credit card market.

**Lawsuit on the matter of ascription to the higher issuer commission category.** On August 31, 2010, Bezeq the Israeli Communication Company Ltd. (hereinafter - "Bezeq") filed a lawsuit with the Tel Aviv District Court against ICC, Leumi Card and Isracard (hereinafter together - "the defendants"). The Court was motioned to declare that Bezeq is to be ascribed to the lowest issuer commission category; since its classification to the higher issuer commission category is a violation of the provisions of Section 4 of the Antitrust Law, 1988 (hereinafter - "the Antitrust Law") and that the unilateral increase in the rate of the business commission, dated July 25, 2010, which the defendants, including ICC, committed to collect from Bezeq, according to agreements between them, constitutes a violation of the existing clearing agreement with each of the defendants.

On November 6, 2010, in accordance with the understandings between Bezeq and Isracard, the Court ruled to erase the claim against Isracard.

On November 3, 2010, the defendants filed defense briefs on their behalf. A response on behalf of Bezeq was filed on January 2, 2011. On November 8, 2010, ICC approached the Antitrust Authority in order to obtain its position regarding certain aspects pertaining to the Bezeq lawsuit. The response of the Authority was received on January 6, 2011, in which it clarified that the increase by ICC of the cross commission applying to Bezeq was in accordance with the law; that the inclusion of Bezeq in the lowest category of the issuer commission would be in contravention of the terms of the provisional permit and a violation of the Court's decision; that admittance of the claim of Bezeq would be a decision exceeding the authority of the Court; and that the inclusion of Bezeq in the lower category would be an illegal act.

**Extension of the period of the "PowerCard" agreement.** On July 22, 2010, ICC signed an agreement with "PowerCard" (2000) Ltd. and with Fishman Chains Ltd. (hereinafter: "the Agreement"). The Agreement extends until December 31, 2015, the validity of a prior agreement signed by the parties, with certain amendments. The Agreement establishes the obligations and rights of the parties within the framework of joint activities aimed at promoting loyalty to the chains participating in the "PowerCard Club" on the one hand, and the distribution of credit cards issued by ICC on the other hand.

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## MATERIAL AGREEMENTS

**Agreements with banking corporations.** ICC is engaged in agreements with various banking corporations for the purpose of the issue of credit cards to its customers. Issue of credit cards is made jointly by ICC and the banking corporation, where its status with the International VISA Organization permits issue of the cards. In other cases, issue of the card is made by ICC and distribution to customers is made by the banking corporation.

For details regarding a joint issue agreement with Mizrahi-Tefachot Bank and regarding the grant to Mizrahi-Tefachot Bank of an option to purchase up to 10% of the share capital of ICC, see Note 33 C 3 to the financial statements. For details regarding a joint issue agreement with the First International Bank, see Note 33 C 2 to the financial statements. For details regarding a joint issue agreement with Union Bank and regarding the grant to Union Bank to purchase up to 3% of the share capital of ICC, see Note 33 C 4 .

**Arrangements made between the credit card companies.** For details regarding proceedings at the Antitrust Court in the matter of a binding arrangement for the cross clearing of VISA cards between ICC, the First International Bank, Discount Bank, Bank Leumi LeIsrael B.M. and Leumi Card Ltd., including the appointment of an expert by the Court, see Note 33 C 1 to the financial statements. For details regarding a cross clearing tripartite agreement between the Commissioner, the credit card companies and the banks owning these companies, for the cross clearing of VISA and MasterCard charge cards, see Note 33 C 1 to the financial statements.

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## SEASONAL FACTORS

The seasonality in the fields of issuance and clearing depends on the seasonality of private consumption in Israel.

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## BUSINESS GOALS AND STRATEGY

**The issuance field.** Leading the market through the exhaustion of the banking channel and offering solutions adapted to customer needs, issuance of charge cards in the off-banking channel in existing customer clubs, as well as through the cooperation with various entities for the establishment of additional customer clubs.

ICC is striving to become a significant player in the consumer credit market, through the issuance of off-banking charge cards as an infrastructure for increasing the credit to customers. ICC is striving for a position of strength as an entity that provides varied credit services (including through credit cards), without dependence on banks and developing additional products in this field.

**The clearing field.** ICC's strategy is intended to convert the Company to a clearing agent marketing a comprehensive basket of products to traders, while enlarging its market share in the clearing field. Furthermore, ICC is taking steps towards developing and market additional products to be offered to traders, in addition to discounts and the advancement of payments offered at the present time.

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## OPERATIONS IN THE CAPITAL MARKET

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### TREND OF EVENTS AND DEVELOPMENTS IN THE MACRO-ECONOMIC ENVIRONMENT

**The mutual funds market.** The mutual fund market increased since the beginning of the year by NIS 23.4 billion, from a level of NIS 133.2 billion at the end of December 2009 to a level of NIS 156.6 billion at the end of December 2010. Net positive deposits in all types of mutual funds were recorded in 2010, with the exception of the Shekel funds, where a negative accumulation was recorded. The assets of funds specializing in bonds in Israel grew during the said period by NIS 17.1 billion, despite declines in the assets of State bonds funds (NIS 471 million), of Shekel bonds funds (NIS 1.9 billion) and of foreign currency bonds funds (NIS 164 million). This, due to an increase of NIS 17.7 billion (54.6%) in the assets of other funds specializing in bonds. The assets of the equity funds in Israel increased by NIS 2.5 billion (33.9%). At the same time, the assets of the foreign bonds funds increased by NIS 1.9 billion (56.6%), while the assets of the foreign equity funds remained almost unchanged.

The growth in the assets of the other bonds and equity funds stems, to a large extent, from the rise in prices at the shares and bonds market in Israel, but also from the net inflow of funds to these channels. On the other hand, the decline in the assets of the Shekel funds is explained by the withdrawal of deposits therein.

**The provident fund market.** The provident fund market achieved in 2010 a positive return at an average rate of 9.92%. The said increase reflects the increases in the various indices of the Stock Exchange in 2009.

According to data published by the Capital Market Division at the Ministry of Finance, it appears that the assets of all the provident funds at the end of 2010 amounted to NIS 305,988 million, compared to NIS 279,833 million at the end of 2009, an increase of NIS 26.1 billion (9.3%).

Furthermore, according to data published by the Capital Market Division at the Ministry of Finance Provident funds of the "Provident and Personal Severance Pay Funds" class had in 2010 a net negative accumulation in the amount of NIS 2,910 million. This compared to a net negative accumulation of NIS 2,600 million in 2009. The said data reflects the effect of changes in regulation with respect to provident funds.

**The basket certificate market.** According to data published by the Tel Aviv Stock Exchange, 45 new basket certificates were issued in 2010, and a total of 398 basket certificates were traded at the end of December 2010, of which 382 basket certificates based on 12 local indices and 55 certificates based on international indices.

**Capital market.** For details regarding developments in the capital market in 2010, see "Capital market" above under "Main developments in Israel and around the world in 2010".

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## LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE OPERATIONS IN THE CAPITAL MARKET

The regulatory framework relating to the capital market operations, which was materially changed, among other things, due to the implementation of the recommendations of the Bachar Committee, continues to be updated and is expected to continue and influence the Bank's activities in this line of operation, including the pension consulting field.

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## LEGISLATION AND REGULATION AMENDMENTS REGARDING PENSION SAVINGS

**The plan for intensifying competition in the pension savings market.** On November 30, 2010, the Ministry of Finance issued a plan for the improvement of the market and for intensifying competition and transparency in the pension savings area. According to the plan, the measures to be adopted are expected to correct distortions created in the pension savings market and assist in reducing management fees.

According to the plan and with a view of strengthening the pension market, the Ministry of Finance intends to allow pension consultants to charge a uniform distribution commission in respect of the three pension products, including insurance products (executive insurance), in respect of which, the Bank had not been entitled to a distribution commission up until now.

With the transition to a structure of uniform management fees, the maximum distribution commission will be reduced to 0.2% of accumulated funds (instead of the present commission of 0.25%), to which will be added a component of distribution commission of 2% of the deposit. Draft regulations in this matter are expected to be published in the first quarter of 2011.

Furthermore, in order to help customers understand the extensive amount of information provided, the Ministry of Finance intends to determine a uniform and binding format for a number of forms used in the process of pension consultation, and in particular determine a uniform version for a document combining rationale, illustration and fair disclosure that will be provided to the customer as part of the pension consultation process. Within the framework of this regularization, the Bank will be required to update its consultation system, the documents it produces and the pension consultation forms in general. Draft circulars in this respect are expected to be issued in the second half of 2011.

**Draft circular regarding digital signature.** On January 4, 2011, the Capital Market, Insurance and Savings Division at the Ministry of Finance, issued a first draft circular regulating the manner of use of digital signatures for the signing of documents by customers, as part of a transaction made by an officer having a pension consulting license.

**Capital Market Enforcement Intensification Bill.** On October 18, 2010, the Capital Market Enforcement Intensification (legislation amendments) Bill, 2010, was published, which is designed to extend the enforcement authority of the Capital Market, Insurance and Savings Commissioner with respect to insurers, provident and pension funds management companies and with respect to consultants and distributors operating in the pension market. The Bill suggests expanding the supervisory authority of the Commissioner and granting him administrative investigative authority for the purpose of investigating violations of the supervisory laws relevant to the pension field, including also the Supervision of Financial Services (Engagement in pension consultation and pension marketing) Law, 2005, similarly to the administrative enforcement authority granted to the Israeli Securities Authority, according to the Efficiency of Enforcement Procedures at the Israeli Securities Authority (Legislation amendments) Law, 2011.

**Provident funds operating fees.** The Commissioner of the Capital Market, Insurance and Savings at the Ministry of Finance published a directive, effective as from September 2006, according to which a pension consultant who provides operating services to a provident fund, may not charge the management company operating fees in excess of 0.1% per annum of the total assets of the fund accepting services from him as above.

**Homogeneous interface.** Towards the end of 2008 and at the beginning of 2009, the Ministry of Finance began to take action in order to coordinate the operations of banks and other player in the pension market (product managers, insurance agents, etc.) with the aim of establishing homogeneous interface for the communication of information between managers of pension products and other players in the market and banks acting as advisors. As the first step in creating the said uniform interface, a circular was issued in August 2009 in the matter of "Uniform reduced structure for the transfer of data from an institutional body to a license holder", which came into effect on February 1, 2010.

In continuation of the regulation of information transfer interfaces, the Ministry of Finance issued on October 19, 2010, a second circular that was cancelled even before taking effect, in view of a third circular published on February 28, 2011.

The last circular letter will take effect on October 1, 2011.

**Coding of pension savings products.** As part of the effort to improve the efficiency of the uniform interfaces for the transfer of information between managers of the pension products and the other player in the market and the banks acting as consultants, it has been decided on the integration of a uniform coding system enabling distinctive identification for all pension savings products existing in the market (provident, pension and insurance), by means of a circular issued on December 29, 2010, taking effect on October 1, 2011.

**Pension clearinghouse.** In 2010 efforts continued for the promotion of the pension clearing house. In May 2010, the Bank joined together with other distribution entities and institutional bodies, as a shareholder in the 'Long-term Savings Clearing Company', the object of which is to establish and manage the pension clearing house (hereinafter – "the Clearing House"). On February 28, 2011, Amendment No.3 of the Supervision of Financial Services Law (Engagement in Pension Consultation and Pension Marketing) passed its second and third reading. This Amendment regularizes the activity of pension clearing companies and in particular, the activity of the clearing house. In accordance with that stated in the Amendment, the pension clearing system will afford users, including the Bank, access to information regarding the pension savings of the customer as well as enabling the future monetary clearing with respect to pension savings, similarly to the stock exchange clearing system.

**Circular regarding the contents of the conclusions document.** A circular was published in February 2009 regarding the contents of a conclusions document that is to be provided to the customer following each pension consulting act, including delivery of certain parts of this document to the management company that had been chosen by the customer to manage his pension savings by way of its products. The provisions of the circular came into effect on January 1, 2010.

**Draft circular regarding the decision regarding compensation of customers.** On February 16, 2010, the Capital Market Insurance and Savings Division at the Ministry of Finance issued a second draft of the circular regarding principal decisions under Section 39(c) of the Control of Financial Services Law (Provident Funds), 2005, in the matter of compensation with respect to delay in the withdrawing of funds or delay in the transfer of funds between provident funds or between investment channels, under which, if it becomes effective, compensation may have to be paid to provident fund members, the fulfillment of their requests had been delayed.

**Personally managed provident funds.** Supervision over Financial Services Regulations (Provident funds) (Personally managed provident funds), 2009, were published in October 2009. These Regulations allow depositors to manage their funds in their further education funds and in their second layer of provident funds in a personally managed provident fund, as well as impose certain restrictions on the manner of investments of such funds. According to the Regulations, personally managed funds will not be charged with a distribution commission.

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## LEGISLATION AND REGULATION AMENDMENTS REGARDING INVESTMENT CONSULTING

The directive of the Securities Authority regarding the duty of an investment consultant to acquaint himself with and understand the needs of the customer when discussing his investments and guidelines come into effect in January 2008. The directive details and expands the responsibilities of an investment consultant in respect of obtaining information on requirements and instructions of a customer seeking consulting and advice. The directive requires, inter alia, adoption of an investment policy for the customer

by determining several possible risk levels, in accordance with the customer's requirements and needs, and coordination of several potential investments channels for each risk level.

A new version of the Directives was published on November 17, 2010. The Directives in their new form allow, under certain conditions, performance of a preliminary study of needs by means of a recorded telephone call, and determine, among other things, the contents of the study of the customer's needs, the manner of determining the investment policy pertaining to the portfolio, documentation of the information in the agreement with the customer, refusal of the customer to provide information and the annual updating of the customer's characteristics and policy. The provisions regarding performance of the said proceedings by means of a recorded telephone call came into effect on November 17, 2010. The remaining provisions of the Directive will come into effect on May 31, 2011.

An Amendment to the Law came into effect on June 3, 2010 regulating the investment consulting business, the marketing of investments and the management of investment portfolios, (Amendment 14). The Amendment determined that basket certificates are to be included in the definition of financial assets, so that whoever has an "affinity" (within the meaning of this term in the law) to basket certificates shall not be permitted to act as an investment consultant, but rather only as an investment marketing agent. In light of the said Amendment, the Bank will have to act towards severing its ties with companies issuing basket certificates and/or sell its holdings therein, until August 2013. For details as to the sale of the basket certificates operation, see Note 19 item 23.

The instructions relating to a "qualified customer", included in the amendment of the Regularizing Engagement in Consultancy Law (Amendment 13), came into effect on April 18, 2010, that will enable foreigners qualified in their countries of origin to engage in investment consulting, investment marketing or portfolio management, to offer their services also in Israel without the need to apply for a license, subject to the provisions determined in the Law. The Regulations dealing with this subject were published on January 31, 2011, and will become effective sixty days after their publication date. The provisions of the said Amendment pertaining to "foreign traders" will enter into effect upon the said regulations becoming effective.

Within the framework of the Amendment, the list of factors defined as "eligible customers" has been extended, to whom investment consulting and marketing services may be offered without a license, to include, among others, private customers owning a large asset portfolio (NIS 12 million and over), as well as additional amendments.

**New Regulations regarding Mutual Funds.** On May 17, 2010, Amendment No. 15 Bill for the Mutual Investment Trust Law, 1994, was published. Among other things, the Amendment permits the offer in Israel of foreign mutual funds units in order to improve competition in the mutual funds market in Israel.

In addition, and concurrently to the above, in the matter of Amendment No. 14 to the Regularizing Engagement in Investment Consultancy, in Marketing Investments and in Management of Investment Portfolios Law, 1995 ("Regularizing Engagement in Investment Consultancy Law"), a Bill memorandum was published on November 16, 2010, for an additional amendment of the Mutual Investment Trust Law, in the matter of basket certificates and basket funds, the purpose of which is to match the regulation applying to basket certificates and similar products to the regulation applying to mutual funds, this in order to prevent possible regulatory arbitrage between products similar in characteristics and in purpose of investing therein. Accordingly, the amendment to the Law suggests that the Mutual Investment Trust Law shall apply to any arrangement the purpose of which is mutual investment in securities and currencies and deriving mutual profits there from or from any transaction therein, which is not regulated by any other law, including also basket certificates.

**Regularizing Investment Brokerage Bill, 2010.** The Israeli Securities Authority published on August 22, 2010, the Regularizing Investment Brokerage Bill, 2010. This Bill is designed to replace the Regularizing Engagement in Investment Consultancy, in Marketing Investments and in Management of Investment Portfolios Law, 1995, and to apply to all investment brokers, including analysts, brokers, dealers and providers of securities deposits services. This law is designed to establish an infrastructure for the formation for a regulatory council that will supervise the activities of brokers and will determine rules governing all areas of their operations. To the extent that this Bill will be passed in its present format, it will widen the authority of the Israeli Securities Authority regarding areas of operation, which at present are not being supervised by it, and will bring about a change in the

regulatory and supervisory structure in the capital market field, principally regarding everything relating to the formation of the council and the transfer of regulatory and supervisory authority to it.

## SCALE OF OPERATIONS AND NET INCOME

**Net income** of the operations in 2010 amounted to NIS 138, compared with NIS 119 million in 2009.

Following are the principal data relating to the operations in the capital market:

	Domestic operations					International		Total
	Households	Small Businesses	Corporate Banking	Middle Market Banking	Private Banking	Private Banking	Private Banking	
For the year ended December 31, 2010								
In NIS millions								
Income from financing activities before provision for doubtful debts								
- From external sources	10	3	2	1	1	17	1	18
- Intersegmental	-	-	-	-	-	-	-	-
<b>Total income from financial activity</b>	10	3	2	1	1	17	1	18
Operating and other income	264	47	34	18	35	398	57	455
<b>Total Income</b>	274	50	36	19	36	415	58	473
Operating and other expenses	176	31	18	11	24	260	51	311
Operating Income before taxes	98	19	18	8	12	155	7	162
Provision for taxes on operating income	38	6	7	2	5	58	1	59
<b>Net income</b>	73	22	12	9	16	132	6	138
Average Assets	9	4	18	1	7	39	-	39
Average Liabilities	-	-	2	-	-	2	-	2
Average Risk-assets	472	87	74	33	238	904	-	904
Average assets of provident and mutual funds	27	10	230	16	187	470	-	470
Average customers' securities	33,360	9,186	80,484	8,541	11,834	143,405	10,999	154,404
Average other assets under management	1,215	347	182	404	2,088	4,236	-	4,236

Following are the principal data relating to the operations in the capital market (continued):

	Domestic operations					International operations:		Total
	Households	Small Businesses	Corporate Banking	Middle Market Banking	Private Banking	Private Banking	Total	
For the year ended December 31, 2009								
In NIS millions								
Income from financing activities before provision for doubtful debts								
- From external sources	10	3	5	1	1	20	-	20
- Intersegmental	-	-	-	-	-	-	-	-
Total income from financial activity	10	3	5	1	1	20	-	20
Operating and other income	260	42	27	19	41	389	51	440
<b>Total Income</b>	270	45	32	20	42	409	51	460
Operating and other expenses	150	28	17	12	28	235	40	275
Operating Income before taxes	120	17	15	8	14	174	11	185
Provision for taxes on operating income	43	6	6	3	4	62	4	66
<b>Net income</b>	77	11	9	5	10	112	7	119
Average Assets	7	3	14	1	6	31	-	31
Average Liabilities	-	-	2	-	-	2	-	2
Average Risk-assets	7	3	12	1	6	29	-	29
Average assets of provident and mutual funds	55	25	426	83	308	897	-	897
Average customers' securities	29,366	6,275	64,172	8,014	9,041	116,868	9,677	126,545
Average other assets under management	1,307	302	141	679	1,284	3,713	-	3,713

## DATA RELATING TO THE SCALE OF OPERATIONS IN DIFFERENT AREAS:

**Securities.** On December 31, 2010, the balance of securities held for customers amounted to NIS 112.9 billion, including NIS 9.6 billion of non-marketable securities, compared to NIS 101.2 billion as at December 31, 2009, including NIS 9.7 billion of non-marketable securities, an increase of 11.5%. For details as to income from security activities, see Note 24 to the financial statements.

In addition, the balance of securities held on behalf of customers at the Mercantile Discount Bank as of December 31, 2010, amounted to NIS 13 billion, compared with NIS 11.3 million In 31 December, 2009, an increase of 15.0%.

**Investment portfolio management.** On December 31, 2010, Tachlit was managing 1,619 investment portfolios, which together were valued at approximately NIS 2,862 million, as compared to 1,531 portfolios valued in total at approximately NIS 2,169 million as at December 31, 2009. The above data point to an increase of 57% in the number of portfolios managed and to an increase of approximately 31.9% in the monetary value of the managed portfolios.

In addition, Mercantile Discount Bank, through a subsidiary of that bank, manages investment portfolios for its customers. On December 31, 2010 the total monetary value of managed portfolios was approximately NIS 2,306 million, compared with NIS 1,631 million in December 31, 2009, an increase of approximately 36.9%.

**Pension advisory services.** 2010 was the third year in which the Bank provided pension advisory services to its customers. As from the start of operations in March 2008 and until the end of the year, advisory services were provided to some 64 thousand customers. The accumulation of customer assets, to whom advice has been provided, amounted to NIS 7.1 billion, in the said period. In addition, Mercantile Discount Bank provided consulting services to some 3,400 customers, with accumulated financial assets in the amount of NIS 740 million.

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## DEVELOPMENTS IN THE OPERATIONS

**Distribution of mutual funds.** The Bank has entered into distribution agreements with most of the companies managing mutual funds in Israel, for the purpose of distributing their mutual funds to its customers, in consideration for distribution commissions in respect of mutual fund units held by these customers, in accordance with the regulations in this matter. In addition, the Bank is in the early stages of preparation for the signing of distribution agreements with foreign mutual fund managers, once they are permitted by law to offer units of mutual funds in Israel managed by them.

It should be noted that as part of the reform concerning bank charges, banks were prohibited, for the most part, from charging commissions in respect of the purchase and sale of mutual fund units.

**Pension consulting services.** In February 2008, the Bank received a license for the granting of pension advisory services and in March 2008, the Bank has started providing this service to customers.

The Bank provides pension consulting services regarding provident funds, pension funds and further education funds by means of financial consultants stationed at branches and investment centers.

As part of the pension consulting supporting layout, a designated module has been established within the Bank systems for the management of relations with pension consulting potential customers, starting with establishing the initial connection with the customer (whether initiated by the Bank or by the customer) and continuing with the customer coming to the branch for a meeting with the pension consultant. A reporting module has also been developed for the control, and monitoring of the performance at the level of consultant/branch/region and the Bank as a whole.

The Bank has engaged in distribution agreements with most of the operators in the pension market for the purpose of distributing further training funds, provident funds and pension funds managed by them. The Bank is obliged to engage with all suppliers of pension products (of the provident funds and pension funds that do not comprise insurance products, as well as further training funds) who are interested to do so, in distribution agreements for products managed by them in consideration for a distribution commission of a rate and payment terms identical to those of an identical service. The rate of the distribution commission is determined in regulations and is payable in respect of the pension assets (which are not insurance products) of customers who had received consulting services from the Bank in respect of products for which the Bank has distribution agreements with companies managing these products. The distribution commission generally amounts to 0.25% of the assets to which the advisory services apply.

In the wake of the present financial crisis, public awareness of the importance of pension planning has grown and accordingly the demand for pension advisory services at the Bank branches has grown significantly.

Concurrently, the crisis caused many customers to take a decision and transfer the provident fund management to another investment channel or to another management company, and in certain cases even to withdraw their funds.

As a result of the fact that no uniform protocol for communicating data and no central clearing house for the transfer of funds exist as yet, many complaints are received from customers regarding delays in performing transfer operations. These complaints are brought to the knowledge of the management companies and are monitored by the Bank.

**Approach by the Antitrust Authority.** In a letter dated July 10, 2008, the Restrictive Trade Practices Authority informed that it is studying the extent of entry by banks into the pension consulting market, and requested the Bank to provide data regarding the pension consulting services actually provided by the Bank. The Bank has delivered the requested data to the Authority.

**"Capital market move".** The Bank launched a major long-term strategic move several months ago intended to increase Discount

Bank Group's share of capital market income. Within the framework of this move, the Bank will upgrade in the coming years the core, trading and customer service systems in the securities field of operations and foreign currency trading alongside a parallel deployment, organizational and business, in respect of the relevant customer sectors in each of the Bank's divisions.

**Sale of the remaining interest in the provident fund activities.** For details regarding the sale of the remaining interest of Mercantile Discount Bank in the operations of provident funds, see Note 19 C 22 to the financial statements. Net gains of NIS 28 million were recognized in respect of this sale, derived from the amount that is not in dispute between the parties.

**Sale of the basket certificate operations.** For details regarding the sale of the basket certificates operation, see Note 19 C 23 to the financial statements. In respect of this sale, the bank is expected to record net gains of NIS 24 million in the first quarter of 2011.

**Sale of the mutual funds management operations of Mercantile Discount Bank.** The income of Mercantile Discount Bank in 2010 from the management and distribution of mutual funds amounted to NIS 6.6 million, compared to NIS 6.2 million in 2009. The net gain derived from this transaction amounted to NIS 5 million. (See Note 19 C 24 to the financial statements).

**Providing securities services to American customers.** Following changes in the enforcement policy of the U.S. Authorities regarding bank accounts managed outside the U.S., the Bank has re-examined the provisions of the U.S. law relevant to this issue. In view of the findings of the examination, the Bank intends to terminate the provision of securities services to U.S. related customers (both existing and new), and to prohibit the use of American means of communication for the purpose of providing securities services to customers staying in the U.S. In continuation of the adoption of the said policy, suitable guidelines have been determined within the framework of the procedures applying to the operations of the Bank and of the relevant subsidiaries in the Group.

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## MARKETING AND DISTRIBUTION

The distribution of products and services is undertaken by segment employees through the use of the Bank's existing distribution apparatus, the branch network, investment centers, private banking centers, staff units and the Bank's subsidiary companies. For further details, see "Consulting services" in the Section "The retail sector - General" in the Chapter "Activity of the Group according to principle segments of operation" above.

As stated above, following the new legislation for the implementation of the Bachar Committee recommendations, the Bank has become a financial and pension consultant independent of the providers of the products, and distributes a range of financial and pension products.

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## CAPITAL MARKET SERVICES

The Bank provides its customers with an array of investment consulting services, securities trading and operating in Israel and abroad. These are offered to private customers, institutional customers and capital market operators. The Bank offers varied services, which include: equity securities activity in Israel and abroad, bonds (including convertible bonds), short-term Government loans (MAKAM), options, foreign currency, structured deposits, basket certificates, derivatives in Israel and abroad, securities offerings and lending of securities, as well as providing professional and objective investment consulting regarding securities and financial assets.

Some of the Bank's customers maintain securities portfolios managed by various portfolio managers operating through the Bank, including through the subsidiary Tachlit Investment House.

Since March 2008, the Bank also provides pension advisory services. For this purpose, the Bank has entered into distribution agreements with most of the entities operating in the pension market, distributing further training funds, provident funds and pension funds managed by them (for further details see above).

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## COMPETITION

In the capital market activity, the Bank competes both with other banks and with private brokers.

In the field of financial products competition exists against the consulting entities as well as against the marketing entities (the providers of the products) as regards the sale to customers of one or another financial product.

Income received from pension consulting requires the existence of a valid pension consulting agreement between the consultant or the marketing entity and the customer. Accordingly, fierce competition over customers is expected, trying to create with them a long term relationship, since in the event that the customer will sign a pension consulting agreement with another entity, the producer of the pension instruments will pay the commission since that date to that other entity. In cases where the customer has not signed an agreement with the marketer or consultant, the producer of the pension instruments is not required to pay any commission at all. Accordingly, competition is expected against all the consulting entities on the one hand and the marketing entities as well as against the providers of the products (insurance companies, insurance brokers, pension funds, etc.) on the other hand.

In the course of 2008 and 2009, all the banks, including the two largest banks, began operating in this field.

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## GOALS AND BUSINESS STRATEGY

- Intensifying the activity in the field of pension consulting that began in March 2008 and the continued development of systems supporting this activity;
- Completing the preparations for operating as a "supermarket" for financial and pension products;
- Improvement in securities trading by means of the Internet, development of the activity of arbitrage player and capital market players;
- Continued cultivation and distinction of the status of the investment consultant.

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## CONSTRUCTION AND REAL ESTATE ACTIVITY

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### MARKET DEVELOPMENTS

**General.** The growing activity in the construction and real estate sector continued in 2010 compared to 2009, this on the background of the growth in the residential construction field. The volume of investment in residential construction grew at a rate of 11.7%, compared with 2009, and in continuation to a growth of 5.5% in 2009. The volume of investments in non-residential construction and other construction work continued to increase at a rate of 2.6%, following a decrease of 5% in 2009.

The following developments occurred in the various operating segments in 2010:

**Residential construction.** An increase of 4.3% in the number of new residential units in demand<sup>(1)</sup> compared to 2009. Eliminating private construction and acquisition groups, the increase in the number of new residential units reached a rate of 7.6%. The distribution of demand according to regions shows an increase in demand for residential units at the edges of the central region<sup>(2)</sup> and mainly in the various peripheral areas (especially in Ashkelon and Be'er Sheva), in which it is still possible to find non-luxurious residential units at reasonable prices in line with the purchasing power of potential purchasers. In contrast, in preferred areas, like Tel Aviv and Jerusalem, the high prices resulted in a decline in demand compared to 2009.

- The southern, Haifa and central regions recorded an increase in new residential units in demand at rates of 47.6%, 20.6%, and 5.7%, respectively;

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(1) The term "new residential units in high demand" replaces according to definitions of the Central Bureau of Statistics the previous term "apartments sold", and includes both apartments sold and apartments not for sale the construction of which has begun (construction for self use, acquisition groups and construction for rent).

(2) Central Israel - areas located in a triangle the vertices of which are Ashdod, Nataniya and Jerusalem.  
Periphery - the remaining areas in the country, among which are the southern, Haifa and northern regions.

- The Jerusalem and Tel Aviv regions recorded a decline of 11.3% and 2.2% respectively;
- Inventory of privately built new residential units as of the end of 2010 was similar to that of 2009. Following an increase in the inventory of residential units in the first half of 2010, the second half of the year reverted to the continued downward trend in inventory. Some 63% of the inventory of available residential units concentrated in the Tel Aviv and central regions;
- A significant increase in the demand for mortgage loans was recorded in 2010 due to the acceleration in residential units prices and apprehension regarding the worsening credit terms for borrowers;
- The increased demand for new residential units in preferred areas of the central and peripheral regions alongside limited supply was accompanied by an increase in residential units and land prices in continuation to the significant price increases in 2009. The continued rise in prices caused the Bank of Israel to dictate stricter credit terms for mortgages with the aim of increasing their cost and calm down the demand for residential units. And indeed, in the last quarter of the year there are indications for stability in prices.

**Luxury apartments.** A downward trend was noticed in demand on the part of foreign residents, principally in the Jerusalem, Tel Aviv, Nataniya and Ashdod areas, accompanied by a decline in prices.

**Income generating real-estate - office buildings.** A slight decline was noticed in occupancy rates and rental fees in Tel Aviv. At the same time a slight increase in rental fees was recorded in the satellite towns in the Dan Region as a result of the growth in population, the growth in the residential real estate market and the relatively low rental fees. The relative stability in this market was maintained mainly due to the low supply of new construction.

**Income generating real-estate - commercial buildings.** Stability was noticed in demand on the part of institutional bodies and private investors, for quality commercial property in preferred areas in central and peripheral regions, mostly for shopping malls and open shopping centers, coupled with stability in occupancy rates and rental fees. As a result of merger and acquisition transactions, there was an upward trend in the concentration of ownership of most income generating and commercial properties by a number of leading companies.

**Real-estate activity abroad.** The decline in investments by Israeli companies in entrepreneurial and income generating real estate abroad continued due to the following developments:

- Selectivity by foreign banks in certain financial markets abroad in the granting of finance for development projects and potential purchasers of real estate assets;
- A significant decline in the finance granted by Israeli banks to leveraged investment companies operating abroad in the real estate market, used as equity for investment in real estate or for the refinancing of existing income generating properties;
- The need to provide equity at higher rates than in the past for financing quality income generating properties (25%-40% compared to 10% and even less prior to the crisis);
- A decline in the value of income generating real estate in certain areas in the United States and in certain European countries coupled by difficulties in realizing properties.

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## DEVELOPMENTS IN THE SEGMENT'S FINANCING RESOURCES

In 2010, companies operating in this sector raised funds through the issue of corporate bonds in an amount of NIS 8.9 billion, compared to fundraising of NIS 6.2 billion in 2009. Most of the fundraising was done by large real estate corporations, rated "A" and above, the acceleration in the pace of fundraising stemming from the following factors:

- Low interest rate environment;
- Significant demand on the part of institutional bodies, mainly mutual funds, for investing in variable shekel interest rate bonds;
- The desire to issue new series of bonds prior to the coming into effect at the beginning of October 2010, of regulation changes following the recommendations of the Hodek Committee;

- Improvement in the business performance of real estate companies operating in the local market and signs of stabilization of the business environment of corporations operating in certain foreign markets.

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## EXPECTED DEVELOPMENTS IN THE SECTOR IN 2011

It is expected that in 2011 the increase in volume of activity of the real estate sector will continue as a result of the growth in investments in residential construction and in national infrastructure projects.

Following are the expected developments in the various operating segments:

**Residential construction - Central region.** Stability in activity and in demand which will be accompanied by stability down to slight decline in prices, due to high levels of prices and a limited supply of available-for-sale lands at reasonable prices.

**Residential construction in the periphery.** Increase in activity and in demand that will be accompanied by a rise in prices, mainly due to relatively low price levels existing at the present time.

The route of activity reviewed in the direction of movement of the demand for residential units from the center to the periphery, will be influenced mainly by the prices of land and residential units and less by the rise in mortgage interest rate and their deteriorating terms.

In the last few days, the Prime Minister has proclaimed a new plan for the acceleration of residential construction with a view of curbing the increase in prices of apartments. At this stage it is difficult to ascertain the manner in which the plan will be implemented and whether it will have an effect on prices already in the coming year.

**Residential construction – luxury apartments.** A decline in demand for luxury apartments on the part of foreign residents and local investors, coupled by a decline in prices, mostly in Tel Aviv and Jerusalem, in continuation of the decline that began in 2010.

**Income generating property - office space.** Increased demand for office space in preferred areas in the center of the country, coupled by a moderated rise in prices due to the improvement in economic condition and in the condition of business lessees and a low supply of office space in preferred areas.

**Income generating property - commercial space.** Stabilization in demand for quality commercial properties coupled by stability in prices, due to demand on the part by institutional bodies and private entrepreneurs for commercial property generating long-term stable rates of return.

**Infrastructure.** Central Israel - areas located in a triangle the vertices of which are Ashdod, Nataniya and Jerusalem.

Periphery - the remaining areas in the country, among which are the southern, Haifa and northern regions.

**Financing of foreign operations.** Standstill in the volume of investments by Israeli companies in entrepreneurial real estate for residential and income generating properties in certain markets in the U.S. and Eastern Europe. At the same time, the beginning of investments in other markets in Western Europe, the U.S. and Canada, in which it is expected that economic recovery will continue and in which it is possible to realize business opportunities for the acquisition of properties at low prices. The low availability of financing resources for potential purchasers of real estate in some of the foreign markets, difficulties in the refinancing of part of the properties the value of which had been eroded during the crisis compared to the amount of credit granted to finance them.

**Developments in finance resources.** The volume of fundraising through bond issues by corporations of this sector is expected to tone down in 2011, in view of the accelerated fundraising in 2010 and the coming into effect of the Hodek Committee recommendations. Nevertheless, the low returns on corporate and government bonds, a low interest environment, demand on the part of mutual funds and institutional bodies for new investment products and principally, the need for available resources for the recycling of bonds in large amounts that are due for redemption, will support the continued fundraising by corporations in this sector.

At this stage, it is too early to assess the effect of changes in regulations on the ability of companies in this sector to raise funds following the recommendations of the Hodek Committee. However, according to the trend noticed in the bond market, starting with October 1, 2010 (date on which the directives came into effect) it seems that the volume of fundraising has not declined,

but issuing companies now have to undergo a more lengthy and complex process, which among other things includes obtaining approval from the financing banks.

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## DIRECTIONS OF BUSINESS DEVELOPMENT IN THE SEGMENT'S MARKETS

In view of the relatively high financial stability shown by the industry during the crisis period and the expectations for the continued growth in 2010, the Bank has defined the following fields of activity as the preferred fields for the granting of credit facilities subject to meeting the regulatory restrictions.

- Construction of residential projects not in the field of luxury apartments in the center of the country and in preferred areas in the periphery by contractors/entrepreneurs that are financially sound, with whom the Bank has prior positive experience regarding projects already completed;
- Land available for construction in demand areas in central Israel and in peripheral areas, in respect of which the Bank intends to finance residential and/or commercial construction projects in the format of closed project financing;
- The granting of medium-term finance for current and/or investment operations to large and well established real-estate companies showing financial stability;
- Construction of income generating properties, mostly shopping malls and open commercial centers in preferred areas by entrepreneurs who have considerable financial means securing in advance a part of the potential rental income;
- The financing of national infrastructure projects, in cooperation with other banks and/or institutional bodies, giving preference to projects in essential fields, such as: electricity, water and transportation. The projects are to include an identified and settled source for the recovery of the investment, including income secured by the Government.

The above information comprises a forward looking statement. The above reflects the evaluation of the Bank's management while keeping in mind the information available to it at date of preparation of the financial statements, as discussed above in this Section and based on publications of various entities, such as the Central Bureau of Statistics, the Ministry of Housing, the Bank of Israel and others. The information may not materialize if the decline in the level of domestic demand will continue and/or intensify as a result of a deterioration in the political/security situation, a significant decline reaching a complete freeze in the availability of financing resources on the financial markets in Israel and abroad, intensified recession conditions in the global markets, continued fluctuations in interest and exchange rates globally and in the Israeli economy and other developments in macro economic conditions that are not under the Bank's control.

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## CREDIT POLICY IN THE CONSTRUCTION REAL ESTATE ACTIVITY

The Bank's credit policy is based on the following principles:

- The greater part of the credit facilities made available to the real estate sector will be processed through the real estate and infrastructure department;
- The financing of residential construction projects and income generating real-estate projects is to be executed by the "construction loan" method, which allows close supervision of the project being financed;
- The allocation of credit facilities to project financing will be conditional upon minimum equity capital invested by the promoters at the stage of purchasing land and at the financing stage, and upon minimum profitability rates of the projects that should not fall below the standards determined by the Bank in this respect;
- Release of surplus funds in a project shall be made subject to concurrent compliance with sales rates and minimum construction completion rates as well as a reasonable coverage spread for the conclusion of the project;
- The allocation of credit facilities secured by pledges on income generating projects and on rental income is conditional upon the existence of solid lessees and ability to service the loan.

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## DEVELOPMENTS IN REAL ESTATE AND CONSTRUCTION ACTIVITIES

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### SCALE OF OPERATIONS AND NET INCOME

**General.** In view of the increased activity in the field of residential construction in 2010, the Bank has expanded its business activity with construction companies. As reported with respect to most of the projects being built, the rate of sales exceeded the rate of construction progress, a fact that increased exposure to guarantees granted under the Sales Act against the utilization of the banking loan facility.

**Net income** from the operations in 2010 amounted to NIS 232 million compared to income of NIS 181 million in 2009, an increase of 28.17%.

**The return on equity**, calculated on the capital allocated to the operations on the basis of the average balance of operations risk assets, was 12.1% in 2010 compared to a rate of 10.8% in 2009.

**Provision for doubtful debts** amounted in 2010 to NIS 161 million, compared with NIS 190 in 2009, a decrease of 15.26%.

Following are the principal data relating to the construction and real estate operations:

	Domestic operations			International operations			Total	Total
	Small Businesses	Corporate Banking	Middle Market Banking	Total	Middle Market Banking	Corporate Banking		
For the year ended December 31, 2010								
In NIS millions								
Income from financing activities								
before provision for doubtful debts								
- From external sources	110	252	67	429	120	9	129	558
- Intersegmental	(30)	69	18	57	(30)	-	(30)	27
<b>Total income from financial activity</b>	<b>80</b>	<b>321</b>	<b>85</b>	<b>486</b>	<b>90</b>	<b>9</b>	<b>99</b>	<b>585</b>
Operating and other income	20	27	12	59	9	1	10	69
<b>Total Income</b>	<b>100</b>	<b>348</b>	<b>97</b>	<b>545</b>	<b>99</b>	<b>10</b>	<b>109</b>	<b>654</b>
Provision for doubtful debts	43	38	(5)	76	32	53	85	161
Operating and other expenses	19	69	27	115	30	7	37	152
Operating Income (loss) before taxes	38	241	75	354	37	(50)	(13)	341
Provision for taxes on operating income	13	84	27	124	2	(16)	(14)	110
<b>Net (loss) income</b>	<b>25</b>	<b>157</b>	<b>48</b>	<b>230</b>	<b>36</b>	<b>(34)</b>	<b>2</b>	<b>232</b>
Return on equity (percentage)	19.7	12.1	21.2	14.9	17.8	(55.4)	0.8	12.1
Average Assets	1,828	14,080	2,521	18,429	2,395	875	3,270	21,699
Average Liabilities	769	1,785	699	3,253	354	-	354	3,607
Average Risk-assets	1,819	18,582	3,305	23,706	2,751	875	3,626	27,332
Components of income from financial activities:								
Margin from credit activity	67	269	68	404	83	9	92	496
Margin from deposits activity	6	9	3	18	7	-	7	25
Other	7	43	14	64	-	-	-	64
<b>Total Income from financing activities before provision for doubtful debts</b>	<b>80</b>	<b>321</b>	<b>85</b>	<b>486</b>	<b>90</b>	<b>9</b>	<b>99</b>	<b>585</b>

Following are the principal data relating to the construction and real estate operations (continued):

	Domestic operations			International operations			Total	Total
	Small Businesses	Corporate Banking	Middle Market Banking	Total	Middle Market Banking	Corporate Banking		
For the year ended December 31, 2009								
In NIS millions								
Income from financing activities before provision for doubtful debts								
- From external sources	84	705	155	944	88	20	108	1,052
- Intersegmental	(14)	(383)	(73)	(470)	2	-	2	(468)
Total income from financial activity	70	322	82	474	90	20	110	584
Operating and other income	17	23	13	53	29	3	32	85
<b>Total Income</b>	87	345	95	527	119	23	142	669
Provision for doubtful debts	19	98	17	134	56	-	56	190
Operating and other expenses	18	79	25	122	61	10	71	193
Operating income (loss) before taxes	50	168	53	271	2	13	15	286
Provision for taxes on operating income	18	59	20	*97	7	1	8	105
<b>Net (loss) income</b>	32	109	33	174	(5)	12	7	181
Return on equity (percentage)	51.9	9.4	16.4	12.1	(2.4)	21.5	3.0	10.8
Average Assets	1,693	13,136	2,645	17,474	*2,685	880	3,565	21,039
Average Liabilities	686	1,894	618	3,198	595	-	595	3,793
Average Risk-assets	952	18,024	3,082	22,058	2,757	880	3,637	25,695
Components of income from financial activities:								
Margin from credit activity	58	278	68	404	82	19	101	505
Margin from deposits activity	4	6	3	13	8	-	8	21
Other	8	38	11	57	-	1	1	58
<b>Income (loss) from financing activities before provision for doubtful debts</b>	70	322	82	474	90	20	110	584

\* Reclassified.

## LEGISLATIVE AND REGULATORY LIMITATIONS AND SPECIAL CONSTRAINTS APPLYING TO THE ACTIVITY

The limitations described above applying to the business segment also apply to construction and real-estate operations. In addition, it should be noted that as part of Proper Banking Management Directives, a limitation applies to industry credit concentration, where that part of the credit being the responsibility of the banking corporation (including off-balance sheet credit) granted to a certain industry, as defined in the Directive, exceeds 20% of total credit granted to the public being the responsibility of the banking corporation. The rate of Bank's exposure as regards credit to the construction and real-estate industry as of December 31, 2010 amounted to 18.44% (19.66% at the end of 2009).

**Letter regarding "acquisition groups".** On March 25, 2010, the Supervisor of Banks issued a letter, against the background of the

significant increase in the volume of operations of property acquisition groups, turning it into a very material component in the field of residential construction beginnings. In his letter, the Supervisor of Banks points out the risks involved in the operations of acquisition groups compared to the risk involved in providing credit to "standard" residential construction operations, and which creates concern for a material deterioration in the quality of credit provided by banking corporations.

According to the letter, during the period of construction and until its completion, credit (both balance sheet and off-balance sheet) granted to an acquisition group, intended for the construction of ten or more residential units, shall be classified as indebtedness of a real estate corporation (even if the acquisition group is not so officially incorporated). Respectively, the said credit shall be averaged at the rate of 100% in computing the ratio of capital to risk assets (instead of a ratio of 35%, or 75%, according to the Basel II rules, had such credit been considered as a loan for housing purposes).

According to the said letter, the content thereof shall be implemented as early as possible, and no later than the financial statements as of June 30, 2010.

The effect of the said letter on the Group's total capital to risk assets ratio, in Basel II terms, as of December 31, 2010, was negligible (comparative data was reclassified accordingly). Following the said guideline, the Supervisor of Banks published on August 15, 2010, a clarification, according to which, despite the required change in the classification of such loans, the instructions for computing provisions for doubtful debts by the "period in arrears" method will apply to them (if and when conditions for such computation arises).

**Bank guarantees in accordance with the Sales Act (residential units) (Assurance of investments of residential units purchasers), 1974 (hereinafter: "Sales Act")**. On November 21, 2010, the Sales Regulations (residential units)(Assurance of investments of residential units purchasers)(bank guarantee), 2010, which determines a uniform format for a bank guarantee according to the Sales Act (residential units)(Assurance of investments of residential units purchasers), 1974. The Regulations entered into effect in February 2011, following which, Proper Banking Management Directive No. 456, regarding the format of the guarantee under the Sales Act (residential units) was withdrawn.

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## SERVICE TO CUSTOMERS OF THE SEGMENT

Most of the business activity in the real estate and construction segment is carried out by the Bank's real estate and infrastructure department. The department provides a wide range of banking services both to the large and medium level corporations engaged in the promotion and investment in residential and income generating real estate in the local market. In addition the financing operations of the segment are also conducted by business managers at the large corporations department, mostly with respect to holding companies, the principal activity of which centers on the holding of companies in the real estate field.

Within the framework of the real estate and infrastructure department operates a unit specializing in complex transactions for the finance of investments in national infrastructure projects (energy, electricity, water and desalination plants and toll roads, mostly by the PPP method). The unit engages in allocating appropriate finance packages with the participation of institutional investors (who have advantage in raising long-term financing resources) or in cooperation with other banks in financing the transaction.

At the Group's level, the activity is conducted by means of the following subsidiaries:

**Mercantile Discount Bank** provides the service to customers of this segment by means of the real estate department dealing with all real estate companies conducting business with this bank and engaged in entrepreneurship that includes financing through the "closed project finance" method, for construction projects principally residential buildings (handled by the construction project finance department), contract construction, income generating real estate and real estate holdings (handled by the real estate department).

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## CRITICAL SUCCESS FACTORS OF THE OPERATIONS

The critical success factors of the segment include:

- Current communication with customers, qualitative service, continued customer satisfaction as regards the quality of service

- and the financing of projects that had been completed;
- Providing prompt response to applications for credit and other related services;
  - Use of specific analyzing and monitoring tools assisting in the decision making process and in the control during the period of project financing;
  - Adequate understanding and mapping of the market is required in order to identify risks/opportunities in various sectors, e.g. standard residential construction, luxury residential construction, rental office and commercial property;
  - Identification and finance of projects in preferred areas in the center of the country and in the periphery.

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## THE MAIN ENTRY AND EXIT BARRIERS OF THE OPERATIONS

Customers of the sector conduct business with several banks at any given time, so that the relative advantage of the operations is based upon the Bank's long-term relationship with them, including continued satisfaction as regards the quality of service and the financing of projects. In order to provide quality customer service, highly proficient personnel are required, with comprehensive familiarity with customers of this segment, nature of their activity and analysis of their needs and requirements, while adapting the Bank's products to such needs. In addition, systems are required to monitor and control exposure and risks relating to project financing.

The said close-end system of project financing is, prima facie, supposed to allow the construction company to finance each project at another bank.

Nevertheless, considering the fact that surplus created in respect of projects financed by the Bank or current credit facilities allotted to companies and/or promoters is used in many cases as capital for leveraging other projects, a certain difficulty exists as regards the transfer from bank to bank, mainly among small and medium customers who are particularly affected by the limited availability of financial resources for the contribution of capital.

Suitable preparation is required for the purpose of compliance with regulatory as well as internal limitations prescribed by the Board of Directors with respect to the Bank's maximum rate of exposure in financing the sector.

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## ALTERNATIVES TO PRODUCTS AND SERVICES OF THE OPERATIONS AND CHANGES THEREIN

Off-banking financing constitutes an alternative financing source for segment customers as to long and medium-term credit used for the financing of investments and/or the purchase of income producing property, while in building projects, customers generally prefer the use of medium-short term bridging finance for the set up period.

As from the second half of 2009, against the background of the improvement in business performance of corporations operating in the local market and the thriving capital market, the availability of part of the large and financially stable customers to off-banking financing resources has increased. The directives that had been determined following the recommendations of the Hodek Committee, which requires the obtaining of guarantees turned companies in this segment into preferred targets for institutional bodies due to pledges on real estate assets which they are able to provide as security for loans. Nevertheless, medium and small size customers are still highly dependent upon the banking industry in obtaining finance for their operations.

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## STRUCTURE OF THE COMPETITION PREVAILING IN THE OPERATIONS AND CHANGES THEREIN

Most of the competition in this activity takes place within the banking industry. In times when equity and bonds can be raised on the capital market, the off-banking finance serves as an alternative resource for long-term financing required, generally, for construction and/or acquisition of income generating assets in Israel or abroad or as capital financing the construction of real estate projects abroad.

In financing infrastructure projects and income generating properties in Israel competition exists with local banks and institutional bodies (such as insurance companies and pension funds).

Some of the institutional bodies provide guarantees under the Sales Act to purchasers of apartments.

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## COPING WITH COMPETITION

Providing professional service, timely response and establishment of a comprehensive and ongoing communication system with customers, while maintaining an overall view of their financial needs, constitute the principal means to confront competition successfully.

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## PRODUCTS AND SERVICES

The services offered include:

- Credit for residential construction projects and/or income generating properties projects (primarily office and commercial space considerable parts thereof are marketed in advance);
- Credit for the construction and acquisition of income generating properties intended for commerce or office premises;
- Credit for current finance and/or investments in Israel, and in exceptional cases also for investments abroad;
- Providing guarantees under the Sales Act to purchasers of residential units and to the rights of owners in land in the context of combination transactions;
- The granting of credit for national infrastructure projects at the construction and operating stages.

For further information relating to services provided to segment customers, see above, 'Corporate segment.'

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## MORTGAGE AND HOUSING LOAN ACTIVITY

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### DEVELOPMENTS IN THE MORTGAGE MARKET

The mortgage market is typified by intense competition between the banks operating in this market.

The volume of housing loans granted out of bank's own funds by the mortgage banks in 2010, not including internal recycling of loans, amounted to NIS 47,050 million, compared to NIS 34,622 million in 2009, an increase of 35.9%. Loans from State funds continued its downward trend of over several years and declined by 36.5% to NIS 468 million. Total credit granted by the mortgage banks in 2010, excluding credit from State funds and internal recycling of loans, totaled NIS 54,950 million, compared with 39,758 million in 2009, a growth of 38.2%.

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### SECTORS OF OPERATION

**Loans for the purchase or building of housing units.** Loans for the purchase or building of housing units (by private individuals). The loans are generally granted to private individuals (households). These loans constitute most of the activity in the mortgage loan field.

**Multi purpose loans secured by a mortgage on a housing unit.** These loans are granted not in the course of purchasing or building of a housing unit but by using it as collateral. Discount Mortgage Bank offers house owners whose property is free of a mortgage or with a relatively low mortgage loan compared to the value of the property, to use the property as collateral for raising funds for use of the household.

**Supporting activity - Mortgage related insurance.** As an additional security for credit granted by Discount Mortgage Bank, this bank requires its customers to purchase property insurance and in some of the cases life assurance.

In the course of 2005, the Supervisor of Banks in conjunction with the Supervisor of Insurance Business determined new arrangements as regards the marketing of insurance policies by mortgage banks while granting housing loans, which were

subsequently also fixed in legislation.

For many years, Discount Mortgage Bank offered its customers to purchase insurance by means of that bank, serving as an insurance brokers for this purpose. The customer could choose using the services of that bank or of any other insurance agent. As from January 1, 2006, Discount Mortgage Bank no longer offers the sale of these insurance schemes as a broker.

Discount Mortgage Bank formed a subsidiary, **Discount Mortgage Home Insurance Agency (2005) Ltd.**, which acts as an insurance broker. This subsidiary operates independently and sells insurance through a telephone service separate from that bank's telephone service.

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## BUSINESS STRATEGY

Discount Mortgage Bank regards the housing loan field as its principal activity and as the leverage for its future expansion thereby directing most of its marketing efforts and sales towards this activity. Discount Mortgage Bank has set its goal to grant housing loans to customers of Discount Bank and to maintain its customers upon the recycling of housing loans.

Discount Mortgage Bank is of the opinion that the financial margin of the credit products offered by the mortgage banks has reached its lowest point alongside the adverse effect on the operating income of the mortgage banks caused by the intense competition in this market. Discount Mortgage Bank is facing the said competition by improving its service and making it more efficient, by the continuing activity within the framework of "Discount Layout" and by the tightening of the synergy with Discount Bank, the finance of Acquisition groups and by gradually increasing its operations in granting finance for any purpose secured by a mortgage on a residential unit.

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## SCALE OF OPERATIONS AND NET INCOME

**The volume of housing loans granted.** In 2010, the volume of housing loans granted amounted to NIS 4,906 million, compared to NIS 4,183 million in 2009, an increase of 17.3%. The above amount includes some NIS 370 million of loans recycled in 2010, compared to NIS 232 million in 2009, an increase of 59.3%.

**Net income** from the operations in 2010 amounted to NIS 39 million, compared with NIS 30 million in 2009, an increase of 30%.

**The return on equity**, calculated on the capital allocated to the operations on the basis of the average balance of operations risk assets, was 5.7% in 2010, compared with 3.4% in 2009.

**Provision for doubtful debts** in 2010 to NIS 3 million, compared with NIS 3 in 2009.

Following are the principal data relating to the mortgage and housing loan operations:

	Domestic operations			Total
	Households	Small Businesses	Middle Market Banking	
For the year ended December 31, 2010				
In NIS millions				
Income from financing activities before provision for doubtful debts				
- From external sources	160	37	-	197
- Intersegmental	(43)	(13)	-	(56)
Total income from financial activity	117	24	-	141
Operating and other income	48	4	-	52
<b>Total Income</b>	165	28	-	193
Provision for doubtful debts	4	(1)	-	3
Operating and other expenses	118	10	-	128
Operating income before taxes	43	19	-	62
Provision for taxes on operating income	16	7	-	23
<b>Net income</b>	27	12	-	39
Return on equity (percentage)	4.7	10.8	1.4	5.7
Average Assets	16,327	1,276	179	17,782
Average Liabilities	1,531	69	-	1,600
Average Risk-assets	8,016	1,517	233	9,766
Average other assets under management	1,538	-	-	1,538
Components of income from financial activities:				
Margin from credit activity	114	22	-	136
Other	3	2	-	5
<b>Total Income from financing activities before provision for doubtful debts</b>	117	24	-	141

Following are the principal data relating to the mortgage and housing loan operations (continued):

	Domestic operations			
	Households	Small Businesses	Middle Market	Total
			Banking	
For the year ended December 31, 2009				
In NIS millions				
Income from financing activities before provision for doubtful debts				
- From external sources	173	45	3	221
- Intersegmental	(64)	(24)	(2)	(90)
Total income from financial activity	109	21	1	131
Operating and other income	49	2	1	52
<b>Total Income</b>	158	23	2	183
Provision for doubtful debts	-	3	-	3
Operating and other expenses	123	8	-	131
Operating income before taxes	35	12	2	49
Provision for taxes on operating income	14	4	1	19
<b>Net income</b>	21	8	1	30
Return on equity (percentage)	2.7	10.1	13.6	3.4
Average Assets	14,879	1,262	123	16,264
Average Liabilities	1,760	87	-	1,847
Average Risk-assets	12,350	1,256	123	13,729
Average other assets under management	1,772	-	-	1,772
Components of income from financing activities:				
Margin from credit activity	106	18	1	125
Margin from deposits activity	-	-	-	-
Other	3	3	-	6
<b>Income (loss) from financing activities before provision for doubtful debts</b>	109	21	1	131

## LEGISLATIVE RESTRICTIONS

**Proposed Bills.** Two Bills were tabled before the Knesset in March 2010, regarding housing loans:

- Housing Loan Bill (Amendment - the duty to refer to the special committee and to an exceptions committee before submission of an application to act upon a mortgage), 2010 - According to this Bill, a debt execution file for foreclosure of mortgaged property may not be opened prior to approaching the borrower and explaining his right to apply to an exceptions committee. Submission of an application to the committee will delay debt execution proceedings by six months or until the committee hands down its decision, the later of the two. Opening a debt execution file by a bank without referring the borrower to the exceptions committee, will subject the bank to indemnification of the borrower, without proof of damage, at an amount equal to 10% of the outstanding balance of the loan. The borrower has the right to waive entitlement to indemnification at the rate of 10% of the outstanding balance of the loan, and file for indemnification in respect of the full damage caused to him.
- Loans with no Right of Recourse Bill, 2010 - According to this Bill, in case of a default in the repayment of a loan, a bank

may act towards the realization of the pledged asset only, with no right to sue the borrower for the outstanding balance of the loan.

In the opinions of the Bank and of Discount Mortgage Bank, the said Bills, if passed in their proposed format, will have a material effect upon the mortgage loan activity of the Group.

**Capital adequacy limitation.** Whereas the activity within the framework of Discount Layout (see below) is conducted by Discount Mortgage Bank, it may be hampered by the capital adequacy limitation of this bank. The ratio of capital to risk assets of Discount Mortgage Bank at December 31, 2010, reached a rate of 18.3%.

In the years 2008-2009, the Bank invested an amount of NIS 160 million in the capital of Discount Mortgage Bank and an amount of NIS 350 million in debt notes of this bank.

This investment was intended to support the capital adequacy of Discount Mortgage Bank and to enable it to continue in developing its business.

**Restriction on the credit concentration.** Proper banking Management Directives require an additional provision in respect of credit concentration as regards housing loans, in the event that the balance of housing loans in respect of which a provision based on the period in arrears has been recorded, net of such a provision, exceeds 1.5% of the total balance of housing loans. As of December 31, 2010, the said rate at Discount Mortgage Bank amounted to 1.09%, therefore no provision was required.

**Reform of the Execution Law in the matter of alternative housing.** This amendment to the Law is expected to have a material effect on the housing loan market and on the banks operating in this market. The Bank believes that this Law will have a material effect on income from mortgage loan activity.

**Ruling by the Uniform Contracts Court.** See Section "Legislation and supervision" hereunder for details regarding the ruling given in the matter of prejudicial terms in a loan contract of the First International Bank. Discount Mortgage Bank believes that this ruling may have a material effect upon it.

**Letter of the Supervisor of Banks in the matter of developments in the risk pertaining to housing loans.** On July 11, 2010, the Supervisor of Banks published a directive regarding developments in the risks relating to housing loans. The directive stated that in view of recent developments in the housing market, banks are required to re-examine their loan portfolios and their credit policies in the matter of mortgages and to verify that their policy agrees with the risk appetite that had been defined by their business strategy. It was also determined that every banking corporation shall create a supplemental provision in respect of housing loans, at the rate of at least 0.75%, in respect of each housing loan granted as from July 1, 2010 and thereafter, the primary financing ratio thereof was higher than 60%.

Discount Mortgage Bank has performed an examination showing that the minimal supplementary provision as stated is adequate, considering the credit risk existing at present with respect to new credit granted by Discount Mortgage Bank at the financing level determined by the Supervisor of Banks.

In 2010, both Discount Mortgage Bank and Mercantile Discount Bank were required to increase the supplementary provision in the amount of NIS 5.1 million, upon the implementation of the Directive.

Further to the said guidelines, with a view of improving credit risk management in this field, the Supervisor of Banks published on July 13, 2010, a Directive widening the reporting in the matter of housing loans, with effect as from June 30, 2011.

**Letter of the Supervisor of Banks in the matter of leveraged housing loans.** On October 28, 2010, the Supervisor of Banks issued a directive regarding a change in the risk weight, within its meaning in Proper Banking Management Directive 203, on that part of a loan bearing a variable interest rate. The crux of the Directive is that in view of recent developments in the housing market, each new housing loan approved since October 26, 2010, the amount of which is in excess of NIS 800,000, and which its funding rate is over 60% of the cost of the property and the part of the loan bearing a variable rate of interest is in excess of 25%, shall oblige the lending banks to increase the risk weight applying to such loans to 100%.

**Directive in the matter of the treatment of problematic housing debts – Proper Banking Management Directive No. 314.** For details regarding the Directive, see Note 1 AA (4) to the financial statements.

## COMPETITION

Most of the banks compete in the mortgage market: mortgage banks, mortgage banks that have been merged and turned into a division of a commercial bank, as well as commercial banks. In addition, some of the insurance companies also offer mortgage loans. Competition in this market is fierce and is clearly price directed. Competition is affected, among other things, by perceiving the mortgage banking industry as an anchor product in preserving existing customers and recruiting new customers.

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## MARKETING OF MORTGAGE PRODUCTS

Discount Mortgage Bank serves its customers in 75 points of sale, four independent branches (Tel Aviv Main Branch, Pal Yam Branch in Haifa, The Diamond Exchange Branch in Ramat Gan and the Modi'in Branch), and 71 branches located within the branches of Israel Discount Bank Ltd. or near them. Discount Mortgage Bank also operates a call center divided into two specialized units: a sales center dealing with approaches by customers interested in new loans, including close attendance to the customer during the process of granting the loan, and a customer relations center attending to existing customers.

Discount Mortgage Bank engages in the marketing and advertising of its many varied products, customizing them to the changing requirements of the public, to changing economic conditions and to market trends. Concurrently, Discount Mortgage Bank continues to expand its activity with varied populations, such as: purchase groups, foreign residents, students, VIP's and others.

Housing loans in Mercantile Discount Bank are granted through specialized branches of this bank.

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## A MORTGAGE MARKETING CAMPAIGN - "DISCOUNT LAYOUT"

The Bank in conjunction with Discount Mortgage Bank launched in July 2007 an attractive interest rate mortgage layout intended to enlarge the credit portfolio of Discount Mortgage Bank and its share in the mortgage market.

The Bank determines who is entitled to the Discount layout and issues them a confirmation entitling them to the interest terms of the layout.

The Bank provides Discount Mortgage Bank with financial resources in accordance with the terms of the marketed mortgages (back to back) less a predetermined margin (hereinafter: "the Deposit"). It has been agreed that in cases of early redemption or recycling of the loan, the Deposit made by the Bank would be concurrently redeemed or recycled.

At the beginning of 2010, in view of the excess financial resources accumulated by Discount Mortgage Bank, it has been decided that Discount Mortgage Bank will be able to grant credit within the framework of the outline, also from its own resources.

Discount Mortgage Bank grants such entitled customers mortgages under attractive interest terms, subject to criteria determined by the Bank (as of 2010 - a monthly salary of NIS 4,000 and over or personal capital of a minimum amount of NIS 0.5 million). The customer has to comply with these conditions for a period of at least five years. If the customer does not abide by the entitlement terms, the interest rate will be increased according to the bank's guidelines (and concurrently the deposit interest would be increased at the same rate).

The entitlement confirmation issued by the Bank allows the customer to refer to Discount Mortgage Bank for obtaining the attractive interest rate, but it does not oblige that bank to grant mortgage loans under the layout channel since it is Discount Mortgage Bank which bears the credit risk.

According to an agreement which has existed between the parties for several years, Discount Mortgage Bank pays the Bank a one-off commission in respect of referral of the Bank's existing customers.

The accounting treatment adopted by the Bank and by Discount Mortgage Bank with respect to the said campaign is in accordance with the accounting treatment applied to transactions of granting other loans for housing purposes and to transactions involving the receipt of other deposits from banks or other deposits made with banks.

The volume of credit offered by Discount Mortgage Bank has significantly increased following the outline, from an amount of NIS 1.4 billion in 2007 to NIS 4.1 billion in 2010. According to the Bank of Israel data, the market share of Discount Mortgage Bank

has increased from 5.6% in the first half of 2007 to 8.0% in 2010 (9.5% in 2009).

Discount Mortgage Bank believes that its market share in the next months will continue to be high relatively compared to that existing prior to the launching of the layout.

A part of the information given above constitutes a forward-looking information, based upon the assessment of Discount Mortgage Bank, taking into account the growth recorded in the market share since the layout has been put into operation.

The total credit for housing purposes granted within the framework of the "Discount layout" in 2010 amounted to NIS 3,537.0 million. The total credit for housing purposes granted outside the framework of the "Discount layout" in the said period amounted to NIS 179.8 million. The total deposits made by the Bank within the framework of the "Discount layout" amounted to NIS 3,184.4 million in 2010.

	CPI linked	Non-linked	Foreign currency linked	Total
In NIS millions				
"Discount layout" housing loans - from resources provided by the Bank	1,163.8	2,060.7	30.9	3,255.4
Non-"Discount layout" housing loans - from resources of Discount Mortgage Bank	281.6	-	-	281.6
Non-"Discount layout" housing loans	45.5	131.0	3.3	179.8
Deposits provided by the Bank	1,159.9	1,995.6	28.9	3,184.4

An additional amount of NIS 71.0 million was deposited at the beginning of January ,2011 of which NIS 3.9 million in the CPI linked segment, NIS 65.1 million in the non-linked Shekel segment at variable interest rate and NIS 2.0 million in the foreign currency linked segment.

The average interest rate on loans granted within the framework of the "Discount layout" in the CPI linked segment was 2.03% in 2010. The average interest rate on loans granted within the framework of the "Discount layout" in the non-linked Shekel segment was variable interest of 2.20% in 2010.

The resources provided by the Bank to Discount Mortgage Bank bear interest at the rate charged on the loan less a predetermined economic margin.

## INFORMATION SYSTEMS

In February 2007, the Board of Directors of Discount Mortgage Bank approved the "Sky" Project, which objective was the upgrading of the existing information systems. For details regarding the engagement of Discount Mortgage Bank with the Bank for receiving computer services, see "Main future projects" in "Information and computer systems" in the Chapter "Fixed assets installations".

## INTERNATIONAL OPERATIONS

### GENERAL

The overseas operations of the Discount Group are mainly carried out by the Bank's subsidiaries in the United States, South America (including the Bank's representative offices) and Switzerland, and by means of the Bank's branch in the U.K. The international operations are characterized by commercial business activity and by private banking.

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## LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE INTERNATIONAL OPERATIONS

The principal restrictions applicable to the international operations are briefly described below:

**Exposure restriction with regard to overseas extensions.** At the end of August 2008, the Supervisor of Banks issued a new guideline in the matter of exposure of a banking corporation to the activity of overseas extensions. The guideline states that the Board of Directors of a banking corporation which operates or intends to operate through overseas extensions must discuss and approve a comprehensive policy statement regarding the activities of overseas extensions. Within the framework of the said statement of policy, the Board of the banking corporation is required, among other things, to determine a restriction or a set of restrictions as to the exposure regarding the activities of overseas extensions, which should reflect the risk propensity applying to the operations of the overseas extensions, on condition that the principal part of the operations of the banking corporation and the banking group is located in Israel.

Banking corporations were requested to prepare for the implementation of the new guideline no later than the end of February 2009. The restriction determined in the past in a Regulatory Letter, shall be cancelled concurrently with the approval of the exposure restriction by the Board of the banking corporation. The Supervisor of Banks extended from time to time the date for implementation of the new Directive by the Bank.

On May 24, 2010, the Bank's Board of Directors adopted Discount Bank Group's risk appetite declaration, which had been formed as part of the process of evaluating the capital adequacy, the ICAAP, in which it had been determined, among other things, that the volume of operations of the foreign extensions shall not exceed 30% of the risk assets of the Group (excluding operating risk; in accordance with the first pillar of the Basel II recommendations). Furthermore, specific limitations as to the maximum volume of risk assets to be allocated to each of the Bank's foreign extensions have been determined as well as additional specific limitations.

On December 31, 2010, the calculated rate of the Bank's exposure with respect to overseas extensions stood at 19.0% of total risk assets.

The Bank monitors, on a monthly basis, the development of the exposure rate in respect of its operations in overseas extensions.

**Overseas regulatory supervision.** Operations of the international segment in the various countries are subject to regulatory supervision on the part of the appropriate authority in the country in question.

For details of the investigation regarding matters relating to the prohibition of money laundering, conducted at IDB New York, see "Discount Bancorp Inc." under "Main investee companies" and Note 6 D to the financial statements hereunder.

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## SCALE OF OPERATIONS AND NET INCOME

**Net income** in 2010 amounted to NIS 108 million, compared with NIS 132 million in 2009, a decrease of 18.18%.

**The return on equity**, calculated on the capital allocated to the international operations on the basis of the average balance of segment risk assets, was 6.0% in 2010, compared with 7.3% in 2009.

**Provision for doubtful debts** amounted in 2010 to NIS 244 million, compared with NIS 221 in 2009, an increase of 10.4%.

Following are the principal data relating to the international operations:

	Households	Corporate Banking	Middle Market Banking	Private Banking	Financial Management	Total
For the year ended December 31, 2010						
in NIS millions						
Income from financing activities before provision for doubtful debts	3	160	310	202	365	1,040
Operating and other income	-	67	65	142	(78)	196
<b>Total Income</b>	3	227	375	344	287	1,236
Provision for doubtful debts	-	140	91	10	3	244
Operating and other expenses	1	108	182	346	80	717
Operating Income (loss) before taxes	2	(21)	102	(12)	204	275
Provision for taxes on operating income	(1)	22	21	4	121	167
<b>Net income</b>	3	(43)	81	(16)	83	108
Return on equity (percentage)	108.9	(6.6)	12.7	(9.5)	22.5	6.0
Average Assets	36	5,981	7,665	4,591	16,159	34,432
Average Liabilities	161	1,496	3,252	18,006	10,156	33,071
Average Risk-assets	36	9,417	9,074	2,115	5,180	25,822
For the year ended December 31, 2009						
Income from financing activities before provision for doubtful debts	7	184	308	226	330	1,055
Operating and other income	-	29	58	94	(11)	170
<b>Total Income</b>	7	213	366	320	319	1,225
Provision for doubtful debts	13	64	98	15	31	221
Operating and other expenses	1	150	243	306	75	775
Operating Income (loss) before taxes	(7)	(1)	25	(1)	213	229
Provision for taxes on operating income	-	11	22	25	39	97
<b>Net income</b>	(7)	(12)	3	(26)	174	132
Return on equity (percentage)	(74.7)	(2.9)	0.7	(18.7)	29.1	7.3
Average Assets	141	6,784	*8,149	4,184	18,619	37,877
Average Liabilities	25	1,993	4,226	17,685	12,217	36,146
Average Risk-assets	141	*8,773	*10,569	2,073	*6,194	27,750

\* Reclassified.

## TAXATION

Under an agreement made with the Israeli tax authorities, the income of the Bank's overseas banking subsidiaries is added to the Bank's chargeable income, such that the Bank pays tax on the pre-tax accounting income of its overseas subsidiaries to the extent of the difference between the tax notionally payable in Israel on that income at the tax rate applicable to the Bank in Israel and the tax payable to overseas tax authorities.

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## DEVELOPMENTS IN THE SEGMENT

**Asset-Backed Securities.** For details as to the Group's investments in asset backed Securities, see above "Securities" under "Developments of Assets and Liabilities".

**IDB (Swiss).** In November 2010, the Vice President and Risk Manager of IDB (Swiss) submitted a report, which included various findings, among which are findings that prima-facie indicate violations of the law and procedures. The said findings have been submitted for an independent examination by KPMG (Swiss), and except for violations of Bank procedures, no violations of the law, as claimed, have been found. Appropriate reports have been submitted to the Swiss authorities.

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## SERVICE TO SEGMENT CUSTOMERS

**Europe.** IDB (Swiss) Bank, a wholly owned subsidiary of the Bank. IDB (Swiss) Bank, located in Geneva and which also operates a branch in Zurich (formerly Arzi Bank, which has been merged, as stated) focuses on exclusive private banking operations, by which it has succeeded in attracting customers and expanding the extent of its business. The Bank's Swiss office provides advanced private banking and investment management services to existing and potential customers of the Group, both foreign residents and residents of Israel, at an international financial center. A representative office of IDB (Swiss) Bank operates in Israel. This office only provides information, promotes the business activities of IDB (Swiss) Bank in Israel and provides service relating to the submission of an application for opening a customer account in a foreign country.

In addition, the Bank has a representative office in France (Paris). The Bank studies the continued operation of the representative office.

The Bank has a branch in London that provides commercial and private banking services to Israeli and Jewish customers and to corporations, in Britain and Western Europe. The main activity of the branch comprises the granting of credit to the hotel industry and the financing of foreign trade in the fuel and energy field. In addition, the branch is also engaged in private banking. The branch provides foreign trade services that include, documentary credits and the discounting of bills. The branch operates under the corporate banking division and is supervised and controlled by the supervision and control unit of the Bank's foreign extensions at the Head Office in Israel, as well as by the internal audit and the Bank's credit controller.

**United States.** As aforementioned, IDB New York ("IDB Bank") is the largest of the Israeli banks operating overseas.

This bank maintains three branches in New York (the Staten Island branch was opened in September 2010), one branch in Florida, two branches in California and one branch in the Cayman Islands.

IDB Bank has an Uruguayan banking subsidiary, Discount Bank (Latin America), and representative offices situated in various centers in South America and Israel.

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## SERVICES AND PRINCIPAL PRODUCTS OF IDB BANK

**Credit -** IDB Bank provides financing to a variety of U.S. based corporations and also, at times, to the principals of these privately held companies.

**Middle Market -** IDB New York operates mostly in the field of middle market finance for companies operating in various business fields, particularly in the New York Metropolitan Area, South Florida and Los Angeles. Examples of some of the industries in which IDB Bank is active are diamonds and jewelry, apparel and accessories, food, finance companies, retail, not-for-profit, sports and entertainment. Clients are provided with a full range of services and financings, including accounts receivable management, customer credit guarantees, collections, advances against accounts receivable and inventory, seasonal over advances and import financing.

**Asset Based Loans -** This includes accounts receivable financing, inventory/equipment financing, letters of credit, terms loans as well as funding for mergers and acquisitions, for middle market companies. Asset Based Loans allows IDB Bank to value and

leverage a client's assets to provide working capital.

The distinction between asset-based loans and other secured loans resides in the amount of monitoring required to ensure the existence, value and integrity of the collateral. It is this constant collateral appraisal and field process that functionally differentiates asset based loans from other secured commercial loans.

**Factoring** - This activity serves a wide range of diverse companies in many different industries. One of the Division's strengths is its ability to custom-design a factoring package to suit each client's needs.

**Commercial Real Estate Lending** - Principal products include lines and letters of credit and fixed and floating rate loans for all real estate asset classes, e.g., facilities for the acquisition and adaptive re-use of retail, office, residential and hotel properties. There are also longer term loans on stabilized projects, including participations with other U.S. financial institutions. Focus is always put on maintaining a high degree of credit quality. IDB Bank continues to be committed to help support the development and revitalization of neighborhoods.

**Trade & Finance** - Related credit and trade finance letters continue to be a significant source of fee income for IDB Bank. IDB Bank continues to be a major issuer of documentary letters of credit in its peer group and also continues to be ranked within the top 10% of all U.S. commercial banks as reported by Documentary Credit World, out of the 300 banks on their list. IDB Bank's Automated Letter of Credit Customer Initiation System is a state-of-the-art, personalized Internet-based Letter of Credit system that connects a company's personal computer directly with IDB Bank's Amending Letter of Credit Department. The software makes issuing and amending Letters of Credit faster, easier and more accurate than ever before.

**Retail Banking** - IDB Bank offers the gamut of banking products and services, including personal and business checking accounts, money market accounts, time deposits, etc.

**International Private Banking** - This segment provides highly personalized service to non-U.S. clients. As in all segments of IDB Bank, building solid relationships with clients is paramount.

Deposits from non-U.S. clients represent some 66% of IDB Bank's entire deposit base. The products and services of IDB Bank's broker-dealer subsidiary, IDB Capital Corp., are also available to International Private Banking customers. Officers of the International Private Banking Department are also licensed representatives of IDB Capital Corp.

**U.S. Private Banking** - Customers include personal and corporate clients alike. The products and services of IDB Bank's broker-dealer subsidiary, IDB Capital Corp., are also available to these customers.

**Deposits** - About 58 % of IDB New York's customer deposits are from residents of Latin America. These same depositors vary their investment patterns between deposit based products offered by IDB Bank and investing with IDB Bank's brokerage subsidiary; dependent upon interest rates and maturities vs. opportunities in the bond and equity markets.

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## STRUCTURE OF THE BANKING GROUP

The Bank's Group is composed of commercial banks in Israel and overseas, a mortgage bank and financial services companies. Total investment in the consolidated and affiliated companies as at December 31, 2010, amounted to NIS \_\_\_\_ billion, compared with NIS 10.1 billion on December 31, 2009.

Following is the distribution of net income (loss) by the Group's structure:

	Contribution to Group's results		Contribution Disregarding the effects of coverage of investment <sup>(1)</sup>	
	2010	2009	2010	2009
In NIS millions				
<b>Banking Activity:</b>				
<b>Commercial banks:</b>				
In Israel - the Bank (including branches overseas)	246	296	79	278
- Mercantile Discount Bank	113	180	113	180
- First International Bank	<sup>(2)</sup> 180	<sup>(2)</sup> 161	<sup>(2)</sup> 180	<sup>(2)</sup> 161
Overseas - Bank offices	(37)	112	130	130
Discount Mortgage Bank	29	30	29	30
<b>Other Activities:</b>				
Israel Credit Cards	130	153	130	153
Other financial services	27	11	27	11
Total operating income	688	943	688	943
Loss from extraordinary operations	36	(20)	36	(20)
<b>Net income</b>	<b>724</b>	<b>923</b>	<b>724</b>	<b>923</b>

Notes:

- (1) The Bank in Israel created a surplus of liabilities in foreign currency, constituting coverage for the Bank's investment in Discount Bancorp, Inc., and IDB (Swiss), with the aim of preventing exposure to fluctuations in the exchange rate of the shekel against the U.S. dollar and the Swiss Franc. In the Bank's Statement of Income in Israel, income and expenses arising from exchange rate differentials on the surplus of liabilities mentioned above are presented under the item "income from financing activities before provision for doubtful debts". This income and expenditure is taken into account in the calculation of provision for taxes. Income and expenses arising from exchange rate differentials on overseas investments are presented under the item "Bank's share in operating income of investee companies, net of tax effect". This method of treatment has an effect on the presentation of the Bank's after-tax operating income and on the contribution of the overseas units to net income. In 2010, the shekel was revalued in real terms as against the U.S. dollar by 6.0%, compared with an appreciation of 0.7% in 2009. In 2010, the shekel was devalued in real terms against the Swiss Franc by 3.3%, compared with a devaluation of 2.9% in 2009. The said net revaluation, in 2010, resulted in an increase in the Bank's net operating income after tax in Israel by NIS 167 million, compared with an increase of NIS 17 million in net operating income in 2009. Concurrently, there was a decrease/increase in the positive contribution by overseas extensions to the Bank's results.
- (2) Including a reversal of a part of the provision for tax in respect of the Bank's share in the earnings of the First International Bank, in the amount of NIS 53 million and NIS 10 in 2009 (see Note 6 D to the financial statements).

## GROUP MANAGEMENT

Proper Banking Management Directives regulate, among other things, the Group conduct of the banking corporation as regards various issues. Proper Banking Management Directive No. 301 (in the existing version) requires the Board of Directors of a bank to determine a policy with respect to exposure to various risks (credit risks, market risks, operational risks, liquidity risks, legal risks, etc.) concerning its subsidiary companies and foreign extensions. Furthermore, the Bank's Board is required to determine a policy concerning everything relating to its involvement in determining employment and retirement terms for employees of the subsidiaries of the banking corporation and to verify that the subsidiaries' boards of directors discuss the said terms. The Board of Directors has to ensure that any new activity is approved by it only after it had studied the risks involved in the new operation, it had examined the mechanisms to be used by it in managing, measuring and controlling the risks, it had determined quantitative limits and verified that human resources, financing resources and mechanized and technological infrastructure are available in order to ensure proper absorption and management of the new operation and its compatibility with the banking corporation's existing operations. The Board of Directors must also set guidelines to ensure that corporations controlled by the banking corporation will provide the banking

corporation the information it requires in order to maintain at the Group level an ongoing follow-up, supervision and control over the business of the Group and the scope of risks involved. These guideless shall include the establishment of a central head office unit that will analyze the said information and will report to the management of the banking corporation the condensed data and its recommendations, in accordance with a reporting format approved by the Board. Proper Banking Management Directive No. 313 requires implementation of borrower and group of borrowers credit limits on a consolidated basis.

The new Proper Banking Management Directive No. 301 (hereinafter: "the new Directive"), published in December 2010 (see "Legislation and supervision" below), requires that the Board of Directors shall discuss, decide and form guidelines, as the case may be, regarding the overall strategic goals of a banking corporation and of corporations controlled by it, including its domestic and foreign extensions, including the fundamental operating guidelines and the risk appetite. In the matter of supervision and control mechanisms over controlled corporations, it is required that the Board of Directors shall determine general guidelines regarding the structure of corporate governance in such controlled corporations, in a manner that would contribute to efficient supervision over the Group.

The new Directive includes, for the first time, reference to the framework of considerations of the controlled corporation, and requires that the Board of Directors of the controlled corporation must take into consideration the overall strategic goals of the Group, the overall risk management policy of the group and the overall guidelines of the group regarding the supervision and control mechanisms over controlled corporations, determined, respectively, by the Board of Directors of the controlling banking corporation, in as much as they agree with the interests of the controlled banking corporation and with the provisions of Section 11 of the Companies Law, regarding the purpose of the company.

For details regarding the group risk management, see "Strategy and processes" in the item "Management of market and liquidity risks" under "Exposure to risk and risk management" above.

For details regarding the duty to set a policy with respect to employment and retirement terms at subsidiary companies, see "Remuneration policy in a banking corporation" under "Human resources" below.

## MAIN INVESTEE COMPANIES

At the end of 2010, 24.5% of all assets in the consolidated balance sheet were assets of consolidated companies in Israel, and 20.5% were assets of overseas consolidated companies and branches. The contribution to the net income by the consolidated companies in Israel amounted to NIS 327 million in 2010 (in 2009 the contribution amounted to NIS 363 million). The contribution to the net income by overseas consolidated companies totaled a loss of NIS 37 million in 2010 (in 2009 the contribution amounted to an income of NIS 112 million), and the contribution to the net income by affiliated companies amounted to NIS 186 million in 2010 (in 2009 the contribution amounted to NIS 153 million).

The total contribution by both domestic and overseas investee companies to the Bank's net results amounted to NIS 476 million in 2010, compared with NIS 628 million in 2009, a decrease of 24.2%.

Disregarding the effect of the coverage of the investment in overseas subsidiaries, net of the tax effect, the contribution of both domestic and overseas investees to the Bank's net results in 2010, would have been NIS 643 million, compared with 646 million in 2009, a decrease of 0.5%.

Following are the main developments in principal investee companies.

### DISCOUNT BANCORP, INC.

Discount Bancorp, Inc. (hereinafter: "Bancorp") is a wholly owned subsidiary of the Bank, which is a bank holding company, incorporated in accordance with the law of the State of Delaware.

Bancorp is the 100% shareholder of Israel Discount Bank of New York (IDB New York). IDB New York is the largest Israeli bank operating overseas. Pursuant to Bancorp's Certificate of Incorporation and By-Laws, IDB New York may not be sold by Bancorp

unless the Bank has given its consent (the data presented hereunder in this section have been taken from Bancorp's audited financial statements).

**Total assets** at the end of 2010 amounted to US\$9,319 million, compared with US\$9,520 million at the end of 2009, a decrease of 2.1%.

For details regarding investments by IDB New York in mortgage backed securities, see "Development of assets and liabilities" above and Note 3 to the financial statements hereunder.

**Total loans** at the end of 2010 was US\$3,858 million, compared with US\$3,491 million at the end of 2009, an increase of 10.5%.

**Total deposits** stood at US\$6,112 million as at the end of 2009, compared to US\$6,208 at the end of 2009, a decrease of 1.5%.

**Shareholder's equity** amounted to US\$767 million at the end of 2010, compared with US\$710 million at the end of 2009, an increase of 8.0%.

**The ratio of capital to risk assets**, computed according to the principles applying in the U.S. was 14.7% as at December 31, 2010, compared with 14.9% at December 31, 2009.

**Net income** in 2010 amounted to US\$51.3 million, compared with US\$43.8 million in 2009, an increase of 17.1%.

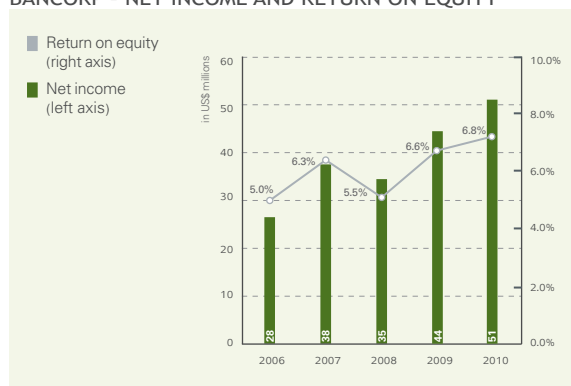
The increase in income was affected primarily from a decrease in provision for other than temporary impairment loss on securities in an amount of US\$18.8 which was offset by a decrease in net interest income. On the other hand, the provision for doubtful debt increased by US\$4.6 million, and tax expenses decreased by US\$5.4 million.

**Return on equity** was 6.8% in 2010, compared with 6.6% in 2009.

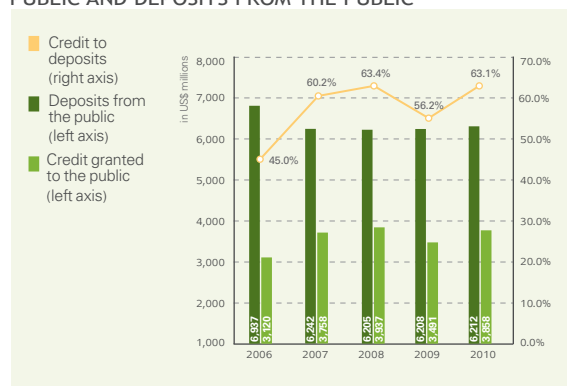
**The contribution of the Bank's investment in Bancorp to the Bank's net results** reached a negative amount of NIS 24 million in 2010 (after deducting a provision for additional taxes of NIS 165 million that applies to the Bank in Israel), compared with income of NIS 120 million in 2008 (after deducting provision for additional taxes of NIS 24 million that applies to the Bank in Israel). The said contribution is comprised of Bancorp's net income in 2010 (after deducting the provision for tax as aforesaid) of NIS 141 million disregarding exchange rate differentials on the investment of NIS 165 million, compared with net income of NIS 141 million (after deducting a provision for taxes as aforesaid) and disregarding exchange rate differentials on the investment of NIS 21 million in 2008.

Alongside the exchange rate differentials on the said investment, the Bank in Israel recorded financing income/expenses in 2010 and financing income/expenses in the preceding year, in respect of the surplus foreign currency liabilities that the Bank created as coverage for the investment in Bancorp.

BANCORP - NET INCOME AND RETURN ON EQUITY



BANCORP - DEVELOPMENT OF CREDIT GRANTED TO THE PUBLIC AND DEPOSITS FROM THE PUBLIC



## MERCANTILE DISCOUNT BANK LTD.

Mercantile Discount Bank Ltd. ("Mercantile Discount") is a wholly-owned subsidiary of the Bank. At the end of 2010, Mercantile Discount Bank operated through 77 branches, compared with 73 branches in 2009.

**Total assets** at the end of 2010 amounted to NIS 22,560 million, compared with NIS 21,807 million at the end of 2009, an increase of 3.5%.

**Total credit granted to the public** at the end of 2010 was NIS 15,082 million, compared with NIS 13,848 million at the end of 2009, an increase of 8.9%.

**Total deposits from the public** at the end of 2010 amounted to NIS 18,736 million, compared with NIS 18,178 million at the end of 2009, an increase of 3.1%.

**Shareholder's equity** at the end of 2010 amounted to NIS 1,855 million, compared with NIS 1,695 million at the end of 2009, an increase of 9.4%.

**The ratio of capital to risk assets** amounted to 13.6% on December 31, 2010, compared with 12.2% on December 2009. On January 25, 2011, the Board of Directors of Mercantile Discount Bank resolved that the total capital adequacy ratio of this bank shall not fall below 13%.

**Net income** was NIS 147 million in 2010, compared with NIS 180 million in 2009, a decrease of 18.3%.

The principal factors affecting the business results of Mercantile Discount Bank in 2010, as compared with 2009: a decrease in the income from financing activities before provision for doubtful debts (a decrease of NIS 14 million, 2.0%); a decrease in the provision for doubtful debts (a decrease of NIS 6 million, 5.3%); a decrease in operating and other income (a decrease of NIS 53 million, 12.9%), an increase in operating and other expenses (an increase of NIS 57 million, 8.2%) and a decrease in the effective tax rate. In contrast, Mercantile Discount Bank recorded in the reported period income from extraordinary operations of NIS 34 million.

The decline in financing income stemmed mainly from a decrease in other financing income, which is explained, mostly, by a decline of NIS 37 million in gains on realization of bonds, and a decline of NIS 15 million in interest income in respect of amounts collected from problematic debts. The decline in operating and other income is explained by a decline of NIS 24 million in net gains accumulated in the deposits in respect of employee rights and from a decline of NIS 46 million in gains on realization of Bezeq shares and dividends on Bezeq shares recorded last year. The decline in operating income was offset by a 4.7% rise in operating commission.

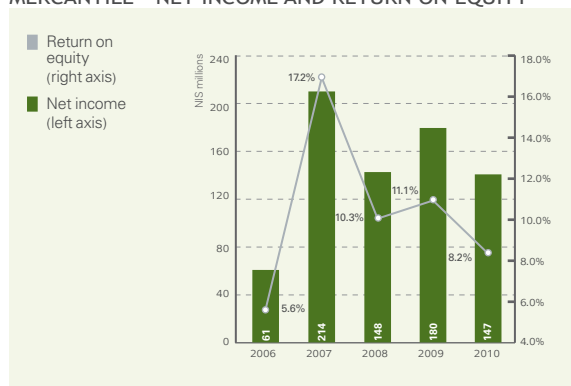
The increase in operating and other expenses stemmed mainly from a 14.2% increase in payroll and related expenses, following the updating of provisions for employee rights and the increase in the number of positions and in wage rates.

**Return on shareholders' equity** in 2010 was 8.2%, compared with 11.1% in 2009.

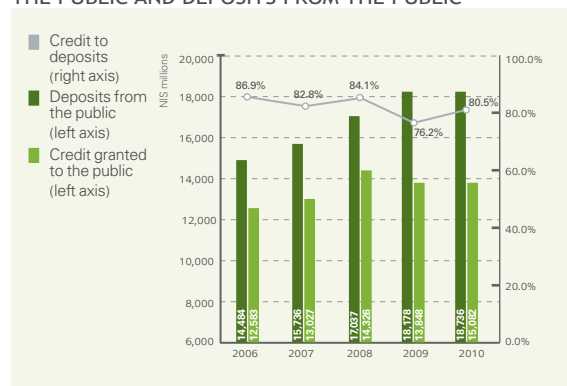
For details regarding a request to approve an action as a class action filed, among others, against Mercantile Discount Bank and the Bank, regarding payments received in respect of foreclosures executed through magnetic media, see Note 19 C item 11.3 to the financial statements.

For details as to the motion for a declarative ruling in the matter of charging the debtor's account with violation interest, see Note 19 C item 11.9 to the financial statements.

MERCANTILE - NET INCOME AND RETURN ON EQUITY



MERCANTILE - DEVELOPMENT OF CREDIT GRANTED TO THE PUBLIC AND DEPOSITS FROM THE PUBLIC



## DISCOUNT MORTGAGE BANK LTD.

Discount Mortgage Bank (hereinafter: "DMB") is a subsidiary of the Bank. As of December 31, 2010, the Bank held all of its equity and of its voting rights.

Discount Mortgage Bank operates 75 sales stations, four independent branches (Tel Aviv main Branch, Pal-Yam Branch in Haifa, the Diamond Exchange Branch in Ramat Gan and the Modi'in Branch), as well as 71 branches operating within the branches of Discount Bank or adjacent to them.

**Total assets** at the end of 2010 amounted to NIS 17,418.0 million, compared with NIS 15,884.4 million at the end of 2009, an increase of 9.7%.

**Total credit granted to the public** amounted at the end of 2010 to NIS 17,099.6 million, compared with NIS 15,294.1 million at the end of 2009, an increase of 11.8%.

**Shareholder's equity** amounted to NIS 1,120.5 million at the end of 2010, compared with NIS 1,090.1 million at the end of 2009, an increase of 2.8%.

**Net income** amounted to NIS 30.4 million in 2010, compared with NIS 31.0 million in 2009, a decrease of 1.9%.

The business results of DMB for 2010, were affected, inter-alia, by an increase in income from financing activity (an amount of NIS 6.8 million, 5.9%), by a decrease in the provision for doubtful debts (an amount of NIS 4.8 million) and by a decrease in operating and other expenses (an amount of NIS 5 million, 4.1%).

**Return on shareholders' equity** in 2010 was 2.8%, compared with 3.4% in 2009.

**The ratio of capital to risk assets** amounted to 18.3% on December 31, 2010, compared with 18.8% on December 31, 2009. On December 31, 2009, the Bank invested NIS 160 million in the share capital of DMB. This investment was intended to support the capital adequacy of DMB and to enable it to continue in developing its business. On November 21, 2010, the Board of Directors of DMB resolved that the total capital adequacy ratio of this bank shall not fall below 13%.

**The Contribution of the Bank's investment in DMB** to the Bank's net results amounted to NIS 29.4 million in 2010, compared with NIS 30.0 million in 2009, a decrease of 2.0%.

See Note 19 C article 11.10 to the financial statements for details of the uncertainties relating to DMB. in the matter of charging commission in respect of life assurance and property insurance of borrowers, article 11.11, regarding the charging of a premature redemption commission in the case of realizing a life assurance policy of a deceased borrower, article 12.1 in the matter of insuring property for amounts exceeding its reinstatement value and Section 12.4 in the matter of charging an early repayment commission on commercial loans.

## FIRST INTERNATIONAL BANK OF ISRAEL LTD.

The First International Bank of Israel Ltd. ("FIBI") is an affiliated company of the Bank. As of December 31, 2010, the Bank held 26.4% of its share capital and voting rights. For details regarding the agreement with FIBI Holdings Ltd., in the matter of the Bank's ownership of shares in FIBI, see "Material agreements" below and Note 6D to the financial statements.

**Net income** amounted in 2010 to NIS 484 million, compared with NIS 568 million in 2009, a decrease of 14.8%.

**The Bank's share in the net income of FIBI** in 2010 amounted to NIS 180 million (including an amount of NIS 53 million regarding the reversal of a part of the provision for taxes in respect of the investment in the First International Bank), compared with NIS 161 million in 2009 (including an amount of NIS 10 million regarding the reversal of a part of the provision for taxes in respect of the investment in the First International Bank).

**Return on shareholders' equity** in 2010 was 8.0%, compared with 9.7% in 2009.

**The ratio of capital to risk assets** amounted to 12.50% on December 31, 2010, compared with 13.8% on December 31, 2009.

**Distribution of Dividend.** On September 6, 2010, the Bank received a cash dividend of NIS 212 million.

**Unifications of share capital.** Upon completion of the process for the unification of the share capital of FIBI, the rate of the Bank's holdings in FIBI increased to 26.4% in the voting rights. In accordance with the provisions of the agreement with FIBI holdings, the Bank deposited with a Trustee shares which grant it voting rights in excess of 11.09%.

The distribution of a dividend and the unification of the capital have been made in accordance with the said agreement with FIBI Holdings.

For details regarding a legal action filed against FIBI in the matter of life assurance commissions and property insurance in contravention of the law and regarding a request to approve it as a class actions, see Note 19 C 13 to the financial statements. For details regarding a motion for approval of an action as a class action suit filed against the First International Bank in the matter of the ruling of the Antitrust Commissioner that restrictive arrangements have existed between the banks, see Note 19 C to the financial statements, item 12.4.

## ISRAEL CREDIT CARDS LTD.

Israel Credit Cards Ltd. ("ICC") is a subsidiary of the Bank. As of December 31, 2010, the Bank owned 71.8% of the equity and 79.0% of the voting rights in ICC. ICC issues and operates "VISA", "Diners" and "MasterCard" credit cards.

**Total assets** amounted, at the end of 2010, to NIS 8,646 million, compared with NIS 8,579 million at the end of 2009, an increase of 0.8%.

**Shareholder's equity** amounted to NIS 1,131 million at the end of 2010, compared with NIS 1,056 million at the end of 2009, an increase of 7.1%.

On March 15, 2009, the Board of Directors of ICC adopted a policy according to which ICC will not distribute dividends out of retained earning that had accumulated or that will be accumulated by ICC until December 31, 2009.

**The ratio of capital to risk assets** amounted to 16.2% on December 31, 2010, compared with 13.7% on December 31, 2009.

On February 27, 2011, the Board of Directors of ICC adopted a policy according to which, the total capital ratio to risk assets of the company shall not fall below a rate of 15%.

**Distribution of dividend.** On December 31, 2010, ICC distributed a dividend of NIS 150 million, out of earnings of 2010 (the Bank's share is NIS 108 million). On March 23, 2011, the Board of Directors of ICC resolved to distribute a dividend of NIS 75 million out of the profits of 2011 (the share of the Bank in this dividend is NIS 54 million).

**Total income** amounted in 2010 to NIS 1,104 million, compared with NIS 1,157 million in 2009, a decrease of 4.6%.

**Net income** amounted in 2010 to NIS 215 million, compared with NIS 249 million in 2009, a decrease of 13.7%.

**Return on equity** reached 18.3% in 2010, compared with 26.3% in 2009.

**The contribution of the Bank's investment in ICC to the Bank's net results** in 2010, amounted to NIS 130 million, compared with NIS 153 million in 2009.

**Issue of capital notes to the Bank.** On December 31, 2010, ICC issued to the Bank subordinate capital notes in the amount of NIS 30 million.

**Material weaknesses in the internal control over financial reporting - 2009.** In the 2009 Annual Report, ICC reported two material weaknesses found in the internal control over financial reporting, as described below:

1. Against background of the findings of the internal audit of ICC, management of ICC has evaluated, within the framework of the preparation of the financial statements as of December 31, 2009, the internal control over financial reporting with respect to the recording of expenses, in particular marketing and advertising. The said evaluation indicated the existence of a material weakness stemming from the lack of effective internal control required in order to ensure that the accounting entries relating to expenses, and in particular marketing and advertising expenses, would be properly recorded, processed, summarized and reported with a reasonable measure of assurance as to their reliability.

As of June 30, 2010, ICC completed a remediation process with respect to the recording of expenses, as above stated. In view of the improved controls and following the examination of their effectiveness, ICC's Board of Directors and Management believe that the material weakness relating to the recording of expenses (in particular marketing and advertising expenses) no longer exists as from June 30, 2010.

2. In the course of an audit performed in the end of 2009 and the beginning of 2010 by ICC's internal auditor, certain material deficiencies had been found in the control environment of ICC International Ltd., a subsidiary of ICC, which operated in the field of clearing international electronic trading and whose operations were merged into ICC in December 31, 2009. Against the background of the findings of the internal audit and of developments in the field of clearing international electronic trading transactions (for further details see Note 33 A to the financial statements), management of ICC has evaluated, within the framework of the preparation of the financial statements as of December 31, 2009, the internal audit over financial reporting layout at ICC International, with reference to clearing operations of international electronic trading transactions. The said evaluation indicated the existence of a material weakness in the control layout at the entity level relating to clearing operations of international electronic trading transactions. This weakness stems from the lack of supportive control processes and a proper control environment at ICC International, required to assure that the accounting entries relating to such operations would be properly recorded, processed, summarized and reported with a reasonable measure of assurance as to their reliability.

The control components at the entity level are: control environment; risk evaluation process at organization level; information and communication; supervision and follow-up. Deficiencies had been found in most of the said components, which together amounted to a material weakness.

During 2010, ICC examined the central processes that affect the control components at the organization level with the help of outside consultants, and acted towards the tightening of controls and operations at the organization level, in particular those which constitute the infrastructure for the atmosphere and tone at the top. This, being the concept that the resolute approach of management in these matters will seep in down the organizational structure and will bring about a stronger internal control layout with improved efficiency.

Within this framework, changes have been integrated into the work processes at ICC, principally, the outlining of a reporting and transparency culture, a culture of compliance with legal and regulatory requirements, intensified supervision and control by management and the board of directors and improvement of corporate governance.

Among the measures adopted were the replacement of senior executives of ICC, risk mapping, development of control and monitoring tools, improvement of policy documents, updating and refreshing procedures and improvement of the flow of information both inside and outside ICC.

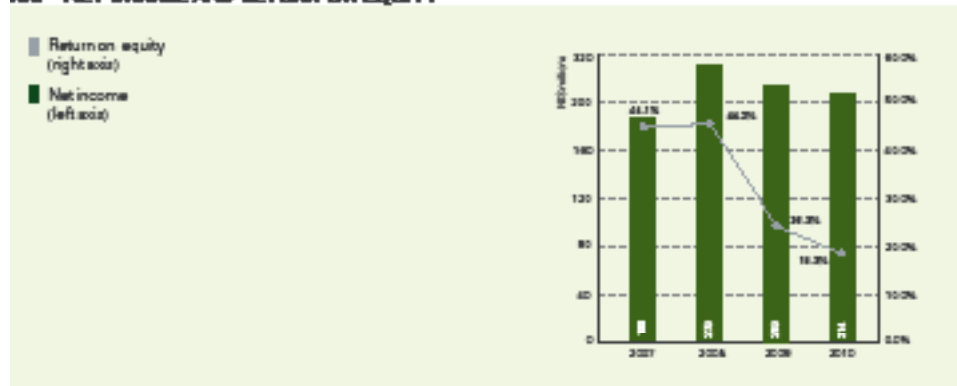
As of December 31, 2010, ICC completed a remediation process relating to the control components at the entity level. In view of the improved controls and following the examination of their effectiveness, ICC's Board of Directors and Management believe that the material weakness in the control layout at the entity level relating to clearing operations of international electronic transactions no longer exists as from December 31, 2010.

It should be noted that within the framework of process examination, as stated, certain deficiencies had been identified, the remediation

of certain of which has not yet been completed and is included in the work plan of the company for 2011, including the following matters: completion of the treatment of findings included in the audit report of the Bank of Israel in the matter of money laundering prohibition, the establishment of a separate chief risk manager function, completion of the establishment of the legal consultancy layout, continuing designated training sessions for management grades, completing the writing of procedures and their integration. In their opinion regarding internal control over financial reporting, the independent auditors of ICC stated that, in view of the material weaknesses identified by the management of ICC, as described above, ICC has not maintained an effective internal control over financial reporting as of December 31, 2009, based on criteria determined by the combined framework of internal control of COSO. The auditors of ICC further noted that the above mentioned material weaknesses had been taken into consideration in determining the type, timing and scope of audit procedures employed by them in performing the audit of the consolidated financial statements of ICC for the year 2009, and that the report on the internal control over financial reporting did not affect their audit report on the annual financial statements, which included an unqualified opinion on the said financial statements. The internal control layout over financial reporting at ICC as of December 31, 2010, has been audited by the independent auditors and found to be effective.

**Audit at ICC regarding the implementation of the Prohibition of Money Laundering Law.** During the second half of 2008 and the first half of 2009, the Audit Department of the Bank of Israel performed an across the board audit in the matter of the implementation of the Prohibition of Money Laundering Law. An audit report was received by ICC on June 20, 2010, in which were detailed deficiencies found during the audit, which prima facie constitute violation of various provisions of the Law, including directives of the Supervisor of Banks applying to ICC. Among other things, ICC has been instructed in the audit report to correct the deficiencies mentioned in the report and to determine procedures and modes of operation in order to comply with the provisions of the Law and Regulations. ICC is acting towards the rectification of the deficiencies and the implementation of the recommendations included in the audit report. For details regarding the activity in the credit card field, including developments in the field of clearing of international electronic trading transactions, see "Credit Card Operations Activity" under "Further details as to activity in certain products" above and note 33 to the financial statements.

ICC - NET INCOME AND RETURN ON EQUITY



## ISRAEL DISCOUNT CAPITAL MARKETS AND INVESTMENTS LTD.

Israel Discount Capital Market and Investments Ltd. (hereinafter: "DCMI"), a fully owned and controlled consolidated company of the Bank, is engaged in investment in companies, in private investment funds and venture capital funds, in investment banking and in the underwriting and management of public offerings of securities (through a subsidiary).

**Total assets** as at December 31, 2010 amounted to NIS 703 million, compared with NIS 690 million at the end of 2009, an increase of 1.9%.

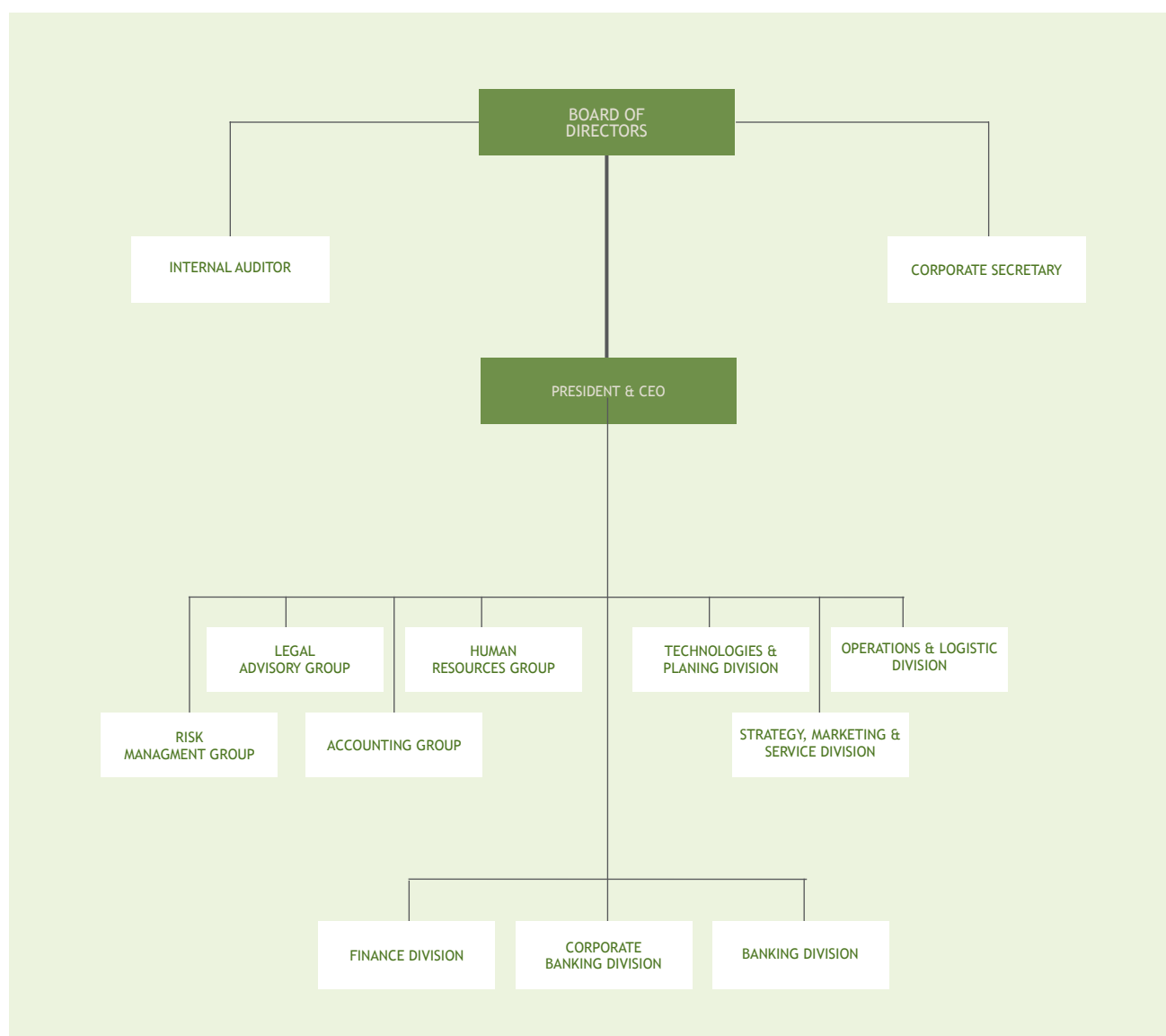
**The net income** in 2010 amounted to NIS 10.5 million, compared with NIS 7 million in 2009.

**Contribution of the Bank's investment in DCMI to the Bank's results** amounted in 2010 to a loss of NIS 9 million, compared to a loss

in the amount of NIS 7 million in 2009 (difference between net income of Israel Discount Capital Markets and Investments Ltd and between its contribution to the Bank's results is derived from differences in implementation of generally accepted accounting principles). During 2010, DCMI, through a subsidiary, participated in 56 public offerings of securities (of which 6 with underwriting) with a total volume of approx. NIS 15 billion (15 public offerings with a total of approximately NIS 8.5 billion in 2009), and in 2 private placements of securities with a volume of approx. NIS 1 billion (three private placement with a total volume of approximately NIS 0.6 billion in 2009). Of the said issues in 2010, 3 public issues of a total amount of NIS 1.2 billion and one private placement of an amount of NIS 200 million, were issued made by the Discount Group, compare with public offerings in a total amount of NIS 1,771 million and one private placement in the amount of NIS 102 million in 2009.

## HUMAN RESOURCES

### ORGANIZATIONAL STRUCTURE CHART



## A CHANGE IN THE ORGANIZATIONAL STRUCTURE

### REORGANIZATION OF THE SERVICE LAYOUTS IN THE CORPORATE BANKING AND BANKING DIVISIONS

At the present time, Management of the Bank is reorganizing the service layouts to corporate and private customers of the Bank. It has been decided on the transition to three new and focused service layouts available to corporate customers, according to the volume of operations of the customer at the Bank.

Corporate customers having a credit facility of NIS 50 million and over will be served by the Corporate Banking Division. Corporate customers having a credit facility of between NIS 5 and NIS 50 million will be served by the commercial department of the Banking Division, operating in six commercial centers. Customers having a credit facility of up to NIS 5 million will be served by the Bank's branches.

The Corporate Banking Division will include the large corporation department, serving the large Bank's business customers having a credit facility of NIS 50 million and over and a sales turnover of NIS 150 million and over, the real estate and infrastructure department and the special credit department. Concurrently, the Division will continue to offer specialized services for the foreign trade layout, the Diamond Exchange branch, the Tel Aviv main branch and the London Discount branch.

Alongside the service layouts to corporate customers, the Bank strengthens the specialized service layouts for private customers.

The name of the Retail Banking Division has been changed to Banking Division, and it will include the commercial department, transferred from the Corporate Banking Division. This department will provide services to commercial customers and to middle market customers, and will merge two service layouts, the credit centers and the business centers, into one service layout to provide comprehensive service to this segment through a countrywide disposition of six business centers. The 147 branches of the Bank will be divided into six regions, answering directly to the Head of the Banking Division, and will handle private customers. Service for customers of the branches will improve in view of the decision to increase the authority of Branch managers, a move that would reduce the time needed to provide response to customer requests. The specialized service layout in the branches will be strengthened by specialized credit officers and investment and pension consultants. Private customers active on the capital market will continue to receive specialized and suitable service in 10 countrywide investments centers.

Within the framework of the overall change some ninety Head Office employees will be transferred to the service layouts at the Division and at the Bank. Furthermore, redundant office space used by the merged services will be vacated and offered for sale. Alongside the said preparations, the Bank is preparing to reposition the private banking layout, which will constitute one of the Bank's central growth mechanisms in the coming years.

**Establishment of a customer asset division.** On March 2011, the Board of Directors decided to establish a Customer Asset Division. The Division will contain the investment consulting services at the Bank (financial and pension), the private banking services, the development and management of Bank products, as well as being responsible for investment portfolios management and for Discount Trust Company. Establishment of the Customer Asset Management Division is designed to support one of the central targets of the Discount Group – the development and intensification of activities in the capital market and private banking area.

### CHANGES IN THE ORGANIZATIONAL STRUCTURE (2010)

**Establishment of the Strategy, Marketing and Service Division.** In March 2011, the Division was established, which will be responsible for the Group's strategy, for marketing at the Bank, for the quality of service provided to customers and for the Bank's activity in the direct channels.

The following organizational changes were approved at the end of March 2010:

- **Organizational change in the Operations and Information Systems Division.** The Operations and Information Systems Division was divided into two divisions, each headed by a member of Management at Executive Vice President level: The IT & Planning Division and the Operations & Logistics Division.

Since the decision on the change in the organizational structure, organizational preparations are being made in each of the two new divisions. Preparations in the IT and Planning Division have been completed and the integration of the changes was completed in July 2010. Due to the scope of the planned changes in the Operations and Logistics Division, their integration is expected during the next few months.

- **Organizational change in the Retail Banking Division.** The change involved the elimination of 5 regions and creation of 9 areas. In conjunction with this change, the division head office is being aligned with the branch structure, for providing direct service in areas such as credit and investments, to all branch clients.  
For further details, see "Retail banking - household segment" above, under "Activity of the Group according to principal segments of operations".

**Establishment of the risk management layout.** For details as to the decision of the Board of Directors to establish a risk management layout, headed by the Bank's Chief Risk Manager, see under "Risk management policy and objectives" under "Exposure to risks and risk management" above.

## LABOR FORCE AND PAYROLL COSTS

There were 6,027 employees in full-time positions in the Bank in Israel (not including the Bank's branches abroad) at the end of 2010, compared with 6,110 at the end of 2009, a decrease of 1.4%.

The average monthly number of employees, based on full-time positions, in the Bank in Israel (not including overseas branches) dropped in 2010 and amounted to 6,041, as compared to 6,132 in 2009, a decrease of 1.5%.

There were 10,221 full-time positions in the Group in Israel and abroad at the end of 2010, compared with 10,290 at the end of 2009, a decrease of 0.7%.

The average monthly number of employees in full-time positions in the Group, both in Israel and abroad, at the end of 2010, was 10,219, compared with 10,319 at the end of 2009, a decrease of 1%.

Following are the labor force data of the Group and the Bank, in terms of positions<sup>(1)</sup>:

	As of December 31		Monthly average in	
	2010	2009	2010	2009
The Bank in Israel	6,027	6,110	6,041	6,132
Domestic subsidiaries	3,394	3,335	3,381	3,324
Group total in Israel	9,421	9,445	9,422	9,456
Overseas branches	37	34	35	35
Overseas subsidiaries	763	811	762	828
Group total overseas	800	845	797	863
<b>Group total overseas and Israel</b>	<b>10,221</b>	<b>10,290</b>	<b>10,219</b>	<b>10,319</b>

(1) The number of positions includes conversion into overtime positions with the addition of positions of software house employees who provide services to the Bank and after deduction of positions the payroll cost in their respect has been capitalized to fixed assets.

Following are details of the cost per position, in NIS thousands<sup>(1)</sup>:

	2010	2009	Change in%
The annual average direct cost per employee position in the Bank in Israel	220	215	2.3
The total annual average cost per employee position in the Bank in Israel	334	332	0.6
The average annual overall payroll cost per employee of the Group in Israel and abroad	312	308	1.3

(1) Payroll costs also include the cost of software house employees, as stated in the footnote to the preceding Table, less payroll costs capitalized to fixed assets.

## HUMAN RESOURCES ACCORDING TO SEGMENTS OF OPERATION

The positions stated according to segments of operation include positions of direct employees of the segment and positions of head office staff of various levels, the cost of their employment had been allocated to the segment. The calculation of the number of positions, as stated, is based on a model for the allocation of costs used by the Bank, as adjusted in the circumstances and on the basis of assessments.

	Financial							
	Households	Small Business	Corporate Banking	Middle Market Banking	Privet Banking	Non-Financial Companies	Financial Management	Total
For the year ended December 31, 2010								
Average number of positions in the segment	4,662	1,853	1,161	956	545	6	1,106	10,289
Of which:								
Management positions	828	352	283	216	124	3	195	1,999
For the year ended December 31, 2009								
Average number of positions in the segment	4,544	1,853	1,248	1,008	572	4	1,090	10,319
Of which:								
Management positions	757	317	290	229	114	3	205	1,915

## LABOR RELATIONS

**General.** Labor Relations at the Bank are based on the Labor Charter, collective labor agreements and employment arrangements that are consummated mainly in negotiations between the Bank's management and the employees' representatives.

**Labor Charter.** "Labor Charter for the Employees of Israel Discount Bank Ltd. ", which was signed in 1974 (hereinafter: "the Labor Charter") constitutes a wide base outlining and incorporating employment conditions, disciplinary provisions, arbitration procedures and additional procedures and regulations. During the last thirty years, dozens of collective labor agreements were consummated in addition to the Labor Charter. These other agreements include wage and other agreements intended to supplement and expand the Labor Charter, to change the Labor Charter or to cancel certain provisions of the Labor Charter.

The "Employee Agreement" signed on February 1, 2005 (see "Employer agreement" under "Control of the Bank" below), inter alia, extends the validity of the Labor Charter as a collective labor agreement at Discount Bank for a period of five years, i.e. until December 31, 2009, and states that at the end of this period the parties will act with respect to the validity of the Labor Charter in accordance with the provisions of the Charter, namely, its extension by one year at a time beginning on March 31, 2011, unless the Bank's management informs the Employees' Representative Committee otherwise, or the Employees' Representative Committee informs the Bank's management, by advance written notice, three months prior to the said date.

**Rights of association.** The Bank's tenured employees are organized within the framework of the national Employees' Representative Committee. The Representative Committee is divided internally in such a way that employees at the clerical level are included in the come under the Clerks' Committee and authorized signatories and managers are organized under the Managers' Representative Committee. Most of the issues are agreed and signed between the Bank's management and the Employees' Representative Committee. A retirees' Committee also exists, under which the Bank's retirees are organized.

**Bank participation in the budget of the Employees' Representative Committee.** The Bank contributes monthly to the budget of the Employees' Representative Committee, in an amount double the monthly amount contributed by the employees. Five out of the 21 Committee members are officers of the Committee engaged on the Committee on a fulltime basis and receiving a full salary.

The other members of the Committee fulfill various positions in the Bank and serve as Committee members in addition to their regular work. In addition, the Bank provides office premises for the Committee's use and covers the maintenance costs thereof. The Bank assists the representative committee of the Bank's retirees and allows it to conduct activities at the Bank premises in Jerusalem, Jaffa and Haifa.

## PRINCIPAL CATEGORIES WITH RESPECT TO EMPLOYMENT CONDITIONS

The Bank's employees are classified into three categories for purposes of employment conditions:

**Tenured employees.** The employment terms of tenured employees are arranged, as stated, in accordance with the Labor Charter, special collective labor agreements and other employment arrangements. On December 31, 2010, there were 4,002 tenured employees in the Bank (December 31, 2009: 3,924 tenured employees). The majority of the Bank's tenured employees are permanent employees, while a minority constitutes new employees on a trial period.

**Temporary employees.** The employment conditions of temporary employees are arranged mainly in several special collective labor agreements, which detail the conditions and maximum period of their employment. Their maximum period of employment is five years that, under special circumstances, may be extended up to seven years. Temporary employment may be terminated at any time, at the discretion of management. On December 31, 2010, there were 1,902 temporary employees in the Bank (December 31, 2009: 1,893 temporary employees), of which, 248 employees engaged by the Bank (December 31, 2009: 252 employees) and known as "computer temporaries". These employees are engaged in the IT field, and in accordance with an agreement dated 2002 between the Bank's Management and the representative committee of employees, may be engaged in a temporary status for a period of up to seven years.

According to the agreement between the Bank and the Employees' Representatives Committee, the total number of temporary employees is limited to 30% of the total number of the Bank's employees (including temporary personnel but excluding cleaning personnel, and temporary computer personnel).

On February 1, 2009, the Bank signed an agreement with the representative committee of the employees enabling the Bank to employ, with the consent of the committee, and for an indeterminate period of time, persons who completed seven years of temporary employment with the Bank, at terms similar to those applying to them as temporary employees.

**Personal employment contracts.** Employees engaged under personal employment contracts sign, prior to their engagement with the Bank, a personal contract, which precludes the Labor Charter and the collective labor agreements for these employees. Employees engaged under a personal contract include members of Bank management, part of the information technology staff and a defined and specified agreed list of position holders, mainly senior personnel. At present, the scope of personnel employed in accordance with personal employment agreements may reach approximately 80 positions. As of December 31, 2010, the Bank employed, in practice, 65 personnel (including members of management) under personal employment agreements (December 31, 2009: 63 employees engaged under personal contracts).

In addition, the Bank acquires services of manpower company employees and software houses.

As of December 31, 2010, 29 manpower company personnel were employed by the Bank. These employees serve mainly as tellers hired as reinforcement following the transition to a shortened work week (as of December 31, 2009: 14 manpower company personnel).

It should be noted that in recent years the number of temporary staff has risen while the number of workers supplied by manpower companies has decreased, this as a result of completing the implementation of Section 12(a) of the Manpower Companies Law, namely, that workers supplied by manpower companies may not be employed for periods exceeding nine months.

As of December 31, 2010, 839 software house personnel were employed in the Bank. These employees are engaged mainly in software development tasks (as of December 31, 2009: 747 software house personnel).

Following is a summary of employment data in the various categories and the changes therein:

Employees	Tenured employees, personal contracts and members of management <sup>(1)</sup>	Temporary employees <sup>(1)</sup>	Manpower companies	Software house <sup>(2)</sup>	Total
December 2008	3,941	2,033	71	947	6,992
December 2009	3,987	1,893	14	747	6,641
December 2010	4,067	1,902	29	839	6,837
Difference (December 2010 vs. December 2009)	80	9	15	92	196
Difference (December 2009 vs. December 2008)	46	(140)	(57)	(200)	(351)
Positions					
December 2008	4,051	1,955	31	946	6,983
December 2009	4,041	2,025	13	827	6,906
December 2010	4,117	1,973	20	860	6,970
Difference (December 2010 vs. December 2009)	76	(52)	7	33	64
Difference (December 2009 vs. December 2008)	(10)	70	(18)	(119)	(77)

Notes:

- (1) Including the positions of Bank employees the cost of which has been capitalized to fixed assets: 2010 - 137 positions, 2009 - 126 positions, 2008 - 162 positions.  
(2) Including positions of software house employees included in the Bank's manpower data: 2010 - 54 positions, 2009 - 157 positions, 2008 - 162 positions.

## DEVELOPMENTS IN LABOR RELATIONS

**Labor disputes.** The New General Federation of Labor announced, on December 29, 2009 a labor dispute relating to the Bank's clerical staff in the matter of "a demand for signing a wage agreement and the determination of a selective wage increase for the year 2009 in respect of the clerical staff". By virtue of this dispute, the employee representative committee was entitled to apply sanctions as from January 14, 2010, and this was indeed done. The sanctions were withdrawn on January 18, 2010.

Following discussions held between the Bank's management and the employee representative committee (including the Managers' Representation Committee), at the request of the New Federation of Labor, the latter declared on January 31, 2010 a labor dispute in the matter of the demand of the clerks' representative committee to sign a collective agreement regarding the scope of engagement of outsourcing staff and against their continued employment instead of tenured Bank employees and using them as strikebreakers, which in the opinion of the representative committee cause damage to the Bank's organized labor force. Furthermore, as claimed by the committee, the Bank's management refrains from supplying details regarding the engagement of outsourcing staff and of provisional employees. On February 17, 2010, the employee representative committee started implementing sanctions, employed intermittently at the Bank's various units.

On March 2, 2010, the Bank's Management received a notice from the Bank's national employee representative committee that it intends to call on the next day, a meeting of employees during regular working hours. Management informed the employees that it cannot condone a partial and disrupted working day, and accordingly it instructed the employees not to come to work at all. On March 3, 2010, the bank's branch layout closed down. Notwithstanding, 40 service stations at the "Discount Rapid" and "Concept" branches provided service by temporary staff. Furthermore, the direct banking channels (Internet, TeleBank and the dealing room) operated in the usual manner.

Within the framework of the said sanctions, the employee representative committee instructed on March 8, 2010, the staff of the Bank's Accounting Layout to refrain from any activity related to the preparation of the Bank's annual financial statements for December 31, 2009, this until further notice.

At the end of an intensive meeting with the Bank's Management on the night of March 10, 2010, the employee representative committee decided to suspend the sanctions until Passover Eve, a period in which the negotiations between the parties continued. At the end of lengthy negotiations the parties signed four collective labor agreements on May 30, 2010.

**Temporary staff.** An agreement regarding the acceptance of temporary staff as the Bank's regular employees of in the period from date of the agreement and until the end of 2012, so that on December 31, 2012, the total number of all the Bank's regular employees shall not be less than 4,500. The number of temporary staff employed subsequent to the said date may change provided their number shall not exceed 30% of the number of regular employees as it may be from time to time.

**The right of organization and freedom to strike.** An agreement regarding the Bank's obligation to recognize the right of employee organization and the freedom to strike as well as avoiding the breaking of a strike by outsourcing, employing manpower company employees and temporary staff.

**Thirteenth month salary and crediting accumulated vacation days.** An agreement providing the payment of 40% of the thirteenth month salary for 2009 to employees of the managerial staff, which as agreed in 2009 with the employees' committee had not been paid at all. The agreement also credited the clerical staff with two vacation days out of the five vacation days waived by them in 2009.

**An advance on account of a selective addition to salary.** An agreement regarding the payment of an advance at an average rate of 4.5% on account of a selective addition to salary in respect of 2009 for the clerical staff, and at an average rate of 4% on account of 2010 for the clerical and managerial staff. The agreement further specifies that the full amount of the additions to salary shall be agreed upon in the negotiations regarding the wage agreement for the years 2010-2011 concerning all employees, which are to be held as from October 2011. Furthermore, the employees' committee is obliged to maintain industrial peace until December 31, 2011, as regards matters agreed upon in the agreement. The labor dispute regarding the wage agreement declared on December 29, 2009, has been cancelled, and the strike days deducted from the salary of employees applying such sanctions shall be charged to the employees' vacation days.

**Wage agreement for managerial level Bank employees.** A wage agreement was signed on February 17, 2008, whereby most of the Bank's employees of the manager echelon will receive salary increases for the years 2007-2009, at an average rate of 15% for the whole period of the agreement, while the remainder of the manager echelon, which includes senior employees and/or highly paid employees will receive salary increases at an average rate of 7% for the entire period of the agreement plus an award equal to several salaries to be granted on a differential basis. In addition, it has been agreed to do away with wage components in respect of: newspaper, telephone and the "April 1992 agreement" and to update the component in respect of transportation. Furthermore, the parties have committed to maintain industrial peace until April 30, 2010, with respect to the issues settled in the agreement.

**Employment of temporary staff.** On February 1, 2009, the Bank signed an agreement with the representative committee of the employees enabling the Bank to employ, with the consent of the committee, and for an indeterminate period of time, persons who completed seven years of temporary employment with the Bank, at terms similar to those applying to them as temporary employees.

**Changes in the employment ordinance.** In October 2009 the Bank's management approached the representative committee of the Bank's employees in writing proposing a series of discussions (in continuation of several prior discussions in the matter), with a view of making changes in the employment ordinance adjusting it to the Bank's present and future needs, ensuring the Bank's economic stability and securing the present and future employment of the staff.

## EMPLOYEE REMUNERATION

The principal salary components include the basic salary which includes a seniority increment, representation and signature fees to each employee in accordance with his seniority and position.

The basic salary constitutes the basis for salary increments and for the payment of split working hours' remuneration at the rate of 2.5% of the salary (to entitled employees only), shift remuneration (to entitled employees only), overtime, 13th month salary and long term service award. Likewise, there exists an additional payment at the rate of 4% under a collective agreement of January 2006, payable to those entitled to split-time payment. Part of the employee's remuneration is linked to the CPI. in cases where

the change in the CPI is a negative figure, the employees' wages are not reduced and the drop in the CPI is setoff against the rise in the CPI in following months. Employees are also entitled to various additional benefits. Bank employees are promoted by grades only and are also entitled to a long-service bonus equal to several monthly salaries plus additional vacation days, at the end of 20, 30 and 40 years of service in the Bank. A collective labor agreement dated November 22, 2007, granted employees an option to redeem in cash the "Jubilee vacation" days to which they will be entitled during their period of employment, in amounts determined by the parties to the agreement. The labor agreement further specified that new employees shall not be entitled to "Jubilee vacation" as well as wage components in respect of nursery school and summer camp.

Part of the employees is entitled to global overtime payment and, for other employees, payable overtime is subject to approval by the employee's authorized superior. The Bank does not have a computerized system for determining the number of hours actually worked by the employees ("time clock").

Most of the Bank's employees are entitled to recreation pay in an amount significantly higher than the amounts provided by law. Employees are also entitled to accepted provident and continuing education funds contributions.

The Bank's liability to severance pay for its employees is calculated according to the employee's basic salary, global overtime payment, 1/12 of the employee's 13th month salary and other additional benefits.

Bank employees are also entitled to certain benefits after their retirement, which are similar to those to which regular employees are entitled.

The Bank is preparing for the required changes in provisions for severance compensation under the Expansion Order regarding the establishment of compulsory pension for every employee and under Amendment No. 3 to the Provident Fund Law, which are effective January 1, 2008.

According to the Expansion Order, the Bank is required to contribute for severance compensation on a personal basis and up to a maximum rate (as from January 1, 2013 onwards) of 5% of the employee's salary or of the average wage in the economy, whichever is lower. According to the Amendment to the Provident Fund Law, the Bank's contributions for severance compensation shall not be deposited in a central severance pay fund, as hitherto was the practice, starting January 1, 2008 in respect of new employees and starting January 1, 2011 in respect of other employees. For further details see Note 16 to the financial statements.

**Reduction in wages in 2009.** The salary of employees engaged under various personal and provisional agreements, having an inclusive salary level of at least NIS 10 thousand, has been reduced by 5.5%, with effect as from February 2009, for a period of twelve months, with no effect on the level of salary used to compute social benefits. In accordance with agreements with the committee of the managerial staff, employees belonging to the managerial level have waived their right to a thirteenth month salary for the year 2009, where under certain circumstances, the reinstatement of 40% of such salary will be considered at the beginning of 2010. According to agreements with the clerks committee, employees of the clerical level have waived their right to five days of paid vacation and to the payment by management in respect of a Jewish New Year present.

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## SPECIAL REMUNERATION TO MANAGERIAL PERSONNEL

A managerial rank employee who has been promoted is entitled to a 5% salary increase (provided that at least 12 months have elapsed since the date of his last entitlement to such increase due to promotion and/or transfer). A managerial rank employee who has been transferred to another position is entitled to an increase of 2% to 7% of the salary according to the salary table (basic salary components), at management's discretion, taking into account the additional responsibility and/or the special managerial effort required for adaptation to the new position following the transfer, and provided that at least 12 months have elapsed since the date of his last entitlement to such increase due to promotion and/or transfer. As at December 31, 2009, the staff of the managerial grade numbered 1,267 (December 31, 2009: 1,224 employees).

## OFFICERS AND SENIOR MANAGEMENT MEMBERS GROUP OF THE CORPORATION

Members of this group of employees are subject to an advance notice period longer than the period set by the law, and to the period of the occupational limitation (between two to twelve months), in respect of which they are entitled to an adaptation grant (2-12 monthly salaries).

For details regarding a stock option plan for the Bank's senior officers, see Note 13 D to the financial statements.

## AWARDS TO EMPLOYEES AND MANAGERS OF THE BANK

For details regarding an award plan for members of management, see Note 16 to the financial statements. The budget for the plan would be determined on the basis of the annual return to capital of earnings from ordinary operations. The awards would be granted according to the rate of return. The aim of the plan is to create a structured relation between the success of the Bank and the remuneration of employees and managers in the short and long term.

**Award in respect of 2009.** The Bank's Board of Directors decided at the end of March 2010, to grant Bank employees an award in respect of the year 2009 in an amount equal to 0.9 of a monthly salary.

**Award in respect of 2008.** The return on capital in 2008 did not establish the right to a bonus in respect of the year 2008, in accordance with the bonus plan for that year. In March 2009, the Bank's Board of Directors decided to grant the Bank's employees a special award in respect of 2008 equal to one half of a monthly salary.

## WORK ON THE DAY OF REST

The Bank's personnel on duty at the computer center and security personnel work on rest days as defined in the Work and Rest Hours Law, 1951. The work of computer workers on duty on such days requires a special permit obtained by the Bank and which is extended from time to time. The work of security personnel is performed in accordance with a general permit.

## RETIREMENT OF EMPLOYEES

Following are details regarding the number of employees who retired from the Bank in the years 2006-2010:

The year	The total number of retired employees (including early retirement)	The number of employees who has elected early retirement
2010	62	13
2009	37	3
2008	86	28
2007	172	103
2006	262	205

## LABOR RELATIONS OF THE PRINCIPAL SUBSIDIARIES

**ICC.** An approach made by the New Federation of Labor was received by ICC in April 2010, according to which, over one third of the staff of ICC elected to join the New Federation of Labor. The Federation of Labor declared itself as the representative employee union among the staff of ICC and requested that the management of ICC begin discussions with it regarding labor relations at ICC.

**Discount Mortgage Bank.** An approach made by the Federation of Labor was received by Discount Mortgage Bank in March 2010, according to which, over one third of the staff of Discount Mortgage Bank elected to join the Federation of Labor. In light of this,

the Management of Discount Mortgage Bank has been asked to recognize the Federation of Labor as the representative organization. The parties conducted a verification of the facts in question, at the conclusion of which the Management of Discount Mortgage Bank recognized the Federation of Labor as a representative organization. On March 13, 2011, a collective labor agreement was signed for the first time with the representative committee of employees of DMB and the New Federation of Labor. The agreement constitutes the rights and terms of employment of the employees of DMB (with the exception of salary additions), and is in effect for the period until December 31, 2013.

**Mercantile Discount Bank.** Labor relations with employees of this bank, except for those having a personal employment agreement, are principally based on a basic labor agreement - "labor statute" - and complementary collective agreements. These agreements determine, among other things, that wage terms, work and related terms shall be linked to those of Bank Leumi Le'Israel B.M.

## LEGISLATIVE RESTRICTIONS, REGULATIONS AND ARRANGEMENTS

**General.** In addition to the labor charter, the various collective agreements existing from time to time, the Bank operates within the framework of laws and regulations applying to all entities in the economy. A short description of the principal restrictions applying to the Bank with respect to its labor relations is given hereunder.

**Amendment 24 to the wage protection law, 1958.** Amendment 24 to the Wage Protection Law came into effect on February 1, 2009, according to which an employer is required to provide his employees a monthly pay slip detailing the payment made to the employee. The amendment requires the pay slip to include certain details concerning the composition of wages. It is also required to state the number of days on which the employee actually worked, as well as the number of hours actually worked, including overtime, in accordance with the record keeping alternatives provided by the Law. The amendment set forth criminal sanctions and civil remedies.

The Bank is preparing to adapt the structure of the pay slip issued by the Bank to the format required by Amendment 24 to the Wage Protection Law.

## REMUNERATION POLICY IN A BANKING CORPORATION

A report issued in April 2008 by the FSF regarding the fortification of the capital and economic markets, referred to the negative influence which an inappropriate remuneration policy might have upon the volume and type of risks taken by banking corporation. Accordingly, the report contained a recommendation relating to the need to adjust the remuneration policies of companies operating in the financial sector to the long-term overall organizational profitability of the company.

On April 5, 2009, the Supervisor of Banks announced that as part of the adoption of the FSF recommendations and with a view of reducing risks emanating from inappropriate incentive structures, banking corporations and companies under their control are required to adopt no later than December 31, 2009, appropriate remuneration policies. The policy is to be determined by the board of directors based on wide overall organizational considerations (total payroll cost, desired wage differentials between various employee grades, etc.) and on the principles detailed in the said document.

The remuneration policy should be a general policy pertaining to all employees of a bank, special emphasis being put on the remuneration of senior members of management and of officers who influence the risk taking by the banking corporation.

Banking corporations were required to examine existing employment agreements in light of the remuneration policy to be determined and to the extent possible, to act towards changing/updating agreements that do not comply with such policy.

The Bank's Management had completed the drafting of the remuneration policy document, which was brought for approval of the Board of Directors at its meeting of January 11, 2010. The Board adopted the principles of the remuneration policy and directed the Bank's Management to submit a work plan for the implementation of the said principles.

The Board has determined that within the framework of the discussions of the remuneration plans and/or the update of the remuneration plans, the need for the uniformity of the parameters entitling the various employee populations to the right to an award, should be considered.

The Board noted that the remuneration policy document would be presented to the subsidiary companies, with a recommendation

by the Bank that the principles of the remuneration policy should also be adopted by them. During 2010, the human resources layout in coordination with the subsidiary companies is to examine the agreements and/or remuneration plans existing at the Bank and/or at the subsidiaries with the principles of the remuneration policy, and if it transpires that an agreement and/or a remuneration plan are not in line with the principles of the remuneration policy, the human resources layout in coordination with the subsidiary companies, as the case may be, will act to make the necessary adjustments, to the extent possible.

It has also been decided that at least once a year, the remuneration policy document will be brought before Management and thereafter before the Board of Directors, for validation and reapproval.

During 2010, the Bank established principles for the application of the Bank's remuneration policy, in line with the approved remuneration policy and according to the nature of operation at the various divisions of the Bank. The Human Resources Layout is at the final stages of forming the application program, and upon its completion, it will be submitted to the Management and the Board of Directors for approval.

The remuneration policy document has been submitted to the principal subsidiaries in the Group. The Human Resources Layout assisted the principal subsidiaries in the preparation of their own remuneration policy documents, and submitted its comments thereon prior to approval by the respective boards of directors of such subsidiaries.

The remuneration plans for the Bank's Chairman of the Board and for the President & CEO (see Note 22 (G) and (H) to the financial statements) have been prepared in accordance with the principles of the remuneration policy adopted by the Bank.

## DEVELOPMENT OF HUMAN RESOURCES

Development of human resources at the Bank reinforces the Bank's ability to address successfully its business and organizational challenges, through:

- **Constructing, cultivating and reinforcing the Bank's comprehensive managerial backbone** by means of developing a strategy supportive managerial leadership, having a business orientation (service, profitability and value growth) and human resources development and cultivation, in three channels:
  - (1) Leadership developing leading managers
    - Model program - a multi-annual personal development framework for the Bank's talented personnel. A comprehensive process was launched in April 2010 for the dynamic formation of knowledge and learning, evaluation, personal experience and transition between positions with respect to managers demonstrating excellence and identified as having a potential for performing senior executive duties;
    - The formation of an influential leadership made up of medium level managers from across the organization - an initiating professional management force, promoting innovation and change.
  - (2) Management - strengthening proficiency
    - Academic enrichment for senior management of the Bank and of subsidiaries in the Discount Group as leaders of strategic subjects;
    - Branch and department managers:
      - (A) "An executive training room" - a practical-applied exercise environment, subject focused, to strengthen the variety of managerial abilities and qualifications of branch managers and of department managers, and to improve the field-head office mutual perception.
      - (B) "Branch Managers Forum" - a professional forum that enhances the organizational positioning of the post and increases the managers' ability to lead changes. In addition, the forum serves as a colleague meeting place for joint learning;
      - (C) Training both with respect to professional-banking aspects and with respect to managerial-behavioral aspects, adapted to the needs of managers in the various divisions.
  - (3) Reserves - establishment of the future executive cadre
    - Training reserves for duty (lower and intermediate grade managers);

- Preliminary planning of a development course for the establishment of a cadre for the purpose of management duties at branches. Identification, development and preservation of employees with management potential, within the framework of a classification process integrated into the other development processes at the Bank.

Personal development serves as a central layer of the management reinforcement, and is performed through a variety of methods for improvement of qualifications, evaluation and feedback:

- Assisting and advising managers when assuming new duties and/or on the job managerial training;
  - Sociometry and emotional intelligence as part of executive training and within the framework of developing managerial teams and organic units;
  - "Bottom-up appraisal" (evaluation of managers by their staff) and self-evaluation (by the manager) as well as a complementary process of personal counseling feedback for the manager (Coaching).
- **Improving professionalism and preservation of the professionals**
- Recruitment of and designing a manpower mix with a "desirable" profile, framing and integrating career courses and training and preservation programs of core banking duties;
  - A comprehensive development policy for investment consultants - application of a professional-hierarchical advancement course, a training and qualification program at the various stages of the course and preservation and remuneration mechanisms. An outline and operational framework were established in 2010 for the investment consultants forum - a reinforcing framework for discussion of dilemmas in the matter of the work environment of investment consultants (at branches and at investment centers) and the relation between them and the branches;
  - Pension consultants - advanced professional-banking training on the subject of pensions, focusing on the relations with the customers;
  - Credit officers - instruction complementing knowledge with respect to professional, business and conduct aspects, in accordance with the findings of knowledge mapping;
  - Bankers in service teams - new integrative instruction for the position that includes a qualification component. Instruction in the position by means of a study process for the focused improvement of performance, carried out during work at the branch as well as frontal learning. At the end of the instruction, the employee undergoes a general professional proficiency examination. The innovative training concept standing at the base of the process has been presented in the annual international conference of the American Society for Training and Development (ASTD) in 2010.
  - Tellers - Providing operating retail knowledge and skills relevant to the core duties of the teller as preparation for transition into service team banker with a focus on self study.
- **Development on the organic level**
- Implementation of a multi-disciplinary approach for development on the basis of the "custom made" principle; namely, a basket of organizational and personal development activities designed for the unique needs of the organic unit, designated professional teams and/or professional groups (based on occupation and/or hierarchy grading) from the aspect of organizational consulting (Development of managers and of teams, etc.), service, training and organizational culture. The activity basket is the product of a comprehensive organizational survey.
- Organizational consultancy was carried out during 2010 within the framework of the organizational changes made in the capital market department, operations department, international institutional banking, the international private banking center in Tel Aviv, in business development for foreign residents and within the framework of establishing new concept branches.

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## IMPROVEMENT OF SERVICE

The service concept of Discount Bank sees in the customer an individual who provides the Bank and its employees significance, work and a living. The Bank aspires to create for its customers a personal service experience, causing them to continue and elect it as their bank.

A wide scope training program began in 2010 for the integration of the service concept in the Banking Division - structure of the duty concept and establishing central work processes, while focusing on the customer. Exposed to this concept were the management of the Banking Division, branch managers, officers and selected units of the divisional head office (the service and sales department, business customer department, direct channels, credit centers, regional consultants and the collection department) and in the coordination and planning department, who dictated and validated the critical work processes in the spirit of the service concept.

The integration process had been also supported by study groups for regions managements and by a personal advisory service to each of the regions managers.

At the same time, the application of the nurturing concept continued regarding the experience of the customer at the investment centers, in the information protection department, in the security department - theory and designated measurement processes reflecting the hospitality experience of the customer. Furthermore, the contents of the various professional training at the Bank are divided by occupation and adjusted to the service concept.

**Measurement of the customer's experience.** Measurement of the customer's multi-channel experience continued also in 2010 at the branches, investment centers and in the large corporations department. Measurement data is provided to the managers of the business units as soon as the findings are received and serve as a basis for drawing conclusions from cases of failure or success in providing response to customers. In cases where immediate intervention is required, the unit manager addresses the customer in providing a personal response.

**Handling complaints.** The reduction in the number of complaints was defined as a system objective also in 2010. This, while maintaining the commitment and managerial responsibility all along the managerial backbone.

The focused effort in the years 2009-2010 led to the continued improvement in this field, the number of complaints received through the bank-customer relations department of the Supervisor of Banks at Bank of Israel has declined significantly, from 346 complaints in 2009 to 261 complaints in 2010, a 24.6% decline. (following a decrease of 16.7% in 2009) the rate of complaints found justified had dropped from 25% in 2009 to 22% in 2010 (38% in 2008). The grade awarded to the Bank by the Supervisor of Banks regarding the quality of complaint handling was 93.5% in 2010, compared to 89.3% in 2009 (90.6% in 2008).

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## INFORMATION MANAGEMENT

Information management constitutes an important layer in the management of employee professionalism, influences the quality of service at the Bank and forms a part of the work procedures therein.

Information management is designed to provide an answer to several central challenges:

- Accumulation of professional knowledge, its preservation and its reuse;
- Knowledge sharing by all relevant factors in the organization;
- Turning covert knowledge into overt knowledge;
- Directing the required information to the user in the shortest possible time;
- Improving performance and attaining business goals.
- Shortening of reaction time and the transfer of required knowledge in the fastest and most efficient manner;

The organizational portal on the Intranet system at Discount Bank comprises a central tool in Information management.

Dozens of substance experts currently maintain information communities and information sites. These sites and communities are connected to the core business activities and to central organizational processes, thereby supporting raising the level of employee professionalism and customer satisfaction. An outstanding example is the establishment in 2010 of the Operations and Logistics Division's website and a risk management website.

Statistical data indicate broad use by the employees of the information management tools, which enable beneficial sharing of professional and organizational knowledge.

Additional organizational and cultural processes, such as the selection of outstanding employees and activity in aid of the Bank's

community and accessibility, are accompanied by designated sites planned to provide a response both as to current information regarding the process and as to the possibility of interactive staff operation.

Activities of drawing conclusions, apprenticeship processes and the transfer of duties are also accompanied by designated know-how management tools. Additional applications provide the use of computerized forms, the distribution of procedures and circular letters and competitive data management.

The development of tools and framework for operational needs is performed while emphasizing aspects of cost saving and efficiency. The Bank's information management activity in 2010 focused on the establishment of information communities in the organizational portal and their upgrading. Resources have been invested in improvements and organizing the content at the sites, in order to make them user friendly.

In addition, the activity of the organizational forum of leaders of the information communities - the forum for information sharing regarding methodology and tools, has continued alongside studying developments in this field at other organizations in Israel.

**Drawing conclusions.** Within the framework of promoting organizational learning and integrating risk management concept, the Bank cultivates a culture of drawing conclusions in order to expand organizational knowledge, information sharing, duplicating success and avoiding failure.

Two steering teams lead the integration in the Corporate Banking Division and in the Human Resources Layout. The teams form a policy in the matter of drawing conclusions and lead its implementation, namely, promoting the carrying out of enquiries, assistance in implementing the studied conclusions, distribution of the information derived from such enquiries to other relevant factors, identification of repeated patterns and performing learning inclusion.

A process began in 2010 of an integration process for the drawing of conclusions by the legal advisory service layout.

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## ORGANIZATIONAL CULTURE

**The Discount code of ethics.** The Bank's code of ethics is based on five basic values of Discount Bank people oriented banking vision of: the love of humanity, professionalism, integrity, initiative and commitment. The process of integrating the code in the organization has been intensified in 2010, lead by managers according to the management chain.

**Work-life balance.** In 2010, the Bank continued a move towards promoting an organizational culture of balancing work-life that respects Bank employees' major life events. Ten senior managers, who had received coaching training on this subject, form the leading forum for building and integrating the concept at the Bank.

**Intra-organizational communication - "Taking you personally".** The Bank is investing in the development of open and two-sided communication with its employees, within the framework of realizing the promise of "taking you personally" with respect to both external and internal customers. The intra-organizational communication layout is designed to strengthen the employees feelings of kinship and commitment, while cooperating and providing answers to their questions and expectations.

In order to sense the employees' state of mind, challenges and questions, meetings at various levels are conducted, discussion groups and feedback processes, including:

- Round table - a meeting of the President & CEO or of one of management members with managers and employees;
- Monthly tours of management members at branches and field units accompanied by senior managers from their head offices;
- Intra-organizational surveys, including an "organizational feedback" (survey of employee viewpoints).

With a view of broadening employees' knowledge and understanding as to the Bank's total activities and in order to deliver organizational messages, a variety of communication lines were also used during 2010, including: Senior Forum - a quarterly meeting led by the President & CEO; "Morning magazine" - a weekly television newscast presenting subjects standing at the core of the Bank's endeavor; Employee portal (Intranet) and more.

New communication channels were added in 2010, as follows:

- Group communication forum - periodic meetings for professional discussion of central issues and mutual learning, with the

participation of representatives of companies in the Group;

- "Personal angle" - an Internet newsletter, which includes news and updates concerning various subjects of interest to employees;
- "Talking about results" - communication of business results and their implications to the management chain. A move "connecting" managers to strategic and organizational processes and to the business results, as agents for communicating the information and its implications, with the aim of intensifying responsibility and the commitment of the individual and the unit to the Bank.

**Measurement and evaluation.** In 2010 resources were invested in improving the measurement and evaluation tools, with a view of creating an infrastructure for an objective and relative measurement of production, creating true differentiation and instigating action.

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## TRAINING

In 2010, the staff at the Bank received a widespread response to their professional requirements by means of extensive training and instruction towards the core position (qualification), improvement of business performance (proficiency) and elimination of performance gaps

The knowledge gaps in various areas were filled in during the year according to the identification of needs conducted at the various units. Among other things, an answer has been provided for training needs derived from regulatory instructions that have effect on the banking industry and/or consumer instructions such as impaired debts, prohibition of money laundering and the finance of terror and the Commission Act.

Focus is put on short and applicable training of a varied and innovative mix; experience on the production line, field instruction, apprenticeship and distant learning. A part of the courses was provided by study flashes, their distinction being in their rapid arrival at the employee's "work desk" and in the uniformity and clarity of the message transmitted to a particularly large population.

In the course of 2010 strategic moves at the Bank were addressed at the training level, including:

- Integrating the concept of customer focused promotional service, among the management of the Banking Division and head office positions at the Division, as well as instructing bankers and head of teams at the personal service center;
- Training of all managerial teams at the branches layout on the subject of profitability focused negotiation management and the training of deputy managers in management and operating aspects;
- Training of pension consultants - advanced professional training on the subject of pension; introduction of work principles with a focus on maintaining relations with the customer; the concept of the duties, tools and skills and "contents and management "connection" of branch managers in which pension consultants operate;
- Renewal of the training of tellers, the future cadre for work in service teams;
- Training of all 207 unit compliance trustees in the branches layout and in the Bank's units.

As part of improving professionalism, training continued in 2010 regarding core duties dealing with credit, investment consultancy, bankers in service teams, bankers in concept branches and tellers.

Considerable resources have been invested in professional training specializing in IT, project management, impaired debts and risk management.

**Retail.** A comprehensive training program was initiated in 2010 in the matter of personal goals management as a tool for improving business performance and attaining branch targets. Training has been provided to officers engaged in service and sales duties in the Banking Division and in management teams at the branches.

**Scope of training.** The number of training days in 2010 reached 36,931 compared with 34,127 training days in 2009, a rise of 8.2%. The data regarding the number of trading days relate to actual training days on the College premises, and does not reflect individual study activity that was implemented with respect to a variety of subjects and sectors.

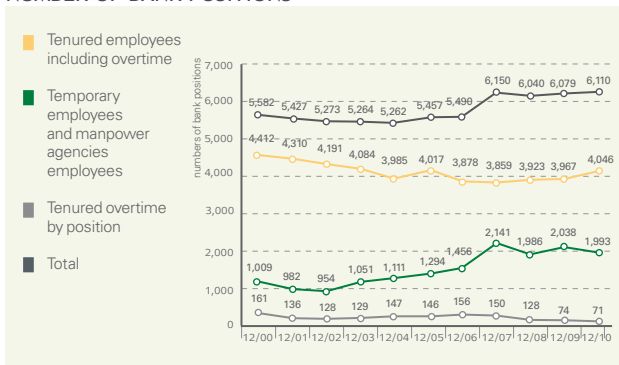
## INVESTMENT IN TRAINING

The Bank's investments in training and in the development of human resources amounted to NIS 18.4 million in 2010, compared with NIS 16.7 million in 2009. The amount includes the training of employees on various subjects of (developing and conducting training activities as well as training consultation). The amount also includes the cost of financing academic studies for Bank employees as well as expenses for professional training, seminars, etc. The amount does not include indirect expenses for instructors' fees, rent and building maintenance. The amount does not also include the relative part of employee payroll in respect of the participation of the staff in providing training courses, in the Bank's training framework, in self study by means of the distant learning computer systems and participation in outside training frameworks.

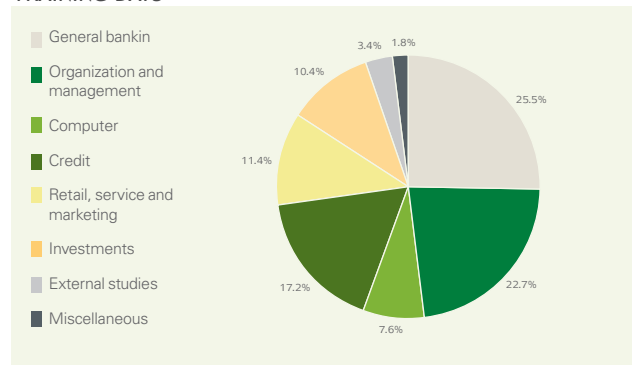
Furthermore, for the purpose of conducting the training, the Bank appoints mentors and training partners who are Bank employees and who, in addition to their regular work, assist in training and in the preparation of training material. The cost in this respect is not included in the above amount.

The increase in investments in 2010 is explained by initiating a development of management and leadership policy at the Bank, in a wide scope process of integrating the service concept and in the increase in scope of professional training in the IT field.

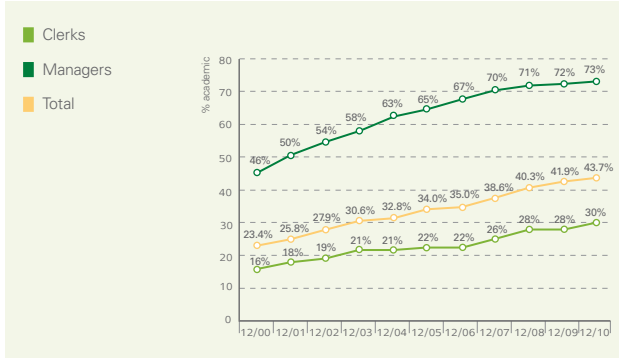
### NUMBER OF BANK POSITIONS



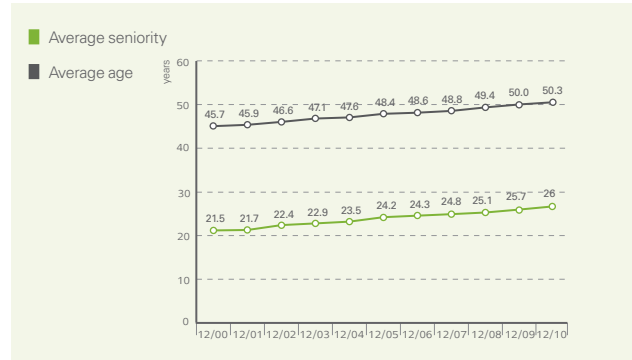
### TRAINING DAYS



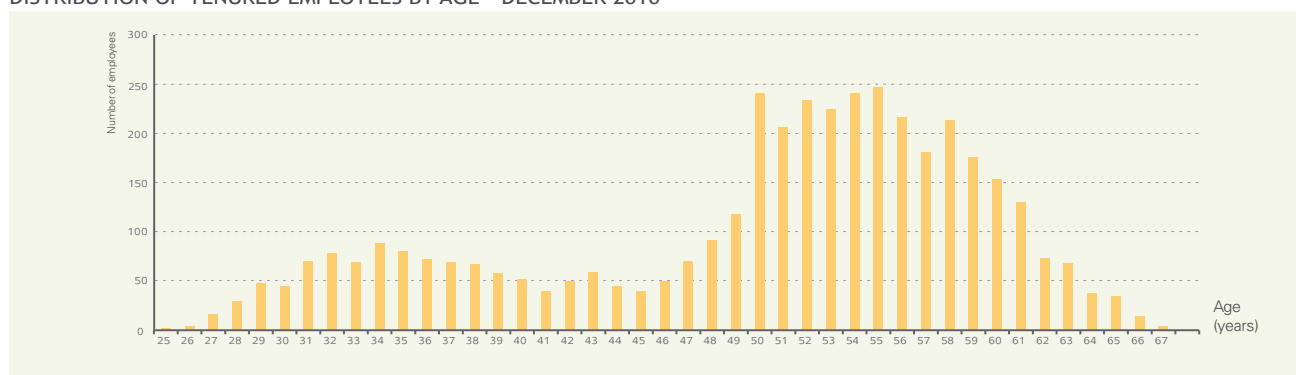
### THE RATE OF UNIVERSITY GRADUATES ACCORDING TO GRADE



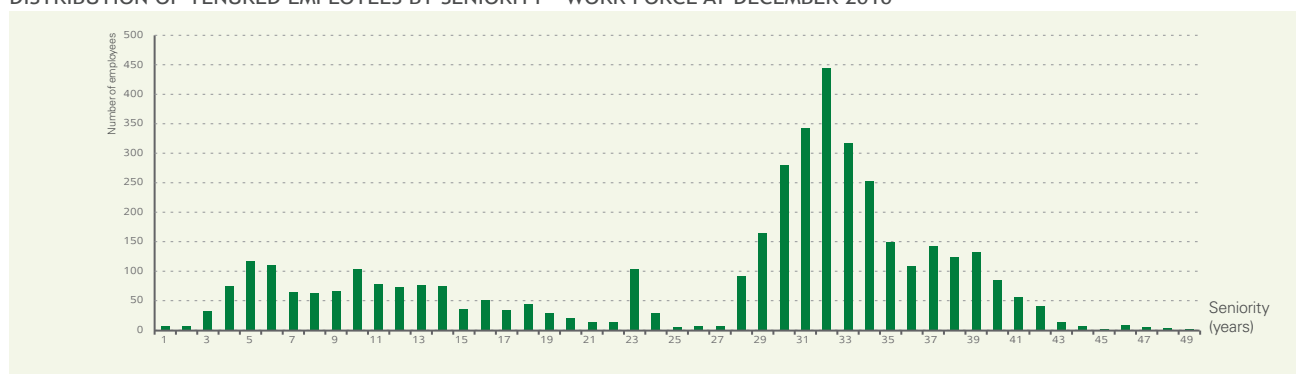
### AVERAGE SENIORITY AND AVERAGE AGE



DISTRIBUTION OF TENURED EMPLOYEES BY AGE - DECEMBER 2010



DISTRIBUTION OF TENURED EMPLOYEES BY SENIORITY - WORK FORCE AT DECEMBER 2010



## CONTROL OF THE BANK

### GENERAL BACKGROUND

In consequence of the crisis on the shares market in October 1983, with respect to the "regulation" of this market, and as part of the measures taken to confront the situation that had occurred, The Government of Israel, on behalf of the State of Israel, entered into a series of agreements that created an arrangement to finance the acquisition from the public of the shares in each of the banking groups that were involved in the crisis. In accordance with the Bank Shares Arrangement (Temporary Provision) Law, 1993, (hereinafter - "the Bank Shares Arrangement Law"), the Bank's shares were transferred to the ownership of the State of Israel on October 31, 1993, which as from that date became the controlling owner of the Bank, due to its holdings of the Bank's shares.

Up to January 31, 2006 the State held 559,870,403 of the Bank's Ordinary "A" Shares, comprising 57.09% of the Bank's outstanding capital and of the voting rights therein, this, after two offers for sale by the State of the Bank's shares made in 1996 and 1997 to the public and to the Bank's employees, in accordance with Prospectuses published by the State and the Bank, and after a private placement of the Bank's shares made to institutional investors in 2001.

According to the information provided to the Bank, on January 31, 2006, the transaction for the sale of a controlling interest in the Bank entered into on February 1, 2005 by M.I. Holdings Ltd. and the Government of Israel (hereinafter - "the Government") on the one hand, and the Bronfman-Schron Group (hereinafter - "the Buyers") on the other hand, (hereinafter - "the Agreement for the sale of a controlling interest in the Bank"), was completed. In the Agreement the Bronfman-Schron Group had purchased shares in the Bank which comprised 26% of its issued share capital (hereinafter "the control nucleus") and was granted an option for a period of three years from date of the closing of the transaction, which expired in the end of 2008, to purchase further shares

which comprised up to an additional 25% of the Bank's issued share capital.

For arrangements that have been made between the Government and the Buyers as to the coordination of their voting and of their exercise of control of the Bank see "Arrangements with Regard to Cooperation Between the Buyers and the Government, in Respect of Holding Shares of the Bank and Exercising the Control in the Bank" and "Instituting the cooperation arrangements between the buyers and the Government as from January 1, 2009 onwards", below.

In May 2006, the State sold shares comprising 6.09% of the Bank's issued share capital and during 2010 the State sold the remaining shares held in the Bank (see below "The sale of shares of the state in the bank"). Upon the sale by the State of the remaining shares in the Bank held by it, all the arrangements regarding cooperation between the Bronfman-Schron Group and the Government have expired.

## ENTITIES IN POSSESSION OF BANK SHARES

On December 31, 2010, and on a date proximate to the date of publication of this Report the Bronfman-Schron Group held 265,164,841 of the Bank's ordinary A Shares of NIS 0.1 each par value (hereinafter: "the ordinary shares"), comprising approx. 25.16% of the Bank's outstanding capital and of the voting rights therein.

The Bronfman-Schron Group's holdings in the Bank's shares are as follows:

159,098,904 ordinary shares, representing approx. 15.10% of the Bank's issued capital and of the voting rights therein, are held by the limited partnership Treetops Acquisition Group LP (hereinafter: "Treetops");

106,065,937 ordinary shares, representing approx. 10.06% of the Bank's issued capital and of the voting rights therein, are held by the limited partnership Treetops Acquisition Group II LP (hereinafter: "Treetops II").

Treetops is a limited partnership that was incorporated in the Cayman Islands. The limited partners in Treetops are members of the Bronfman Group, as set forth below:

- Edgar Miles Bronfman IDB Trusts A through G (seven trusts), the beneficiary whereof is Edgar M. Bronfman, hold approx. 64.273% of Treetops;
  - Matthew Bronfman personally holds approx. 6.424% of Treetops;
  - Matthew Bronfman IDB Trust, the beneficiary whereof is Matthew Bronfman, holds approx. 6.424% of Treetops;
  - Holly B. Lev IDB Trust, the beneficiary whereof is Holly B. Lev, holds approx. 6.424% in Treetops;
  - Adam R. Bronfman IDB Trust, the beneficiary whereof is Adam R. Bronfman, holds approx. 6.424% of Treetops;
- Edgar M. Bronfman is the father of Matthew Bronfman, Holly B. Lev and Adam Bronfman. All the trusts specified above are hereinafter jointly referred to as "the Bronfman Trusts". The trustees of each of the Bronfman Trusts have empowered the beneficiary of the Trust (and with regard to the Trusts the beneficiary whereof is Edgar M. Bronfman, the head of the family - the power of attorney has been given to Edgar M. Bronfman and Matthew Bronfman, provided that in the event of a dispute between them, Mr Edgar M. Bronfman's opinion shall prevail) to make all the decisions with regard to the investment in the Bank, save for matters of replacement of the power attorney (subject to the Bank of Israel's prior approval), making further investments in Treetops and/or the Bank and a sale, entering into and agreement for a merger agreement or any transfer of the interests of the Trusts, in Treetops and/or the Bank.
- PLM/IDB Investment LLC, a company fully owned by Philp Millstein, holds approx. 6.424% in Treetops;
  - Rubinoff IDB Holdings LP, a limited partnership fully owned by Michael Rubinoff, holds approx. 3.207% in Treetops.

In addition to the Bronfman Group members the limited partnership Treetops Special Limited Partner LP (hereinafter: "SLP"), incorporated in the Cayman Islands, holds approx. 0.2% of Treetops, as limited partner. The limited partners in SLP are Matthew Bronfman (approx. 65%) and Michael Rubinoff, through Rubinoff IDB Holdings LP (approx. 35%). The SLP's general partner, is Treetops SLP Ltd., (a company fully owned by Matthew Bronfman, incorporated in the Cayman Islands) holds approx. 0.2% of SLP.

Treetops' general partner, that holds approx. 0.2% of Treetops, is Treetops Acquisition Group Ltd (hereinafter: "Treetops Ltd."), a company incorporated in the Cayman Islands. The means of control in Treetops Ltd. are held by the Bronfman Group members,

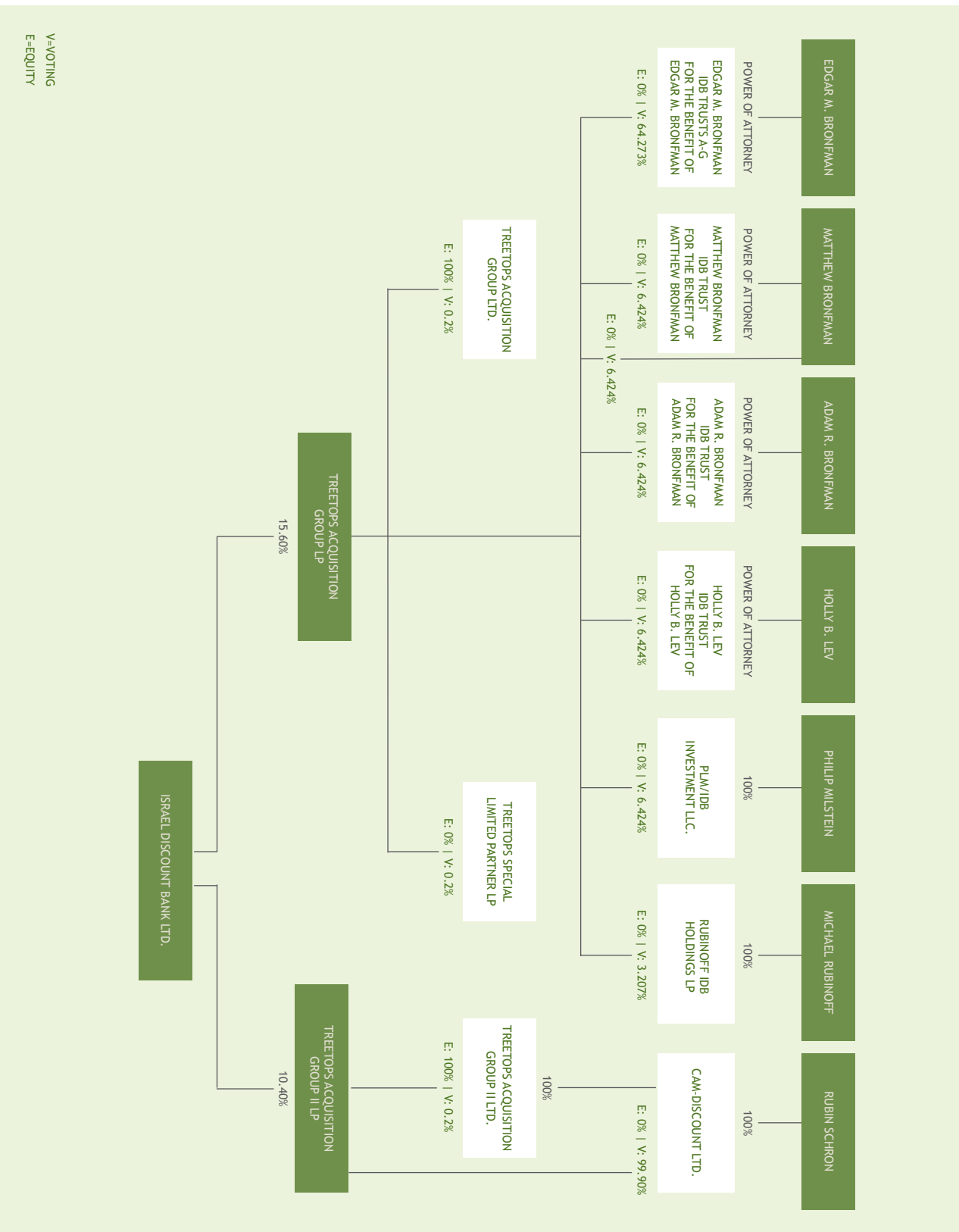
in accordance with the ratio of their holdings in Treetops.

Treetops II is a limited partnership incorporated in the Cayman Islands. The limited partner of Treetops II is Cam Discount Ltd. (hereinafter: "Cam Discount"), that holds approx. 99.8% of Treetops II. Cam Discount is a company incorporated in the Cayman Islands, all the means of control wherein are held by Rubin Schron.

Treetops II's general partner, that holds approx. 0.2% of Treetops II, is Treetops Acquisition Group II Ltd (hereinafter: "Treetops II Ltd."), a company incorporated in the Cayman Islands, all the means of control wherein are held by Cam Discount.

For details regarding the arrangements between the buyers and the government and arrangements among the buyers, see this chapter hereunder.

CONTROLLING SHAREHOLDERS OF ISRAEL DISCOUNT BANK LTD.



## THE GOVERNOR OF THE BANK OF ISRAEL'S PERMIT FOR THE CONTROL AND HOLDING OF MEANS OF CONTROL IN THE BANK

The Governor of the Bank of Israel, after consultation with the licensing committee, granted on January 29, 2006, a permit to Edgar M. Bronfman, Matthew Bronfman, Adam R. Bronfman, Holly B. Lev, Michael Rubinoff, Philip Milstein and Ruben Schron (hereinafter: "the Group"), to jointly control and hold means of control in the Bank in a percentage of 26% of any type of means of control in the Bank (see below for details regarding an amendment to the permit, according to which the rate for a limited period, will be 25.01%). In addition the Governor permitted the Group's members to hold additional means of control in the Bank, in a percentage not exceeding 40% of any type of means of control, all subject to the percentage determined in such regard in respect of each of the Group's members in the annex to the permit. The annex to the permit details the holding of each member of the Group in the Bank and in Treetops and Treetops II partnerships, as detailed in "Entities in possession of Bank shares" above. The corporations and trusts details as aforementioned are prohibited from engaging in any business other than holding the means of control in the Bank. Further detailed in the annex to the permit are the additional percentages of means of control that any one of the members of the Group is permitted to hold beyond his or her share in the controlling interest. It is further determined that additional percentages of means of control will be held in the same manner as that of the controlling interest.

The said permit also includes a permit to control and hold means of control, through the Bank, in banking corporations controlled by the Bank, and in which it duly holds the means of control, all as shall be from time to time.

Following are the main conditions of the permit:

1. "Controlling interest" or "minimum percentage" means at least 26% of any type of means of control in the Bank, divided amongst the Group's members in the manner and ratio detailed in the annex to the permit. (See below for details regarding an amendment to the permit, according to which the rate for a limited period, will be 25.01%).

The Group shall reserve, at all times, the minimum percentage.

2. If the Bank issues, after the grant of the permit, rights to shares or any other security convertible into shares, the Group shall maintain the minimum percentage holdings, computed on the basis of full dilution.
3. (a) For a period of five years subsequent to the date of the grant of this permit, the Group shall not directly or indirectly sell or transfer means of control in the Bank, if as a result thereof it is left with means of control of any type in a percentage lower than the minimum percentage. Any one of the Group's members may sell means of control from the additional percentage exceeding his or her share in the controlling interest, provided that a minimum of six months have elapsed since the last purchase affected by such Group member (in such regard, the exercise of the option from the government shall not be deemed a purchase act).  
(b) Five years from the date of the grant of this permit, the Group may sell or transfer its means of control, provided that it sells or transfers the entire means of control constituting the minimum percentage, to an individual or a Group that has duly received a permit for the control and holding of the aforesaid means of control.

In the Supervisor of Bank's letter annexed to the permit (hereinafter: "the letter annexed to the permit") it was stated that in the event that after five years from the date of the grant of the permit a decision is made by the Buyers to sell means of control in the Bank from the controlling interest such that after the sale none of the Group's members or the buyers require a permit for the control or holding of the means of control in the Bank, pursuant to the law, the following provisions shall apply:

- The two Buyers shall approach the Governor of the Bank of Israel, notify him of their decision and detail the manner of the sale planned by them;
- Before the sale of the means of control, as aforesaid, the Buyers shall make a preliminary with the Governor of the Bank of Israel, regarding the arrangements that shall be made, including the modification of the permit and the trust instrument, in order to allow them to effect the sale of the shares within a reasonable period of time (hereinafter: "the transitional period"), taking into account, inter alia, the implications on the Bank's management and transfer thereof, business

relations with the Bank, the market conditions and the quantity of shares being sold, and the format of holding and voting in respect of the Bank's shares constituting a holding of more than 5% of the means of control in the Bank during the transitional period (without such derogating from the Buyers' fundamental right to effect the sale, as aforesaid).

- (c) Notwithstanding the abovesaid, an additional member may be added to the Group and each of the Group's members may, at the end of five years as aforesaid, transfer or sell the means of control held by him and constituting his share of the minimum percentage, or part thereof, provided that the transferee or buyer cooperate on a regular basis with the rest of the Group pursuant to the Summary of Principal Terms entered upon by the Group as aforementioned, or another agreement approved the Supervisor of Banks, and that a permit was duly granted for the control and holding of the aforesaid means of control. Notwithstanding the above, an additional member may be added to the Group and a Group member may transfer or sell means of control as aforementioned also during the five year period from the grant of the permit, provided that the conditions set forth above had been fulfilled, and provided that the Group will continue being the leading factor both in regard to the percentage holdings as well as with regard to the cooperation between them.
4. (a) The Group's members and the entities through which the means of control are held shall act in accordance with the Summary of Principal Terms approved in advance and in writing by the Supervisor. The beneficiaries of the trusts from the Bronfman Group shall act in accordance with their undertakings to the Bank of Israel, which were approved in advance and in writing by the Supervisor. Rubin Schron, Matthew Bronfman and Michael Rubinoff were permitted to hold a higher share of the right to participate in the Bank's earnings, in accordance with the terms of the cooperation agreement between members of the Group.
- (b) The Group's members shall at all times hold the control and means of control in the Bank in the percentages and manner set forth and specified in paragraph 4 and in the addendum in respect of each of them, and shall not sell or otherwise transfer to another, including to corporations or other entities controlled by them, directly or indirectly, means of control in the Bank or in any of the entities detailed in these paragraphs, even if such sale or transfer does not require a permit pursuant to section 34 to the Banking Law (Legislation), 1981, (hereinafter: "Banking Law (Legislation)), unless otherwise provided in this permit or unless the Supervisor grants his prior written consent thereto.
- In this regard, "sale" - includes a charge, save for certain charges within the Group specified in the permit.
- (c) Notwithstanding the aforesaid, for a period not exceeding three years from the date of the grant of this permit, the provisions of sub-paragraph (b) regarding a charge shall not apply to 6% of the means of control in the Bank that will be charged to the Government of Israel to secure the debt of Treetops and Treetops II to the Government.
5. (a) The Group's member shall not expressly or impliedly agree to the imposition of an attachment on the means of control in the Bank or any of the entities detailed in the permit. The Group's members shall not act in any manner that is such as to actually alter the ownership rights in these means of control or the rights embodied therein and detailed in the definition of "means of control" in section 1 of the Banking Law (Legislation).
- (b) Should an attachment be imposed despite the aforesaid, over means of control as aforesaid held by a member of the Group, the said member shall act in a way available to him for the immediate removal of the attachment.
6. The means of control in the Bank which are held directly shall be deposited by the Group, for the Group's members or for the Group's members and the government, as the case may be, with one or more Israeli resident trustees whose identity, trust instruments and the instructions given to them within the trust instruments shall be subject to the Supervisor's prior written approval.
7. The Group's members, their relatives or corporations under the control of any one of them shall not receive management fees or any other consideration neither from the Bank nor from corporations under the Bank's control; however, they may provide services ordinarily provided by the providers thereof, at market prices, provided that prior written notice has been given to the Supervisor regarding the nature of the service and the consideration, at least 14 business days prior to providing of the service; if the Supervisor has given notice that the service is not of the type ordinarily provided to others or that the consideration for the service is unreasonable, the service shall not be provided.

The provisions of this paragraph shall not apply to directors' remuneration that is paid in an identical amount to all the Bank's

directors.

8. (a) No dividend shall be distributed from the Bank's profits that accrued prior to September 30, 2004. If losses accrued after this date, no dividend shall be distributed until after these losses have been covered; in addition, no dividend shall be distributed from profits from the sale of the Bank's material assets for five years from the date of the grant of this permit.

Thereafter, dividend may be distributed from the sale of assets as aforesaid, subject to the Supervisor's prior written approval (The profits that accrued in the Bank prior to September 30, 2004, which are not available for distribution as aforesaid, amounts to NIS 2,704 million).

- (b) Notwithstanding the aforesaid, dividend may be distributed from profits from a sale of the Bank's material assets in the five years following the date of the grant of the permit, on the fulfillment of all the following conditions:
- (1) The sale derives from legal requirements governing the Bank;
  - (2) The distribution of dividend from profits from a sale of such assets does not result in a reduction in the Bank's minimum capital ratio existing prior to the sale of the said assets;
  - (3) The Bank's board of directors approves the distribution after examining the Bank's needs and its business plans;
  - (4) The Supervisor gives his prior written approval to an aforesaid distribution, after examining the Bank's capital adequacy and the board of directors' decision and the basis thereof.
9. (a) Without the Supervisor's prior written approval, the Group's members or any of them, or corporations under their control, shall not engage in any business, in Israel or abroad, of receiving deposits - even from less than 30 people, or granting credit, or any other financial business in Israel that is such as to compete with the Bank's business.
- (b) Without the Supervisor's prior written approval, the Group's members or any of them, or corporations under their control, shall not be interested parties, directors or senior managers in corporations engaging in business of the type mentioned in sub-paragraph (a) above; in such regard, "interested party" means someone holding 5% or more of any type of the means of control.

10. 100% of the total balance sheet assets of each of the purchasers is to be financed from capital. Notwithstanding, the purchasers will be entitled to finance the acquisition of the controlling interest by way of a debt to the Government of Israel. Financing of the purchase of the means of control in the Bank, including the grant of guarantees for financing as aforesaid, shall not be provided, directly or indirectly, by the Bank or by banking corporations under its control.

11. The Bronfman and Schron Group shall reduce their liability to the Bank in order to comply with Proper Banking Management Directive No. 312 concerning a banking corporation's business with related persons, unless otherwise approved by the Supervisor, in advance and in writing.

12. The Group shall do the utmost to ensure that the memorandum, articles of association and all the Bank's procedures will match and conform with, insofar as required and at any time, with the provision of the permit.

For details regarding the amendment of the permit granted by the Governor and the approval of the Supervisor of banks for the amendment of the agreement for the sale of a core of control in the bank, see below "Instituting the cooperation as from January 1, 2009 and thereafter".

**Amendment of the Governor's permit - November 2010.** According to information provided to the Bank on November 14, 2010, the permit for the control of and the holding of means of control of the Bank, granted by the Governor of the Bank of Israel on January 29, 2006, to the Bronfman-Schron group, has been amended, permitting the group to reduce its holdings, such that the "minimal rate" will be 25.01% of any class of means of control in the Bank instead of 26%, as was specified in the original permit for a period of three years since completion of the public offering. This, only for the purpose and in connection with the public offering of shares by the Bank to be effected after the Bank's publication of rights issue to its shareholders as well as for the purpose of the dilution stemming from option warrants allotted by the Bank in the past. (For details regarding the process of a rights issue and a public offering of shares, see above "Rights issue and public offering of shares" in the Chapter "Capital resources").

## ARRANGEMENTS WITH REGARD TO COOPERATION BETWEEN THE BUYERS AND THE GOVERNMENT, IN RESPECT OF HOLDING SHARES OF THE BANK AND EXERCISING THE CONTROL IN THE BANK

In the Agreement for the sale of a controlling interest in the Bank arrangements and various undertakings have been prescribed with regard to cooperation between the Government and the Buyers, in respect of their holdings of the Bank's shares, and with regard to the exercise of control in the Bank by the Buyers. Furthermore, certain contingencies were determined regarding the provisions of the Bank's Shares Arrangement Law. Among others, the following provisions have been prescribed:

- Provisions were prescribed that will apply for as long as the period for the exercise of the Option shall not have ended (meaning until the end of 2008 or before that due to the Full Exercise of the Option) (hereinafter "the Support Period") with regard to coordinating the manner of voting, by virtue of the Buyers' holding of the Bank's shares and by virtue of the holding of the Government of the option shares, at the Bank's general meetings and also with regard to the appointment of directors to the Bank's board of directors (regarding the amendment of the provisions of the agreement concerning this matter following the termination of the support period and the expiration of the option, see under Section "Instituting the cooperation arrangements between the Buyers and the Government as from January 1, 2009 onwards" hereunder).
- In this clause -
  - "The restriction period" means the period commencing on the closing date and continuing: (1) for so long as the Government and any party on its behalf jointly hold no less than 10% of the Bank's issued share capital or (2) until the end of four years from 31st December 2005, whichever is the shortest period.
  - "The additional period" means the period commencing at the end of the restriction period and continuing: (1) for so long as the Government and any party on its behalf jointly hold no less than 5% of the Bank's issued share capital; (2) until the end of three years from the end of the restriction period; or (3) until after the full exercise of the option, whichever is the shortest period.
- During the restriction period the Buyers shall not carry out any of the following actions (in accordance with Section 10.4 of the agreement for the sale of the control core) and they shall use their best endeavors to ensure that the Bank refrains from executing them, unless the action has been given the Government's prior written consent: (a) the voluntary winding up of the Bank; (b) a split of the Bank, merger of the Bank with companies that are not fully owned subsidiaries, a settlement or arrangement, within the meaning thereof in the Companies Law, 1999, to which the Bank is a party, and any similar operation that affects the Bank's issued share capital; (c) an allotment of shares, change of the rights attached to shares, increase of capital (authorized or issued) and the distribution of bonus shares or the issue of rights by the Bank; (d) payment of management fees or the grant of another benefit by the Bank or corporations of the IDB Group (within the definition thereof in the sale agreement) to interested parties in the Bank, save for determining the terms and conditions of the chief executive officer's employment, and every exceptional transaction in which an interested party at the Bank has a personal interest; (e) a change in the Bank's documents of incorporation.
  - Pursuant to the provisions of the agreement, the Government shall not refrain from granting its consent to the actions as set forth in sub clause (b) above and to the actions as set forth in sub-clause (c) above, that are required for such purpose, save on reasonable grounds, relating to a material change of the Government's rights pursuant to the Agreement for the sale of a controlling interest in the Bank or an impairment to the value of the Bank's shares that the Government holds or an impairment to its ability to sell them.
  - The Buyers have undertaken to use their best endeavors, subject to every law, in order to ensure that during the restriction period the Bank shall refrain from issuing shares and securities convertible into shares, save with the prior written consent of Holdings and the Government, and subject to the matters set forth below: (a) the Government and Holdings shall not refrain from agreeing to the issue of the Bank's shares in accordance with a written initiated demand of the Supervisor of Banks of the Bank of Israel, in accordance with his authority at law; (b) any issue as aforesaid to which the Government or Holdings have given their consent and also any issue of shares by the Bank, during the additional period, shall be effected

in coordination with the Government, and the Bank shall enable the Government to join the sale with shares of the Bank out of the shares that it holds, at a rate of up to one half of the total number being sold in any offer, and all subject to the terms and conditions prescribed for such purpose in the sale contract.

## INSTITUTING THE COOPERATION ARRANGEMENTS BETWEEN THE BUYERS AND THE GOVERNMENT AS FROM JANUARY 1, 2009 ONWARDS

**Activating the cooperation arrangements upon termination of the "support period".** As stated above, according to the agreement for the sale of the controlling interest in the Bank, the exercise period of the option given by the State of Israel to the Bronfman-Schron Group for the purchase of 25% of the Bank's shares held by the State, terminated on December 31, 2008. On this date the Support Period determined in the Agreement also expired.

Following previous notices delivered to the Bank regarding provisional extensions of the terms specified in the agreement, in everything connected to the exercise of voting rights attached to the Bank's shares held by the Government and to the Bank's shares owned by the Buyers, including provisions regarding the voting in general meetings of the Bank's shareholders and regarding the appointment of the Bank's Directors.

On February 15, 2009, the Bank received notice with respect to an amendment of the agreement for the sale of the controlling interest in the Bank. This amendment related to the provisions of Section 11 of the agreement with respect to the appointment of Directors at the Bank

According to the amendment, the arrangements regarding the appointment of Directors in the Bank applied in the period from February 16, 2009 until February 15, 2010 (hereinafter: "period of agreement"), subject to the following changes: so long as the Government holds at least 10% of the Bank's issued capital, the members of the Bank's Board of Directors, at any time, shall number at least 5 Directors, the identity of whom shall be determined by representatives of the Government, and not more than 8 Directors suggested for election by the Purchasers. In the event that the rate of holdings by the Government in the Bank's issued share capital shall fall below 10% during the period of agreement, the number of Directors suggested by the Purchasers shall not exceed 11, while the number of Directors whose identity is to be determined by representatives of the Government, will be 2. In addition, the identity of candidates suggested to act as outside Directors on the Bank's Board, shall for the first time during the period of agreement, in February 2009, be determined by the Purchasers and thereafter by the Government representatives, and so on and so forth. The parties shall also act towards the appointment of an additional Director in the Bank, whose identity will be determined by Government representatives, so that the total number of members of the Bank's Board of Directors will reach 15. Each of the parties may terminate the said amendment by way of a notice in writing to the other party 15 days in advance. Nothing in the contents of the amendment to the sale agreement shall in any way limit the rights of the State of Israel and of M.I. Holdings Ltd. with respect to the sale of Bank shares held by the State.

All other terms of the agreement remain unchanged, and accordingly, other provisions regarding the cooperation during the supporting period (as described above in the Section "Arrangements with regard to cooperation between the Buyers and the Government in respect of holding shares of the Bank and exercising control of the Bank"), have come to an end.

The Bank was further informed that following of the said amendment to the agreement, the permit granted to the Buyers on January 29, 2006, by the Governor of the Bank of Israel for the control and the holdings of means of control in the Bank, was amended on February 9, 2009, in a manner that allows the Buyers to permanently cooperate with the Government of Israel with respect to operating the control in the Bank, in accordance with the sale agreement as amended, to be approved in writing in advance by the Supervisor of Banks. The amendment to the permit further clarifies that extending the period of the agreement itself shall not require receipt in advance of an approval, and notice thereof shall be given to the Supervisor of Banks in writing within seven days of the date on which the period of the agreement was extended.

The Bank was also notified that in accordance with that stated in the amendment to the permit, the Supervisor of Banks approved on February 9, 2009, the said amendment to the agreement for the sale of the controlling interest in the Bank.

According to the information given to the Bank, the Supervisor clarified in February 2009, in response to an approach by the Bronfman Group, that he will allow the controlling group to appoint an observer on its behalf to the Bank's Board of Directors, and that the restrictions applying to a Director of the Bank will also apply to the observer.

**Activating the cooperation arrangements upon termination of the "restriction period".** As stated, in accordance with the agreement for the sale of the controlling interest in the Bank, the "restriction period" specified in the agreement came to an end on December 31, 2009. On February 1, 2010, March 16, 2010 and May 12, 2010, the Bank received notices from the controlling shareholders in the matter of the extension of the period, in accordance with the agreement for the sale of the controlling interest in the Bank. According to the notices, the provisions of the amended agreement for the sale of the controlling interest in the Bank dated February 15, 2009, shall continue to apply even after the termination of the period of agreement and remained in effect until July 1, 2010. Furthermore, the provisions of Section 10.4 of the agreement for the sale of the controlling interest in the Bank in the matter of the commitment of the Buyers not to conduct certain transactions and to act to the best of their ability to prevent the Bank from conducting such transactions (as described above in the Section "Arrangements with regard to cooperation between the Buyers and the Government in respect of holding shares of the Bank and exercising the control in the Bank"), applied even after the termination of the restriction period and until July 1, 2010.

**Amendment to the Agreement - determination of an "additional consent period".** On June 29, 2010, the Bank received notice regarding an amendment of the Agreement for the sale of the controlling interest of the Bank, as detailed in the immediate report dated June 30, 2010 (Ref. No. 2010-01-537576). The amendment relates to the provisions determined in Section 11 of the Agreement regarding the appointment of the Bank's Directors.

According to the amendment, the arrangements relating to the appointment of the Bank's Directors shall also apply in the period starting from July 1, 2010 and ending on the earlier of: (a) January 31, 2012; (b) the date on which the Government shall no longer hold over 10% of the Bank's issued share capital; or (c) the date on which the Purchasers (to remove doubt, both Purchasers and not one of them) will cease to hold the controlling interest in the Bank, within its meaning in the permit for control and the holding of means of control, in accordance with the Banking Law (Licensing), 1981, granted to the Purchasers (hereinafter: "the additional consent period"), subject to the following changes: so long as the Government holds 20% of the Bank's issued share capital - five of the Directors will be proposed for election by Government representatives and eight of the Directors by the Purchasers; so long as the Government holds less than 20% but over 15% of the Bank's issued share capital - four of the Directors will be proposed for election by Government representatives and nine of the Directors by the Purchasers; so long as the Government holds less than 15% but over 10% of the Bank's issued share capital - three of the Directors will be proposed for election by Government representatives and ten of the Directors by the Purchasers. In addition, the identity of the candidates proposed to act as Outside Directors of the Bank shall be determined for the first time during the additional consent period by representatives of the Government and thereafter by the Purchasers, and so on and so forth.

It has been further agreed that the provisions of Section 10.4 to the Agreement for the sale of a controlling interest in the Bank, in the matter of the commitment of the Buyers not to conduct certain transactions and to act to the best of their ability to prevent the Bank from conducting such transactions (see above), shall also apply after the termination of the limitation period, this until the end of the additional consent period.

The Bank has been further informed that on June 27, 2010, the Supervisor of Banks approved the said amendment to the Agreement for the sale of a controlling interest in the Bank (in accordance with the amendment to the permit by the Governor of Bank of Israel for the control and holding of means of control of the Bank. The permit is subject to a provision under which members of the group controlling the Bank may not act, directly or indirectly, to cause the termination of office of an Outside Director of the Bank proposed for election by the Government, including an Outside Director elected under Directive 301 of Proper Banking Management Directives, prior to the end of his tenure of office as stated in the Companies Law, 1999, or in the Directive (namely, three years, or if after the end of three years he has been appointed for an additional period, six years), unless under special circumstances and after obtaining the prior approval in writing from the Supervisor of Banks. The Supervisor further clarified that

the right to appoint Directors in accordance with the amendment to the Agreement for the sale of a controlling interest in the Bank, does not constitute in itself special circumstances.

**Sale of the remaining Bank shares held by the State.** As stated, upon the sale by the State of the remaining shares in the Bank held by it, all the arrangements regarding cooperation between the Bronfman-Schron Group and the Government have expired.

## ARRANGEMENTS BETWEEN THE MEMBERS OF THE BRONFMAN-SCHRON GROUP

According to information provided to the Bank, Treetops and Treetops II (hereinafter - "the Buyers") as well as the members of the Bronfman Group and Rubin Schron (hereinafter - the members of the Bronfman Group and Rubin Schron are named together: "the Investors") entered into an agreement with respect to their investment in the Bank, which includes a Summary of Principal Terms detailing the manner of the cooperation between the Investors, which was approved by the Bank of Israel (hereinafter - "the Cooperation Agreement"). Furthermore, the investors signed a Clarification Letter, which clarifies and/or adds to the terms of the Cooperation Agreement (hereinafter - "the Clarification Letter"). On January 24, 2006, Bank of Israel informed the investors that the sale of shares constituting part of the controlling interest without the prior coordination with the Governor of Bank of Israel, even if effected more than five years after the date of receipt of the permit, would most probably breach the conditions of the permit.

Notwithstanding, the Bank of Israel advised that it has no objection to the Clarification Letter being signed for the purpose of determining certain accords between the Investors, provided that the Clarification Letter would be amended or replaced after the Bank of Israel had examined it. To the best of the Bank's knowledge, the Bank of Israel has not raised the issue matter again and, as of date of publication of this report, the letter of clarification has not been amended or replaced.

The Cooperation Agreement determines, among other things, that of the number of directors that the Buyers are entitled to appoint to the Bank's board of directors, the Bronfman Group and Rubin Schron (hereinafter named: "the Schron Group" and together with the Bronfman Group - "the Groups") are entitled to appoint directors in proportion to the relative percentage of each group in the total ownership rights of all the Investors being limited partners in the two Buyers together (the overall ownership rights as above, in the two Buyers together are hereinafter: "the Interests"). The Bronfman Group is entitled to appoint the first outside director that the two groups would be entitled to appoint, when such office becomes vacant, whereas the Schron Group would be entitled to appoint the second outside director. The identity of the members of the board of directors recommended by each Group is to be determined by the majority of shareholders in the general partner of each of the Buyers. The Buyers would vote by power of their shares in the Bank for the appointment to the board of directors, as aforesaid.

The Cooperation Agreement further stipulates that the Buyers would vote jointly on all issues brought before a General Meeting of the Bank's shareholders. For this purpose, prior to every such general meeting, each Buyer shall hold a meeting of shareholders in its general partner, during which each shareholder would state how, in his opinion, the Buyers are to vote with respect to the issue in question. Excluding decisions regarding specific matters that require a special majority vote of over 67%, as stated below, and with respect to the appointment of members of the board of directors, as stated above, the Buyers shall not vote in favor of any issue brought before a General Meeting of the Bank's shareholders, unless such vote is supported by shareholders holding together over 50% of the Interests.

It has been stipulated that with regard to the following resolutions, a special majority of over 67% of the Interests would be required: sale of Bank shares by the Buyers; a significant raising of capital in which the Bank is involved; mergers, splits, significant acquisitions or sales in which the Bank or the Buyers are involved; issuance of capital or debt securities by the Buyers; any amendment to the rights attaching to the Interests; liquidation (including voluntary) of any of the Buyers; appointment of the Chairman of the Board of Directors of the Bank.

The Cooperation Agreement further stipulates that the net consideration, which each of the Buyers would receive for the sale of shares in the Bank or dividends and other payments that would be received from the Bank, would be distributed by each Buyer as follows: (1) firstly, each Buyer would distribute to each of its Investors a proportion of the said amounts according to the relative share of its investor Interests in that Buyer, until the recovery in full of the amounts invested by him in that Buyer;

(2) secondly, each Buyer would distribute to each of the investors in it an amount equal to 8% per annum (cumulative) on his investment in that Buyer; (3) after having made the payments as described in (1) and (2) above, Treetops (and not Treetops II) would distribute 15% plus as additional amounts to SLP, and the balance (85% excluding the additional amounts) would be distributed to the investors in Treetops, pro-rata to their share, all as detailed in the Cooperation Agreement. Certain amounts paid to SLP by Treetops would be distributed to Mr. Matthew Bronfman, to a corporation owned by Mr. Michael Rubinoff as well as to Cam Discount, all according to the distribution and terms stipulated for this purpose in the Cooperation Agreement. Likewise, terms have been fixed in respect of the exercise of the option.

The Cooperation Agreement further stipulates that the Investors in each Buyer will have the right to participate in future allotments of shares by the Buyer in which it has an interest. It is also stipulated in the Cooperation Agreement, that during the first five years from date of acquisition of the controlling interest (or any shorter period that the Agreement for the Sale of the Controlling Interest allows), no sale, exchange, pledge or transfer (hereinafter together - "transfer") of any of the interests in any Buyer (excluding transfers to family members or family entities) would be permitted without the consent of the general partner of that Buyer. In the event that permission for the transfer has been granted, or subsequent to the said period, any transfer would be subject to the right of first refusal granted to Treetops or Treetops II, as the case may be, and to any other investor, as well as subject to a Tag Along right. In addition, members of the Bronfman Family will continue to hold, at all times, at least 50.1% of the Interests held by members of the Bronfman Group, and Rubin Schron will continue to hold, at all times, at least 50.1% of the Interests held by the Schron Group. It is further stipulated in the Cooperation Agreement that if those who hold over 55% of the Interests would decide to sell over 55% of the Interests, they would be entitled to force the other Investors to sell, under the same conditions, the balance of the Interests held by them.

It was decided that the unanimous approval of Mr. Matthew Bronfman, Mr. Leonard Grunstein on behalf of Mr. Rubin Schron and Mr. Michael Rubinoff, is required to change the controlling shareholders' agreement.

The Clarification Letter stipulates that as from the end of five and one half years from date of closing of the transaction, each Buyer would be entitled to decide to surrender the Bank of Israel permit, for the purpose of the sale of the controlling interest shares, according to the letter attached to the permit (as described above). A Buyer choosing to do so is to inform the other Buyer accordingly, and in such a case the other Buyer would have the right of first refusal or the Tag Along right in respect of all the shares held by him, all subject to and in accordance with the terms to be agreed upon (in the future) between the Buyers regarding this matter. The sale of shares in accordance with this paragraph will not require a majority of 67% of the Investors (as required for the sale of shares according to the Cooperation Agreement).

The Clarification Letter further stipulates that the Cooperation Agreement would be valid so long as anyone of the Buyers holds, directly or indirectly, over 5% of the Bank's share capital. It is further stipulated that the provisions of the Cooperation Agreement which apply to the controlling interest shares, shall apply also to option shares acquired, directly or indirectly, by the Buyers or the Investors through the exercise of the option, including together with others. The voting rights attached to the option shares so acquired as well as to other shares held by the Buyers or Investors, including together with others, shall be used in accordance with the manner in which the Buyers of the controlling interest shares vote, as detailed above.

## EMPLOYEES AGREEMENT

On February 1, 2005, concurrently with the signing of the Agreement for the Sale of a Controlling Interest in the Bank, an agreement was signed between the New Histadrut Federation of Labor (hereinafter: "the Histadrut"), the Representative Committee of Discount Bank Employees and the Accountant General of the Ministry of Finance (hereinafter: "the Employees Agreement"). On February 7, 2005, the Bank's Audit Committee and Board of Directors approved the Bank joining the Agreement. On April 5, 2005, the General Meeting of the Bank's Shareholders approved the Bank joining the Employees Agreement. The Finance Committee also approved the Employee Agreement.

The Employees Agreement was intended to settle several demands raised on behalf of the Bank's employees in connection with their rights in light of the sale of the controlling interest in the Bank by the State. The Employees Agreement determined, among

other things, that the power of the Labor Charter as a collective labor agreement at Discount Bank, shall be extended for a period of five years, namely until December 31, 2009. At the end of this period, the parties shall act with regards to the power of the Labor Charter, in accordance with section 3 thereto.

**Mercantile Employees Agreement.** On May 22, 2005, the Histadrut, The Representative Committee of Mercantile Discount Bank Employees and the Accountant General at the Ministry of Finance signed an agreement, (hereinafter: "the Mercantile Employees Agreement"). On May 30, 2005, the Representative Committee of Mercantile Discount Bank Employees approved the Mercantile Employee Agreement. The Board of Directors of Mercantile Discount Bank approved the agreement on June 9, 2005, and the General Meeting of shareholders of Mercantile Discount Bank approved the agreement on June 20, 2005. The Finance Committee of the Knesset also approved the Agreement. The Mercantile Employees Agreement was intended to settle several demands raised by employees of this bank regarding their rights in light of the sale of the controlling interest in the Bank by the State. The Mercantile Employees Agreement determined, among other things, that the validity of the collective agreements at Mercantile Discount Bank (as the term is defined in the collective agreement dated December 21, 2004 and all its Annexes) will be extended for a specified period until December 31, 2009. At the end of this period, the parties shall act as regards to the validity of the collective agreements, in accordance with the terms of Section 5 of the labor agreement dated May 17, 1968. (the validity of the agreement was extended on January 1, 2010 until December 31, 2011).

## REPAYMENT OF THE STATE'S DEBT WITH RESPECT TO THE AWARD TO EMPLOYEES

An agreement with the employees stated, among other things, that the employees are to receive from the Government an amount of NIS 120 million in consideration for the waiver of their right to acquire the Bank's shares at a discount (hereinafter: "State's award to employees"). It was also provided that the employees will receive from the Bank an amount of NIS 130 million (hereinafter: "Bank's award to the employees").

It should be noted that in a conversation held between the Bank's President & CEO and the Deputy Accountant General at the Ministry of Finance, it has been clarified to the Bank that the amount of the Bank's award to the employees (an amount of NIS 130 million, as stated), reflects the overall cost to the Bank as the employer of the said employees.

It is further noted that the approvals granted by the Audit Committee, the Board of Directors and the General Meeting of Shareholders for the attachment of the Bank to the agreement with the employees, emphasized that the total cost (cost to the employer) to be borne by the Bank shall be NIS 130 million (and should not exceed this amount).

The agreement with the employees provided that the State's award to the employees and the Bank's award to the employees (hereinafter: "the total award") shall be an amount of NIS 250 million. The total award is to be paid to the employees subject to the closing of the agreement for the sale of the controlling interest in the Bank, on the following dates: (1) an amount of NIS 205 million payable during September 2005 or soon after the closing, the later of the two; (2) an amount of NIS 45 million payable no later than at the end of three years from the date of closing or proximate to the date of exercise of the option granted to the Buyers, in the event that the Buyers choose to exercise their right to acquire the option shares in full or in part, at an earlier date (hereinafter: "the deferred payment").

In the first quarter of 2006, soon after the closing of the agreement for the sale of the controlling interest in the Bank, the Bank and its relevant subsidiaries paid the total award agreed upon in the employee agreement. Thus the rights of the employees for an award in accordance with the agreement with the employee agreement.

The total cost of the award, including related expenses (payroll VAT and National Insurance contributions) amounted to NIS 305 million. In view of the above stated, the award to be paid by the State will amount to NIS 175 million, of which an amount of NIS 120 million was paid to the Bank in March 2006. The balance of the State of Israel debt to the Bank with respect to the award to Discount Bank employees amounts therefore to NIS 55 million and its payment is due on February 1, 2009.

According to information relayed to the Bank, concurrently with the signing of the agreement for the sale of a controlling interest in the Bank, an agreement was signed between the Bronfman-Schron Group (hereinafter: "the Buyers") and the Government,

regarding interim financing of the deferred payment component of the State's award to the employees, in respect of that part of the option not exercised by the Buyers. According to the said arrangement, in the event that the purchasers do not exercise the option in full, as actually happened, they will have to provide a loan, which will be transferred to the bank, in order to finance the deferred payment (an amount of NIS 45 million - see above). The repayment of the interim finance is as follows: at any date on which the State will sell shares of the Bank, it will pay the Buyers a proportion of the consideration received by it based on the ratio of the number of shares sold by it to the number of option shares not exercised. The balance is repayable at the end of eight years.

According to the information provided to the Bank, in discussions held at the beginning of 2009 between the State and the Purchasers, the Purchasers asked the State to release them from their commitment to grant a loan to the State on February 1, 2009, as stated, subject to certain conditions to be agreed upon. In this framework, and in order to complete the study of the request of the Purchasers to release them from their commitment to grant the loan, as stated above, The State agreed that the date of granting of the loan and its transfer to the Bank would not fall on February 1, 2009, but at a later date, extended from time to time, recently to September 1, 2011 (or at an earlier date, in respect of which a prior notice of fourteen days will be given).

The Bank's authorized organs approved towards the end of January 2009, the entry into an agreement of the Bank with the State of Israel for the granting of a loan in an amount equal to the amount of the debt of the State to the Bank, for a period not exceeding 13 months, under accepted commercial terms.

Soon afterwards, the Bank submitted to the Accountant General an agreement in this respect signed by the Bank. In response, the Bank was informed by a representative of the State that in view of personnel changes in the Department of the Accountant General, the State requires a short respite to study the matter.

Pursuant to the Accountant General's request of March 1, 2009, the Bank provided on April 27, 2009 certifications by the relevant corporations in the Discount Group, including the Bank, regarding awards granted to entitled employees, as well as the payments made to tax authorities in this respect. This was accompanied by a special confirmation (verification) rendered by the respective independent auditors of the said companies.

To the best of the Bank's knowledge, M.I. Holdings approached the Tax Authorities in December 2009, and presented its position, backed by a legal opinion, whereby the Bank should not have withheld tax and paid payroll tax and profit tax in respect of the State's share in the payment to Bank employees (and therefore the Bank is entitled to a refund of the said tax payments from the Tax Authorities, and on the other hand the Bank has no claim against the State for the refund of the said tax payments), requesting the Tax Authorities to review the case.

As of date of publication of the financial statements, the said debt has not yet been repaid and the agreement in its respect has not been signed.

## THE SALE OF SHARES OF THE STATE IN THE BANK

**The price of the transaction for the sale of the Bank's shares held by the State.** Pursuant to a notice received by the Bank from the State of Israel, on January 14, 2010, the State sold shares comprising 5% of the Bank's issued share capital. The price of the transaction was determined at NIS 8.871 per share. Pursuant to a further notice received by the Bank from the State of Israel, on July 29, 2010, the State sold shares comprising 8.33% of the Bank's issued share capital at an average price of NIS 6.789 per share. Pursuant to a further notice received by the Bank from the State of Israel, on October 28, 2010, the State sold shares comprising 11.7% of the Bank's issued share capital, the remaining Bank shares held by the State, at average price of NIS 7.255 per share.

## LEGISLATION AND SUPERVISION

### GENERAL

The Bank operates within the framework of Laws, Regulations and Directives, certain of which are exclusive for the banking industry, and others, though even not exclusive as above, do have an effect on certain sections of its operations. This framework is based mostly on the Israeli law and its various layers, however, the Bank's conduct in certain areas is also affected by the provisions of foreign law, to the extent that these have an extraterritorial effect relating to its operations.

The Banking Ordinance, various banking laws and the proper banking management directives issued from time to time by the Supervisor of Banks, constitute the central legal basis for the operations of the Bank Group.

These, among other things, define the limits of the operations of the Bank, the permitted operations of subsidiaries and companies related to the bank and the terms for owning and controlling them, the relations between the Bank and its customers, the use made of assets of the Bank, and the mode of reporting to the Supervisor of Banks and the public as to the Bank's said operations.

Alongside these, the Bank is subject to a wide legislation that regulates its capital market operations both on behalf of customers and on its own behalf (for example: investment consulting and customer portfolio management, pension consultation, mutual investments funds, the overall activities of provident funds and restrictions on insurance business activity).

Additional legislation as regards special subjects imposes on banks, including the Bank, specific duties and rules. Thus for instance, the legislation relating to the prohibition of money laundering and the prohibition of financing of terror activities, the credit data law, legislating relating to housing loans, guarantees, etc.

In addition legislation exists, which because of its connection to the operations of the Bank, has a considerable implication on the way the Bank is being managed. In this respect it should be mentioned, among other things, the debt execution laws, liquidation and receivership laws, laws relating to specific economic sectors (local authorities, mortgagees, the agricultural sector) and various tax laws.

The operations of the Bank are subject to supervision and audit by the Supervisor of Banks as well as by other supervisory authorities regarding specific fields of operations, such as the Securities Authority and the Commissioner of the Capital Market, Insurance and Savings at the Ministry of Finance. These entities perform, from time to time, audits at the Bank relating to various fields of operation.

The Bank and its subsidiaries are taking steps towards complying with the duties imposed upon them under the said provisions of the law.

Within the framework of the legislation passed in the wake of the Bachar Committee, a monetary sanction has been prescribed by most of the laws applying to the operations of the Bank, in respect of violations of the provisions of the laws and secondary legislation (including guidelines and circulars) issued or to be issued under them.

Following is a summary of legislation changes and relevant legislation initiatives during the reported period, which have a significant effect or might have a significant effect on the operations of the Bank.

### BANK OF ISRAEL LAW, 2010

On March 24, 2010, the Bank of Israel Law, which replaces the Bank of Israel Law of 1954, was published.

The principal changes in the Law relate to two areas: one, the determination that the main goal of the Bank of Israel is to maintain stability of prices, and the other, strengthening the independence of the Bank of Israel by determining the tools for reaching its goals and in the manner of their implementation.

Within the framework of the Law, the status and duties of entities and officers of the Bank of Israel have been regularized, including the "monetary committee" which duty would be the determination of a monetary policy and the monitoring of its implementation, a duty which in the past was entrusted to the Governor of the Bank of Israel.

Within the framework of the actions, which Bank of Israel will be entitled to carry-out in order to reach its goals, it has, among other things, been decided that the Bank of Israel would be entitled to accept deposits from banking corporations, at terms fixed by it, as well as provide credit to banking corporations at terms to be fixed, including with respect to the collateral required and its scope, including conditions to be determined with respect to the operations of the banking corporations related to such credit, including the rate of interest and other payments with which they may charge their customers.

It is further determined in Section 38(h) of the Law that the Governor may instruct a banking corporation, which does not hold liquid assets in accordance with the liquidity requirements as determined by the Governor, that such banking corporation shall cease the granting of credit, make investments or distribute profits to its shareholders, or that these actions shall be made under restrictions.

According to Section 58 of the Law, the Governor is authorized to impose a monetary sanction in an amount of NIS 5 million, in respect of a violation of the provisions of the Law.

## PROHIBITION OF MONEY LAUNDERING AND PROHIBITION OF THE FINANCING OF TERROR ACTIVITIES

**Prohibition of money laundering.** The Prohibition on Money Laundering Law, 2000 (hereinafter - "Prohibition of Money Laundering Law") came into effect on August 17, 2000, and various regulations and orders have been enacted under it. Concurrently, the Supervisor of Banks issued Proper Banking Management Directive No. 411. This set of regulations imposed upon banks the duty of identifying, verifying, reporting and maintaining records with respect to bank customers and the accounts maintained by them. Furthermore, criminal sanctions and the authority to impose sanctions as well as the forfeiture of funds have been determined with respect to violation of the law and related regulations.

**The addition of predicate offenses.** The Prohibition of Money Laundering Order (change of the first addendum to the Law), 2009, came into effect on February 13, 2010. This added several offenses to the list of predicate offenses under the Prohibition of Money Laundering Law, including piracy and various offenses relating to the environment. The meaning of this amendment is, that a transaction involving assets that had been acquired while performing these offenses in order to disguise the origin of the assets, or being aware that the asset is prohibited, constitutes an offense under the Prohibition of Money Laundering Law.

**Portfolio managers.** A Prohibition of Money Laundering Order was published on November 30, 2010, which applies the duties of identification, reporting and maintenance of records with respect to prevention of money laundering and the finance of terror also on investment portfolio managers.

**Extension of the application of Proper Banking Management Directive No. 411.** The amendment to Proper Banking Management Directive No. 411 came into effect on July 1, 2010, expanding the duties imposed on banking corporations with respect to everything relating to the prevention of money laundering and the financing of terror activities and identification of customers. Among other things, this amendment details measures that the board of directors of a banking corporation must consider when determining the policy of "get to know your customer", strengthens the independent status of the officer responsible for fulfilling the duties according to the Prohibition of Money Laundering Law, and extends the duties of monitoring, supervising and current follow-up of accounts and/or transactions, which involve high risk. Furthermore, the amendment determines that foreign subsidiaries and branches of a banking corporation shall comply, as regards money laundering, with the provisions of the local law or of the Israeli law, the stricter of the two, to the extent that these are not in contradiction of the local law.

For details regarding an additional amendment to the said directive, relating to credit card companies only, see above "Credit card operations" under "Further details as to activity in certain products".

**Proposal for the amendment to the Prohibition of Money Laundering Law.** In July 2007, a Bill for the amendment of the Prohibition of Money Laundering Law was published and passed its first reading by the Knesset. Various amendments are included within the framework of the Bill, among which, extension of the list of predicate offenses (the addition of several offenses under

the VAT Law as predicate offenses), changes in the level of punishment in respect of the offenses specified in the Law, extension of the term "control" (with respect to corporations) over and above the definition specified in the Securities Law, erosion in secrecy and in the confidentiality pertaining to the identity of the reporting entity (in a manner that might expose the identity of the bank officer who reported the transaction), the addition of various segments as reporting entities and extension of the jurisdiction of the Money Laundering Authority.

In July 2009, the continuity rule was applied to this Bill, and the Knesset Constitution, Law and Justice Committee is presently discussing this Bill.

**Prohibition of the financing of terror activities.** The Prohibition on Terror Financing Law, 2005 (hereinafter: "Prohibition on Terror Financing Law"), came into effect at the beginning of August 2005. This Law specifies directives prohibiting the finance of terror activities, and various regulations and orders have been enacted under it imposing on banking institutions additional duties of identification and examination of customers based on published lists of terrorist organizations and activists. Furthermore, criminal sanctions and the authority to impose sanctions as well as the forfeiture of funds have been determined with respect to violation of the law and related regulations.

**The Bank's preparations.** Implementation of the legislation concerning money laundering and the financing of terrorism, obliged the Bank to reorganize computer wise, with respect to training and study courses for employees and managers at the Bank, and for the formation of work procedures. The Bank continues integrating the handling of money laundering prohibition and financing of terrorism prohibition regulations among all relevant staff of the Bank. Within this framework, the Bank has been developing and improving on an ongoing basis the computerized control systems for identifying and pinpointing customers and activities and reporting of such to the authorities.

Considering the many changes that are taking place in the primary and secondary legislation regarding the prohibition of money laundering and regarding the prevention of financing of terror, the preparations and assimilation is a continuous activity, both by the Bank and its relevant subsidiaries.

**Group policy regarding money laundering.** On July 5, 2010, the Board of Directors approved a Group policy paper on the subject of prohibition of money laundering and avoidance of terror finance. The policy paper determines the Group's standards with respect to money laundering and the finance of terror as well as principles for management of this risk on a Group basis. Following the approval of the policy paper, subsidiaries have been approached with the request to adopt and implement the Group policy, mutatis mutandis with the nature and volume of their business operations.

For details regarding an audit by the Bank of Israel in the matter of "Implementation of the provisions of the Prohibition of Money Laundering Law" at ICC, see above in "Israel Credit Card Company Ltd." under "Main investee companies".

## EXEMPTION FROM A BINDING ARRANGEMENT WITH RESPECT TO THE HOLDING AND JOINT ACTIVITY WITHIN THE FRAMEWORK OF ABC AND CBC

Following a new and comprehensive examination the Antitrust Commissioner decided, on November 5, 2008, to grant a conditional exemption from a binding arrangement in respect of the arrangement regarding the joint holdings and operations of the five large banks in Automatic Bank Services Ltd. ("ABS") and Bank Clearing Center Ltd. ("BCC"). The exemption is in effect for three years from date of the Commissioner's decision.

The exemption reiterates the conditions determined in the past and in addition stipulates that interested parties in the Bank and or members of management of the Bank and/or executives in charge of trading, accounting and/or retail operations at the Bank may not act as directors of ABS and BCC. Furthermore, anyone appointed as director of ABS or of CBC, prior to accepting office, must sign an undertaking to uphold the conditions of the exemption.

As part of the conditions of the exemption, ABS is permitted to act towards establishing an overseas backup site for the banking industry's data, which would provide backup services to any bank in Israel wishing to receive such service.

## CONSORTIUM AGREEMENTS FOR THE GRANTING OF CREDIT

The Antitrust Commissioner informed on February 28, 2011, that she had reached the conclusion that the consortium arrangements for the granting of credit, made between banks and insurance companies and between themselves, should continue to exist, and she detailed the conditions, which subject to their existence, she does not intend to enforce the provisions of the Antitrust Law, 1988 upon the said arrangements. The announcement extends the effect of prior announcements issued by the Commissioner with respect to the consortium arrangements, subject to changes made to certain of the terms detailed in the previous announcement and the addition of new terms. The announcement will be in effect for two years since the date thereof, unless another announcement is made before the end of the said period.

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## VERDICT IN THE COURT OF LAW FOR UNIFORM CONTRACTS

On May 5, 2009, a verdict was handed down at the Court of Law for Uniform Contracts, with regard to depriving conditions in a residential loan contract of the First International Bank of Israel ("FIBI"). A decision in the motion to postpone the implementation was also given on October 1, 2009.

The Court ruled that the loan agreement includes clauses that are discriminating clauses that should therefore be eliminated and also directed the amendment of other clauses.

Although the verdict was given in reference to a housing loan agreement, it includes statements which may also affect other contracts in use in the banking system. On January 10, 2010, the First International Bank filed an appeal with the Supreme Court against the ruling of the Uniform Contracts Court. Recently the date for submission by the Union of Banks of the conclusions brief in the appeal has been postponed to May 9, 2011, and the hearing at the Supreme Court was fixed for September 15, 2011. This, in view of the request of the First International Bank to conclude the negotiations being held with the Supervisor of Banks in order to reach an agreement on certain of the items of the loan agreement.

On December 15, 2009, the Supreme Court issued a provisional order for the stay of execution of the verdict. On June 13, 2010, the Court gave its decision in the motion for the stay of execution, according to which, the stay of execution was approved with respect to part of the rulings in the verdict, in respect of which agreement exists with the Supervisor of Bank, and as to the rulings that are in disagreement, the stay of execution was conditional upon the adoption of an agreed version of certain sections of the loan agreement. As to the decision regarding agreement for the waiver of alternative housing, the Supreme Court ruled that the damage that may be caused to the debtors in case the execution is stayed exceeds the damage that might be caused to the First International Bank, and therefore the Court refused to stay the execution. The Bank and Discount Mortgage Bank believe that the results of this process, mainly the decision regarding the retroactive application of the alternative housing section, may have a material impact upon Discount Mortgage Bank.

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## DECISION ON AN APPEAL AGAINST THE RULING OF THE UNIFORM CONTRACTS COURT

On February 18, 2010, the Supreme Court gave a ruling in the appeal submitted by Bank Leumi against the decision of the Uniform Contracts Court from June 10, 2004, in the matter of the uniform contract of Bank Leumi with its customers regularizing the terms of opening a current account with the bank. It has been ruled that it is the prime interest of the bank and, in a direct manner, of the public in general to maintain the economic stability of the bank, while strictly collecting customer debts and preventing exposure to liquidity crisis. This interest of the bank and of the public, constitutes a major consideration in the overall circumstances in which the uniform contract between the bank and its customers is to be examined, and a significant component in the balance required for the purpose of determining whether a certain term in the agreement constitutes a discriminating term or not. Among other things, it has been ruled that there is no flaw or discrimination in the section that entitles the bank to cancel or reduce a credit facility in cases where the bank may face a risk of not being able to collect the debt, due to a deterioration in the repayment

ability of the customer, and the bank does not have to give prior notice, but may inform the customer at the time of cancellation or reduction. The Bank is studying the implications of the said Court ruling upon the terms of engagement with its customers.

**Requirements by the Supervisor of banks.** On July 21, 2010, the Supervisor of Banks instructed the commercial banks to amend by January 15, 2011, the current account agreement in accordance with the ramifications of the Supreme Court ruling in the matter of the "general terms for the management of accounts/deposits" agreement of Bank Leumi.

In his approach, the Supervisor of Banks instructed banks to adjust by January 15, 2011, the housing loan agreement in accordance with the contents of the ruling given by the Court of Uniform Contracts in the matter of discriminating terms in the housing loan agreement of FIBI, with respect to all those matters which had not been appealed against.

Furthermore, the Supervisor of Banks instructed the commercial banks to peruse all agreements used in practice by them, and to confirm to the Supervisor by July 15, 2011, that such agreements have been amended in accordance with the contents of the said rulings, respectively.

The Bank is preparing to comply with the instructions of the Supervisor. On December 5, 2010, the Supervisor of Banks extended the period for completing the said corrections until April 1, 2011. The period for making the corrections stemming from the Court decision in the matter of the First International Bank was extended to May 1, 2011. In addition, the Supervisor of Banks instructed the Banks to include in the homepage of its Internet website a notice as to the existence of a verdict as well as a link thereto and also to insert a notice in the coming semi-annual statement of account drawing the attention of customers to the existence of the said information in the Internet website.

## THE UNIFORM CONTRACTS ACT (AMENDMENT NO. 3), 2010

On June 3, 2010, the Uniform Contracts Act (Amendment No. 3), 2010, was published, taking effect in December 2010. The Amendment requires that each approved uniform contract must state thereon the fact of its approval. In addition, an indirect amendment to the Banking Law (Service to customer), 1981, has been determined, whereby the Governor of the Bank of Israel is empowered to set instructions regarding the font used in a written contract between a bank and its customer, the list of material terms in the contract, the manner in which they should be drafted and highlighted, including instructions regarding the duty to append a separate document in their respect.

To the best of the Bank's knowledge, no guidelines have as yet been published under this Amendment.

## LEGISLATION AND REGULATION WITH RESPECT TO THE PROTECTION OF THE ENVIRONMENT

In June 2009, the Supervisor of Banks issued a letter in the matter of environmental risks management by banking corporations. For further details, see "Environmental risks" under "Exposure to risks and risk management" above.

Concurrently, various legislative and regulatory initiatives were brought up. A private Bill in the matter of polluted lands was tabled for the second time in June 2009, within the framework of which the financing entities may be held responsible for soil pollution and among other things, for the prevention and discontinuation of the pollution. An approval in principle was granted in January 2011, by the Ministerial Committee on Legislation to a Bill proposed by the Government in the matter of the prevention of soil contamination and the rehabilitation of contaminated land, 2011. The Bank believes that legislation and arrangement initiatives regarding the environment, both governmental and private, are expected to continue also in the future.

## AMENDMENT NO. 16 TO THE COMPANIES LAW - CORPORATE GOVERNANCE

On March 7, 2011, Amendment No.16 to the Companies Law in the matter of the implementation of corporate governance rules, as formed by the Ministry of Justice and the Securities Authority, passed its second and third readings in the Knesset. The purpose of the Amendment is to improve corporate governance in Israel and to modify it to reality in Israel and to principles accepted in this respect around the world. The Amendment is intended to improve efficiency of decision making mechanisms in public companies in Israel, to increase transparency in decisions and strengthen the mechanisms of supervision and control over the manner of management of such companies.

Special emphasis has been put within the framework of the Amendment on the changing principles of independence of the Board of Directors in general and of the outside Director in particular, as well as the strengthening of the position of the institutional bodies and the minority shareholders in public companies regarding the process of appointment of outside Directors, with a view of weakening the power of the controlling shareholder in the company to influence its management and direct its activities in view of his personal goals.

This refers to a series of amendments, several of the outstanding of which deal with changing the majority required to approve transactions in which the controlling shareholder has a personal interest; change in the majority required for the initial appointment of an outside Director; extension of the maximum tenure of office of an outside Director and determining directives concerning the independence of the outside Director; emphasizing the duty of the Director to apply independent judgment; determination of directives prohibiting the possibilities of the dual appointment of the Chairman of the Board also as President & CEO of a public company; gender equality in a public company and qualifications in this respect; directives regarding the audit committee – its composition, the manner of taking decisions and extension of its duties and areas of responsibility; authorizing the Securities Authority to impose monetary sanctions on an individual or on a corporation in case of violation of certain directives of the Companies Law and determining recommended corporate governance instructions.

The amendments to the Law will enter into effect within sixty days from date of publication.

Most of the requirements included in the Amendment Bill with respect to corporate governance, are already being applied by the Bank virtue of the Proper Banking Management Directives applying to it, and which are compatible with the principles of corporate governance approved by the Bank (see in "Miscellaneous" hereunder).

## IMPROVEMENT OF ENFORCEMENT PROCEDURES AT THE ISRAELI SECURITIES AUTHORITY (LEGISLATION AMENDMENTS) ACT, 2011

The Improvement of Enforcement Procedures at the Israeli Securities Authority (Legislation Amendments) Act, 2011 was published on January 27, 2011. The Act includes a reform in the enforcement authorities of the Israeli Securities Authority (hereinafter – "the Authority")

The Law grants the Authority, in addition to the enforcement powers existing at present, also administrative enforcement power against individuals and corporations in respect of violations of the Securities Laws, including the Securities Law, the Regularizing of Engagement in Investment Consultancy Law and the Mutual Investment Trust Law (hereinafter: "the Securities Laws").

The administrative enforcement empowers the Authority to adopt an array of enforcement measures, including the imposition of significant fines and monetary sanctions on licensed employees and company officers who violated their duties under the Securities Laws, removal from engagement in securities business, suspension of the license and indemnification of the party injured by the violation.

Furthermore, the Law requires the CEO of the corporation to supervise and adopt all reasonable measures to avoid violations by the corporation and its employees (hereinafter: "supervisory responsibility"). Violations, as above, constitute a breach of the supervisory responsibility, unless satisfactory procedures had been instituted by the corporation to avoid such violations, the CEO had appointed an officer on his behalf to supervise the existence of such procedures including training of the corporation's employees, and the

CEO and adopted reasonable measures for the rectification of the violations and avoiding recurrence thereof.

The Law limits the possibility of insuring and indemnifying individuals and corporations in respect of sanctions imposed within the framework of the administrative enforcement process.

The Bank has installed and is maintaining a layout of procedures designed to ensure compliance with the law and regulations, inter-alia, the Securities Laws. Furthermore, the Bank appointed officers whose duty is to supervise compliance with the provisions of the law. The Bank is studying the implications on the new Law and is preparing to implement it.

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## CHANGES IN THE U.S. TAX LEGISLATION

New tax laws have been enacted in the United States intended to apply to financial institutions outside the U.S. within the framework of the Foreign Account Tax Compliance Act (FATCA).

According to these rules, financial institutions outside the U.S. will be obligated to enter into an agreement with the U.S. Tax Authorities, under which, among other things, they will have to disclose and report to the U.S. Authorities about accounts defined as U.S. Accounts. The rules are expected to take effect in 2013; however the complete guidelines applying under the said rules have not yet been published.

Based on the information known at present, the Bank believes that the above rules are expected to have implications on its activities involving customers having connection to the U.S.

## AMENDMENT OF PROPER BANKING MANAGEMENT DIRECTIVE REGARDING THE "BOARD OF DIRECTORS"

In December 2010, the Supervisor of Banks issued an amendment of Proper Banking Management Directive 301 regarding "Board of Directors". As a general rule, the amendments to the Directives are to take effect no later than January 1, 2012.

The amendments are based upon the recommendations of the Basel II Commission in the matter of "fortification of corporate governance at banking corporations", the applying practice and the regulatory updates on the matter in Israel and abroad.

The amendment to the Directive is the result of seeing the importance of a proper and high level performance of the Board of Directors as part of appropriate corporate governance and the proper management of the banking corporation. As part thereof, the Directives regarding the duties, composition and manner of operation of the Board of Directors have been amended.

Some of the said amendments have already been properly addressed in the framework of the principles included in the corporate governance code adopted by Discount Bank. Notwithstanding, following certain of the amendments, the Bank and the group companies to which Directive 301 applies, will be required to make modifications as well as certain changes to the composition and structure of boards of directors of the Bank and of Group companies.

## ABUNDANCE OF LEGISLATION INITIATIVES

The year 2010, as its preceding years, was typified by an abundance of private law proposals (part of which supported by the Government) regarding the imposition of restrictions on banks (by law or by regulations under it) applying to various fields of activity, including: restrictions on the granting of credit, restrictions on the charging of commissions, restrictions on the payment and/or collection of interest, etc. These law proposals and other similar ones, if passed, might have a material adverse effect on the activities of the Bank and its subsidiaries and on their results of operations in the future. The Bank is not able to evaluate which of these law proposals will in fact be passed and what would be the scope of their effect.

The year 2010 was also characterized by an abundance of regulatory directives, both Proper Banking Management Directives and various instructions regarding reporting to the public issued by the Supervisor of Banks. To these were added instructions by the Commissioner of the Capital Market, Insurance and Savings of the Ministry of Finance and by the Securities Authority, as to

issues under their control, and the decisions taken within the authority of the Antitrust Commissioner.

The implementation of the various instructions requires, on more than one occasion, preparations involving the investment of resources, and sometimes it has a possible adverse impact on the income of banking corporations from various sources. The Bank expects that this state of affairs will also continue in the future. See above also, "Regulation risks" under "Exposure to risks and risk management".

## CRITICAL ACCOUNTING POLICIES AND CRITICAL ACCOUNTING ESTIMATES INSTRUCTIONS OF THE SUPERVISOR OF BANKS

### GENERAL

The financial statements of the Bank are prepared according to generally accepted accounting principles (summarized in Note 1 to the financial statements) and according to instructions and guidelines of the Supervisor of Banks.

The level of regulation regarding the financial reporting of banking corporations is among the highest in the financial reporting field in Israel. The instructions and guidelines of the Supervisor of Banks are comprehensive, detailed and sometimes even dictate the wording to be used by banking corporations. Nonetheless, there are areas where application of the accounting policy involves a high level of evaluation and assessment performed by Management of the banking corporation in the course of preparation of the financial statements.

Application by Management of the accounting principles and the instructions and guidelines of the Supervisor of Banks, requires sometime various assumptions, evaluations and assessments that affect the reported amounts of assets and liabilities, including contingent liabilities, as well as the financial results reported by the Bank. It is possible that when the evaluations and assessments materialize in the future, their results may be different than those anticipated at the time the financial statements were prepared.

Certain of the evaluations and assessments applied involve uncertainty or sensitivity to various variables to a large extent. Such evaluations and assessments, changes in which might have a considerable effect on the reported financial results, are considered evaluations and assessments of "critical" matters.

Management believes that the evaluations and assessments used in the preparation of the financial statements are fair and were made in accordance with the best of its information and professional judgment.

Following is a summary review of evaluations and assessments made as regards "critical" matters:

### PROVISIONS FOR DOUBTFUL DEBTS

The provisions for doubtful debts include specific provisions for doubtful debts, a general provision and a supplementary provision.

The specific provision for doubtful debts reflects the evaluation of Management as to the loss inherent in the credit portfolio, based on rules set by the Supervisor of Banks and on evaluations and assessments. The specific provision in respect of housing loans is made according to a scale (rates of provision and periods in arrears) specified by the Supervisor of Banks. The general provision for doubtful debts comprises 1% of the outstanding debts at December 31, 1990, in inflation adjusted terms. The supplementary provision for doubtful debts is based on various risk characteristics as determined in the instructions of the Supervisor of Banks and according to rates set by him.

Once in every quarter, Management of the Bank examines the credit portfolio with the aim of evaluating the possible loss inherent therein. The process of the loss evaluation includes two stages:

- Identifying customers, the ability of whom to honor their obligation to the Bank has changed, and their resulting classification as "problematic debtors", in accordance with the classes of debts specified in the instructions of Bank of Israel and the criteria

determined therein: "doubtful debts", "non-performing debts", "debts that have been restructured", "debts temporarily in arrears", "debts under special supervision".

- Creating provisions that reflect the anticipated loss in respect of "doubtful debts". In determining the provisions Management relies on information at hand regarding the debtor: his credit rating, history of honoring obligations to the Bank, quality of the collateral given by him and the risk level of the economic sector in which he operates. In addition Management takes into account when making the provision, additional factors, such as: The quality of the debtor's management, his repayment ability and financial flexibility.

The process of assessing the loss inherent in the credit portfolio, as described above, is based on significant assessments that involve extensive uncertainties, such as: the quality of the collateral, repayment ability of the debtor, etc., and on subjective evaluations, both as regards the category to which the problematic debt was classified, such as: the differentiation between "debt in arrears" and "debt temporarily in arrears", and as regards the factors used in computing the provision, such as the quality of management of the debtor and the risk level of the sector in which he operates.

A change in the assessments or evaluations as stated above, might have a significant effect on the provision for doubtful debts included in the financial statements of the Bank.

In addition to the above, part of the assessments mentioned above relies on economic or market variables and part thereof is updated in as much as the cumulative experience gathered in dealing with the debtor increases. Accordingly, the Bank's Management examines once every quarter the assessments used in determining the provisions in respect of problematic debts and updates them where necessary.

See the above section "Development of Assets and Liabilities" for details of the overall credit risk of the Group with respect to problematic debts. For details regarding the credit risk management at the Bank, including details in respect of "Credit exposure to foreign financial institutions" and "Credit risk in respect of leveraged finance" see "Exposure to Risks and Risk Management" above. For details regarding the instruction in the matter of "Measurement and disclosure of delinquent debts, credit risk and provision for credit losses", effective as from the financial statements for January 1, 2011 and thereafter, and for details regarding the expected implications (pro-forma) on problematic debts and on the provisions for credit losses as of December 31, 2010, had the Directive in respect thereof been implemented on such date, see under "Development of assets and liabilities" and below in Note 1 A to the financial statements.

## CONTINGENT LIABILITIES

Against the Bank and against other banks and companies in the Group are pending legal actions on various issues, including class action suits and requests for approval of actions as class action suits. The accounting treatment of contingencies is implemented in accordance with the U.S. Standard FAS 5 - "Accounting for Contingencies" and its related guidelines, and in accordance with the guidelines and clarifications of the Supervisor of Banks, including public reporting directives in the matter of "Accounting for Contingencies".

In assessing the required provision, it is necessary to examine the probability of a loss and to assess its amount. These evaluations affect both the duty itself of creating a provision in respect of the claim and the mode and scope of the disclosure in the financial statements.

According to FAS 5 there are three levels for evaluating the loss: (1) Remote; (2) Reasonably possible; (3) Probable. The U.S. Standard also rules that if the loss cannot be assessed, no provision should be created in respect thereof, but the matter should be disclosed if it might be significant. For the purpose of assessing possible losses as a result of actions filed against the Bank, Management of the Bank and the managements of other banks and companies in the Group rely on opinions of Counsels representing them in these matters.

In the nature of things, such opinions are subjective and face objective evaluation difficulties. Such difficulties grow immensely in cases of class action suits, due to the following reasons.

According to Israeli law, a plea for the approval of a class action constitutes in fact a preliminary procedure in which the Court examines several prerequisites in order to decide the plea. Inter-alia the Court examines whether the claimant is appropriate and

fitting, whether he is in good faith, whether a class action is the fair and appropriate way of dealing with the matter, whether the action reveals joint questions of fact and law, and the Court assesses also the prospects of the action. The Court further determines in the same decision the nature of the group that the claimant would be entitled to represent and on grounds of what cause the action will be filed.

It is understood from the above that most of the parameters are exogenous to the prospects of the action itself, and they are generally clarified in the course of the proceedings (which may continue over several years).

Furthermore, both the manner in which the Court interprets the said prerequisites and the weight that is given to each of them as well as the level of proof required (in view of the little experience and legal precedents), at this early stage, lack uniformity in the legal system, and accordingly it is most difficult to evaluate the prospects of such pleas.

When the Court's decision in the matter is given, a request for permission to appeal is usually submitted, which is also dealt with over a long period. Only afterwards, if the request for appeal is dismissed, the class action begins to be heard subject to limitations determined in the preliminary procedure.

It should be also mentioned that until 2006, class actions related to specific laws, to specific causes and to various effective dates (the date on which the relevant law adopted the option of a class action suit). Also as to the interpretation of these issues contradicting judgments had been given.

The new Law regarding class actions, passed by the Knesset in 2006, regularized all the arrangements made in the matter of class actions in the framework of one law, and extended the causes in respect of which a class action may be brought against banks, over and above those that were included in legislation in the past.

The law also applies to class actions and motions for approval of class actions pending at the Courts at date of its publication. The new provisions determined by the law and the fact that these have recently been tested in Court rulings, add a new dimension of uncertainty to everything concerning the assessment of the prospects and results of class actions and motions for approval of class actions. The accounting principle adopted by the banking corporations in Israel is indeed the U.S. principle, however it is vital to bring into account in this respect the difference in the characteristics of the U.S. reality in comparison to Israeli reality, and the difficulties that arise as a result.

The U.S. has experience of many years (several decades) regarding the issue of class action suits and there is recognized and tested data, including the rate of compromise agreements and the amounts paid in compromise settlements. Such an experience is completely lacking as regards the law and practice in Israel.

Also the legal procedures in the U.S. are different than those in Israel, allowing each party to interrogate the witnesses of the other party before the case is heard in Court, thus making it possible to evaluate the prospects of the action at an earlier stage. The issues discussed above create special difficulties in everything related to class action suits and motions for approval of class actions.

As stated, the Management of the Bank and the managements of other banks and companies in the Group rely on opinions of Counsels. Such opinions are subjective and face objective evaluation difficulties.

Accordingly, it is possible that the actual results of certain of the actions would be different from those estimated based on the opinions of Counsels. In view of the volume of actions pending against the Bank, other banks and companies in the Group, it may transpire that the non-materialization of such estimates would have a material effect on the financial results of the Discount Group.

The Management of the Bank and its Counsels, as well as the managements and counsels of other banks and companies in the Group, examine once every quarter the pending actions and update, where necessary, the provisions created therewith in the light of developments.

It has been determined in the public reporting directive in the matter of "The accounting treatment of contingent claims" that in evaluating the outstanding legal actions, the management of a banking corporation is to rely upon legal opinions of Counsel, which should determine the probability of the exposure to the risk involved in such actions materializing. Claims have been classified according to the probability range for a risk exposure materializing, as follows:

- 1) Probable - probability of over 70%;

- 2) Reasonably possible - probability of over 20% and up to and including 70%;
- 3) Remote - probability of 20% or below.

The financial statements include appropriate provisions for claims in respect of which realization of the related risk exposure is probable.

According to the Directive only in rare cases a banking corporation is entitled to state in its financial statements that in its Management's opinion, based on Counsel's opinion, it is not possible to assess the prospects that a risk exposure would materialize in respect of an ordinary legal action and an action approved as a class action. As to a motion for approval of a class action, the banking corporation is entitled to determine that it is not possible to assess the prospects of realization of the exposure to risk in four financial statements (including one annual report) to be published subsequently to the filing of an action together with a plea to have it approved as a class action suit. Such period is not to include the period in which the Court has stayed the proceedings in the matter. Note 19 to the financial statements states separately the outstanding claims, in respect of which a reasonable assessment of the exposure is not possible.

The banking corporations have been asked to determine for themselves a graded disclosure level relating to the classification of the proceedings according to the assessment of the risk involved therein. Accordingly, the financial statements include disclosure of material legal proceedings conducted against the Bank and Group companies, based on the following criteria: as a general rule, a material legal proceeding is one where the amount claimed is in excess of 0.5% of the equity capital of the Bank, and if it is not possible to assess the prospects of the risk materializing; and of 1% of the equity capital if the prospects of the risk materializing are reasonably possible or remote.

The banking corporations have also been asked to provide disclosure regarding the total exposure in respect of claims that have been assessed, in whole or in part (in respect of the relevant part), as "reasonably possible". Disclosure as above is given in Note 19 to the financial statements.

It should be noted that where the Bank is one of the defendants in an action, and the claimants have not attributed an amount to each of the defendants, the evaluation of the claim amount relevant to the Bank has been made to the best of ability, taking into account that consideration of the total amount might mislead and is incorrect in the circumstances, and that the evaluation does not necessarily represent the allocation as finally determined by the Court.

See Note 19 C to the financial statements for details of material legal actions pending against the Bank and against other companies in the Group. For details as to additional proceedings and claims settled during the year, see Section "Legal proceedings" hereunder.

## ASSESSMENT OF THE FAIR VALUE OF SECURITIES

Securities, excluding bonds held to maturity, are stated in the balance sheet at fair value, except for shares and options in respect of which fair value is not readily available, which are stated at cost.

Differences between the fair value and the stated cost of securities available for sale, are recognized in a capital reserve.

The market value of securities traded on an active market and which have a market price, represents their fair value. The stated fair value relating to securities which are not traded on an active market and which do not have a market price, is a calculated fair value as explained hereunder.

The fair value of bonds issued by foreign banks and financial institutions is based on price quotations by international providers of securities prices that are independent of the Bank, and independent of the issuing entities as well as the marketing entities. These providers are leading international companies that provide price quotation and evaluation services to hundreds of leading financial institutions around the world. For control purposes the middle office performs crosschecks of securities prices, as received from the provider with those published by the Bloomberg system (financial data system) and with quotations by brokers that are not the issuers of the securities. Whenever differences arise between the valuation of the provider and prices quoted by Bloomberg and/or brokers, the matter is brought before the control committee, which decides as to the fair value of the security.

Calculation of fair value of Israeli currency non-marketable securities is performed by the present value of future cash flows method,

on the basis of the discount rate received from an interest rate company. For control purposes, the middle office performs, to the extent possible, tests which compare the resultant fair value amount with prices of other marketable securities of the same issuer or similar securities traded on the market.

## IMPAIRMENT OF AVAILABLE FOR SALE SECURITIES

According to directives and guidelines issued by the Supervisor of Banks and to accepted accounting principles applying to banking corporations, unrealized gains or losses on adjustment to fair value of available for sale securities, net of the tax effect, are directly recorded as a separate item in shareholders' equity and are taken to the income statement in certain cases, including upon realization of the securities. Unrealized losses reflected as a capital reserve are losses of a temporary nature only. Other than temporary losses are taken directly to the statement of income.

The Bank's management is therefore required to examine and evaluate the nature of losses accumulated in respect of the said securities.

For the purpose of determining the nature of losses accumulated in respect of securities as above, managements of the Bank and/or of the relevant subsidiaries, base themselves on the security's various characteristics on which losses have been accumulated and on the company that had issued this security, such as: The loss rate in relation to cost/amortized cost, the period in which the fair value of the security was lower than its cost, the credit rating of the security and changes that had taken place in its rating and attributing impairment to the deterioration in the financial condition of the issuer or to market conditions as a whole, etc.

For further details, see Note 1 I 7 to the financial statements.

The said characteristics and assessments are to a large extent subject to subjective judgment and accordingly changes in assessments and the assumptions and features upon which they are based may have a significant effect upon the financial statements.

## ASSESSMENT OF THE FAIR VALUE OF DERIVATIVE FINANCIAL INSTRUMENTS

The Bank is active to a considerable extent in the derivative financial instruments field, which are presented in the financial statements on a fair value basis as different from the accrual basis. Where the derivative financial instruments are traded on an active market and have a market value, then the market value represents their fair value.

Where the derivative financial instruments are not traded on an active market and do not have a market value, fair value is assessed by means of accepted models for the pricing and revaluation, which take into account the risks inherent in the instrument, such as: the present value of future cash flows expected to be received from the instrument, the Black and Scholes model, etc.

The calculation of the fair value of derivative financial instruments, in respect of their foreign currency component, is based on interest rates and prices prevailing in the international money markets, and with respect to their Israel currency component, on non-linked interest rates and linked interest rates, determined by the Bank's asset and liability management department and through the Bank's dealing room, as the case may be, taking into consideration market prices, liquidity and the existing trading level in the local market. The margin between the sales interest rate and the purchase interest rate comprises a subjective factor, which affects the computation of the fair value of derivative financial instruments.

The fair value of options is based, for the most part, upon the Black and Scholes Model, and it is being affected by the volatility inherent (standard deviations) in exchange rates, interest rates and by the indices relevant to the option bought or written by the Bank. The volatility data of the dollar/Shekel exchange rate and of foreign currency to foreign currency exchange rate are determined by the Bank's dealing room in accordance with the money markets and are supervised by the middle office, being compared with several sources of information.

Establishing the model to be used in computing the fair value of derivative financial instruments, the pricing methodology and the computation of fair value amount, is the responsibility of the middle office, serving as a factor independent of the business units that execute the transactions (hereinafter: "the factor responsible for determining fair value"), by using designated systems (hereinafter: "process of determining fair value") for derivative financial instruments the volume of transactions therein is material.

The process of determining fair value is validated and verified by the department in charge of evaluation of market and liquidity risks at the Risk Management Department, which functions at a suitable professional level and serves as a factor independent of the factor responsible for determining fair value. Validating the said process includes an examination of the compatibility of the model to the type of instrument in question, the fairness and reasonableness of the parameters used in determining fair value, the reasonableness of the resultant fair value amounts, sample examinations of the computations, etc. Validating the models used for the computation of fair value is performed at least once a year, or whenever a material change takes place in the process of determining fair value. The validation process, which mostly includes the reasonableness tests and the sample computation tests, is performed once in every quarter. In addition to the verification and validation process, control measures are being adopted by the Accounting Layout in order to secure the appropriateness and fairness of the fair value of all derivative financial instruments. An interface exists for transmitting the results of the validation and verification processes between the middle office and the department in charge of evaluation of market and liquidity risks. In case of a dispute between these factors, the issue is brought before the control committee (A committee within the risk management layout in which representatives of the Accounting Group participate).

Note 20 to the financial statements presents comprehensive data regarding the Bank's activity in derivative financial instruments as well as information as to the fair value of such instruments, according to type of instrument.

The interest rates in foreign currency and in Israeli currency for the various time periods, constitute also the basis according to which the fair value of the balance sheet items is computed, as well as the cash flows deriving from assets and liabilities of the Bank, as detailed in Notes 18 and 21 to the financial statements.

These interest rates serve also for the computation of the fair value of assets and liabilities hedged against derivative financial instruments, to the extent that they comply with the hedging criteria, as required in the guidelines of the Supervisor of Banks.

Following are details regarding the fair value of financial assets and financial liabilities measured in the balance sheet and/or in the statement of income according to fair value, while distinguishing between instruments, the fair value thereof is determined by quoted prices in an active market and other, on a consolidated basis:

	as at December 31, 2010		as at December 31, 2009	
	Quoted prices in an active market	Other	Quoted prices in an active market	Other
in NIS millions				
<b>Assets:</b>				
Trading securities	2,193	-	2,155	-
Available-for-sale securities	15,645	12,585	14,412	17,782
Debitory balances in respect of derivative financial instruments	189	2,022	234	1,676
<b>Liabilities:</b>				
Creditory balances in respect of derivative financial instruments	90	3,162	254	2,292

## EMPLOYEE RIGHTS

Employees of the Bank and of its consolidated Banking subsidiaries in Israel are entitled to long-service bonuses ("Jubilee Bonuses") comprising several monthly salaries and additional paid vacation days, at the end of 20, 30 and 40 years of employment with the Bank. For details as to a new agreement allowing employees the choice of redeeming in cash such vacation days, see "Developments in labor relations" in the Chapter "Human resources" above. Bank employees are also entitled to certain benefits subsequent to their retirement from the Bank. These liabilities depend on several conditions that have to materialize in the future.

The Supervisor of Bank requires the Bank to base the provision for Jubilee bonus on an actuarial computation and to present it

at discounted value. The Bank engages the services of an independent actuary in preparing the said provision. The actuarial computation is based on several parameters, including the probability that all conditions for the payment of the bonus will materialize: life expectancy, retirement age, the rate of employee retirement prior to the prescribed retirement date, the rate of increase in salary anticipated until date of payment of the bonus and the discount rate. These parameters were determined, inter-alia, in a temporary instruction of the Bank of Israel, based on forecasts prepared by the actuary and the experience accumulated in the Bank. In accordance with the instructions of the Supervisor of Banks, the actuarial computation was based on a discount rate of 4%. The calculation of the provision for Jubilee bonus is sensitive to each of the values and parameters mentioned above. An increase of 1% in the discount rate would result in a reduction in liabilities in the amount of approximately NIS 71 million, while a decrease of 1% in the discount rate would result in an increase in liabilities in the amount of approximately NIS 71 million. For details regarding the Directive in the matter of "Intensifying internal control over financial reporting with respect to employee rights", to take effect as from January 1, 2011, see under "Miscellaneous" below.

## LEGAL PROCEEDINGS

### OUTSTANDING CLAIMS AGAINST THE BANK

Various actions are pending against the Bank and its consolidated subsidiaries, including class action suits and pleas to approve actions as class action, brought against them by customers of the Bank and of its consolidated subsidiaries, past customers as well as allegations with regard to various third parties, who consider themselves harmed or damaged by the actions of the Bank and its consolidated subsidiaries in the ordinary course of their business. Among other things, these actions raise allegations with regard to the unlawful debiting of interest and/or not in accordance with agreements, subjecting one service to another, the failure to execute instructions, applications for the confirmation of attachment orders in respect of attachments served by third parties as regards assets of debtors held, as alleged by them, with the bank, the unlawful debiting of accounts, mistakes in value dates, the invalidity of collateral security and the realization thereof, requests for injunction orders instructing the Bank to refrain from paying out of bank guarantees or documentary credit, as well as to provident funds, securities, construction loans, and applications for the removal of restrictions on an account pursuant to the Dishonored Checks Law, 1981. Management of the Bank believes, based inter-alia on Counsel's opinion and on the opinions of the managements of the consolidated subsidiaries of the Bank, which are also based on counsel's opinion, as the case may be, respectively, that adequate provisions have been included in the financial statements, if required. Material actions outstanding against the Bank and its consolidated subsidiaries are described in Note 19 C to the financial statements.

### DEBT COLLECTION PROCEDURES

As part of the debt collection policy of the Bank and its consolidated subsidiaries, legal procedures are instituted in the ordinary course of business for the collection of debts from the borrowers or from guarantors for such debts, including the realization of collateral provided by the borrowers or by any third parties. Included in such procedures are procedures for receiverships, liquidations, the foreclosure of pledged assets, etc.

### ADDITIONAL LEGAL PROCEEDINGS TO WHICH THE BANK IS A PARTY

On September 15, 2008, the Lehman Brothers Group (hereinafter: "Lehman Group"). At that time, the Bank and IDB New York held Lehman Group's holding company's bonds. Furthermore, the Bank manages various accounts of Lehman Group companies, some of which are for their customers.

On September 18, 2008, at the request of Bank Leumi, a temporary comprehensive attachment order was issued with respect to

assets and rights existing in the Lehman Group accounts with the Bank in an amount of up to NIS 370 million. On October 6, 2008, Bank Leumi filed a petition for approval of the attachment. The Bank has submitted a defense brief.

On November 17, 2008, the Bank served three companies of the Lehman Group with a notice of setoff in respect of all assets and money held by the Group with the Bank as regards all the Group's debts to the Bank, except for accounts managed on behalf of Lehman Group customers.

On March 12, 2009, the Tel Aviv District Court ruled a compromise agreement reached between the Bank and Bank Leumi, to have effect of a Court verdict. According to this agreement, the attachment on assets of the Lehman Brothers companies held by the Bank, executed by Bank Leumi will be approved, subject to the priority rights of the Bank in these assets deriving from the right of set-off to which the Bank is entitled.

On December 10, 2009, the Bank received notice of a motion for contempt of Court that had been submitted to the Bankruptcy Court in New York by Lehman Brothers Inc., against Bank Leumi and Israel Discount Bank. As part of the motion filed in New York, Lehman Brothers Inc. petitioned to apply the stay of proceedings order issued in New York to Bank Leumi and to Discount Bank and to instruct them to stop all proceedings against Lehman Brothers Inc. in Israel, to cancel the attachments on its funds and to allow the Trustee to perform receivership on all its assets in Israel. The Bank claimed that it is subject to proceedings in a Court of Law in Israel. The decision of the New York Bankruptcy Court has not been given yet.

On November 16, 2010, the Bank was served with a request by Lehman Brothers Commercial Corporation for Alternative Dispute Resolution procedures (ADR) regarding a settlement with respect to derivative transactions that were pending at date of the collapse of the Lehman Group. The parties are mutually conducting clarifications in this matter.

## SIGNIFICANT LEGAL PROCEEDINGS SETTLED IN 2010

1. Note 19 C, 11.13, to the financial statements as of December 31, 2009 (p. 501) described a motion for approval of a lawsuit against the Bank, the Accountant General at the Ministry of Finance, the Supervisor of Banks and the Head of the Consumer Protection Authority, as a class action suit, filed on October 29, 2009, at the Jerusalem District Court.

According to the Claimant, the Bank unlawfully discriminates against customers who do not enjoy the reduced interest rate of the Accountant General on loans, as do State employees who are entitled to receive loans at this reduced interest rate. The Claimant claimed a general damage assessed by him at NIS 1 billion.

On January 7, 2010, the Bank submitted a motion for the striking-off in limine of the motion for approval of the suit as a class action suit. On February 11, 2010, the District Court decided to dismiss in limine the motion for approval of the lawsuit as a class action suit.

2. Note 19 C 11.14 to the financial statements as of December 31, 2009 (p. 506) described a motion to approve a lawsuit as a class action against the Bank, submitted on December 25, 2008, by a client of the Bank, in which he argues that the Bank gives a benefit to clients setting up deposits through the internet. The client claimed that the Bank did not provide its clients with the information regarding the rate of the said benefit and the fact that the benefit is cancelled on the first renewal date. The Bank thus operated in contradiction to the regulatory requirements applying to it and misled its customers. The client estimated the damage to all members of the group at NIS 115 million. The claim was struck-off on June 10, 2010, with no order for expenses.

3. A motion was filed with the Jerusalem District Court on June 6, 2010, for the approval of a claim against the Bank and against Discount Gemel Ltd. as a class action suit.

The Claimant, a member of the "Tamar" and "Geffen" provident funds, argued that the Defendants were not entitled to sell the said funds for a monetary consideration and that the monetary consideration received by them in the amount of NIS 620 million, should be divided among members of these funds.

On August 24, 2010, the District Court dismissed the motion for approval of the action as a class action, without calling for the Bank's response.

For details regarding a significant legal proceeding that ended in March 2011, see Note 19(c), item 11.7 to the financial statements.

## PROCEEDINGS REGARDING AUTHORITIES

1. For details regarding various proceedings conducted by the Antitrust Commissioner and concerning the Groups activities in the credit card field, see Note 33 to the financial statements and "Credit card operations" under "Further details as to activity in certain products".
2. For details regarding the decision of the Antitrust Commissioner, given under Section 43(a)(1) of the Antitrust Law, 1988, according to which the Commissioner states that binding arrangements had existed between the Bank, Bank Hapoalim, Bank Leumi, Mizrahi-Tefahot Bank and the First International Bank regarding the communication of information with respect to commissions and in respect of the Supervisor's ruling that in accordance with Section 43(e) of the said Law, the said statement serves as prima facie evidence for everything determined therein in any legal proceedings, see Note 19 C 14 to the financial statements.
3. For details regarding an audit by the Bank of Israel in the matter of "Implementation of the provisions of the Prohibition of Money Laundering Law" at ICC, see above in "Israel Credit Card Company Ltd." under "Main investee companies".
4. For details regarding the terms determined by the Supervisor of Banks and the Antitrust Commissioner in their approval granted to the agreement between the Bank and FIBI Holdings in the matter of the holdings of the Bank in the First International Bank, see Note 6 d to the financial statements.

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## MATERIAL AGREEMENTS

Hereunder is presented a summary description of agreements, entered into outside the ordinary course of business, that might be considered material, to which the Bank is a party, or which according to its best knowledge, the Bank is a beneficiary in terms thereof, including agreements that were valid in the period covered by this annual report, or which affected the Bank's operations during such period.

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### AGREEMENT FOR THE ACQUISITION OF MEANS OF CONTROL IN THE FIRST INTERNATIONAL BANK ("FIBI")

According to an agreement dated July 31, 1983, between the Bank and FIBI Holdings Ltd. and one of its subsidiaries, in terms thereof the Bank acquired ordinary shares of a par value of NIS 5 each in FIBI, which granted the Bank approximately 26% share in the equity and 11% share in the voting rights of FIBI, it was agreed, among other things, that the Bank shall not be involved in the management of FIBI.

The agreement provided that so long as the Bank is in possession of at least 80% of the shares in FIBI acquired by it under this agreement (including bonus shares and rights in respect of these shares), FIBI Holdings will see to it that one quarter of the members of the board of directors and of board of directors' committees of FIBI will be members recommended by the Bank, on condition that the Bank will not recommend persons the appointment of whom might, in the opinion of the Governor of the Bank of Israel, create a conflict of interests. In addition, the said agreement provided that each of the parties thereto shall have the right of first refusal in respect of the acquisition of shares in FIBI held by the other party, whether such sale shall be made on or off the market. The right of first refusal does not apply to sales of up to 20% of the total holdings of each party effected on the Tel-Aviv Stock Exchange in the ordinary course of business.

Furthermore, the right of first refusal does not apply in the case of a sale of FIBI shares by any of the parties to its parent company

or to a company controlled by such party.

The acquisition of the said shares was made in terms of a permit for the acquisition of means of control, under Section 34 of the Banking Law (Licensing), 1981, granted by the Governor of the Bank of Israel on July 20, 1983, in the framework of which the Bank was permitted to acquire up to 30% of the issued and paid share capital of FIBI. As part of the process of obtaining the permit to acquire means of control, the Bank has made a commitment to the Bank of Israel that FIBI will be managed in an independent manner, and that all members of the Board of Directors of FIBI shall be appointed by FIBI Holdings Ltd., 25% thereof to be appointed in accordance with the recommendation of the Bank as approved by the Governor of the Bank of Israel. It was further agreed that the Governor would not withhold his approval of the recommendation of the Bank as above, unless based on reasonable grounds and considering the possibility that such appointments might create a conflict of interests.

**The signing of an agreement with FIBI Holdings - 2010.** On March 28, 2010, an agreement was signed between the Bank and FIBI Holdings, its principal terms are as follows:

- The agreement contains conditions precedent to its validity (hereinafter: "the conditions precedent"), which are: obtaining the approval of the Supervisor of Banks and the approval of the Antitrust Commissioner to the agreement ("the regulatory approvals"), this until the end of 150 days from the date of signing of the agreement; as well as the distribution of a cash dividend of NIS 800 million by FIBI to its shareholders, out of its retained earnings as of December 31, 2005, as per its financial statements (hereinafter: "the distribution");
- It has been agreed that FIBI Holdings will act to the best of its ability towards the unification of the share capital of FIBI, following which, all shares making up the share capital of FIBI shall be of one class and shall confer equal voting rights;
- Israel Discount Bank shall vote in favor of completing the process of unification of the share capital in the general meetings of shareholders of FIBI, subject to obtaining the regulatory approvals to the agreement as well as to the realization of the terms specified in the agreements, inter-alia, completion of actual distribution or obtaining confirmation according to which all required proceedings for the distribution have been realized and all approvals for the distribution have been obtained;
- Soon after completion of the unification of capital, if and when completed, Israel Discount Bank shall deposit with a trustee a number of shares of FIBI, the voting rights attached therein (out of the total voting rights in FIBI) exceeding the existing rate of voting rights held by Israel Discount Bank (hereinafter: "the deposited shares"), this in accordance with a trusteeship agreement to be approved by the Supervisor of Banks. Israel Discount Bank or the trustee shall refrain from acting upon the voting rights attached to the deposited shares. The trustee shall pass on to Israel Discount Bank any dividend or any other benefit of any kind that will be received by him by virtue of the deposited shares, immediately upon their receipt (excluding bonus shares or shares stemming from the unification of the capital, or a split of the deposited shares, or shares deriving from securities convertible into shares, which FIBI may issue in respect of the deposited shares. These shares shall remain in the hands of the trustee and shall become an integral part of the deposited shares for all intents and purposes). The trustee shall release the deposited shares in the event that the ratio of voting rights held by Israel Discount Bank in FIBI shall fall below the ratio existing at present (11.09%) in order to restore the ratio of voting rights to the existing ratio, or for the purpose of transferring the deposited shares, or part thereof, to a third party;
- Until the end of six months from the date of completion of the unification of capital, and subject to the fulfillment of the conditions precedent and subject to the completion of the unification of the capital, Israel Discount Bank shall act towards the sale of 6% of its holdings in the equity and voting rights in FIBI to third parties, provided that market conditions allow this sale at a price that is not lower than the stated value of the investment in such shares in the financial statements of Israel Discount Bank;
- It has been agreed that until the determining date, as signified below, Israel Discount Bank shall be entitled to purchase additional securities within the framework of any rights offer by FIBI to its shareholders, on condition that the additional shares purchased by Israel Discount Bank, if at all, shall be deposited with the trustee and all the provisions applying to the deposited shares shall also apply to them.
- Starting with the date on which all conditions precedent to the agreement are fulfilled, the arrangement existing between

Israel Discount Bank and FIBI Holdings regarding the right of first refusal for the purchase of shares in FIBI, as well as any transfer or sale of shares in FIBI by FIBI Holdings or by Israel Discount Bank, shall not be subject to the said right;

- Starting with the date on which all conditions precedent to the agreement are fulfilled and until December 31, 2013 (hereinafter: "the determining date"), Israel Discount Bank shall be entitled to have FIBI Holdings continue to cause the appointment of one quarter of the Directors of FIBI from among candidates recommended by Israel Discount Bank (subject to directives regarding the prevention of conflict of interests), regardless of the number of shares held by Israel Discount Bank. Subsequent to the determining date, the arrangement existing between Israel Discount Bank and FIBI Holdings, including the arrangement regarding appointment of directors recommended by Israel Discount Bank, shall become null and void. The determining date may be postponed under certain conditions determined in the agreement. Among other things, if the completion of the unification of capital of FIBI is not achieved within one year from date of signing the agreement, the determining date shall be postponed to December 31, 2014.

**Approvals of the Supervisor of Banks and the Antitrust Commissioner.** Following the signing of the agreement, the Bank applied to the Supervisor of Banks and to the Antitrust Commissioner for their approval of the agreement. The approval of the Supervisor of Banks for the agreement and the approval of the Antitrust Commissioner (hereinafter: "the Commissioner") for "merger of companies" under the Restrictive Trade Practices Law, 1988, were received on August 17, 2010, with respect to the process of unification of the share capital to be executed by FIBI.

The parties to the agreement confirmed that the conditions precedent determined in the agreement for this purpose have been fulfilled with the receipt of the above mentioned two approvals.

The agreement, approved by the Supervisor of Banks, specified that the Supervisor of Banks would consider the Bank's request in the event that FIBI would offer rights to all its shareholders and the Bank would seek to participate in such offer.

Among other things, the approval by the Commissioner specified that the Bank must reduce its holdings in FIBI to a rate below 10% of the issued share capital of FIBI by December 31, 2015, or until the end of five years from date of the unification of the share capital of FIBI, the earlier of the two. In addition the bank must reduce its holdings in FIBI to a rate below 5% of the issued share capital of FIBI by December 31, 2017, or until the end of seven years from date of completion of the unification of the share capital of FIBI, the earlier of the two. Alternatively, the Bank must reduce its holdings in FIBI to a rate below 5% of the issued share capital of FIBI by December 31, 2016, or until the end of six years from date of completion of the unification of the share capital of FIBI, the earlier of the two. In addition, the Commissioner's approval specifies that in the event that the Bank does not reduce its holdings until the end of the above mentioned periods, as the case may be, than the excess number of shares in FIBI held by the Bank subsequent to the dates detailed above, shall be sold by a Trustee appointed for this purpose, this in accordance with the arrangements determined in this matter in the Commissioner's approval. Furthermore, it has been determined that the Bank shall not acquire shares in FIBI or any right in FIBI any other way, unless with the prior permission in writing by the Commissioner.

On September 6, 2010, following completion of the distribution and the actual payment in cash of the dividend, in accordance with the agreement, and upon obtaining the regulatory approvals with respect to the agreement, the conditions precedent have been fulfilled and the agreement came into effect.

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## OBLIGATIONS OF THE BANK WITH RESPECT TO CAPITAL MARKET OPERATIONS

In October 1983, within the framework of the "bank shares arrangement", the Bank informed the Minister of Finance and the Governor of the Bank of Israel that, among other things, it would not initiate, either directly or indirectly, orders for the purchase or sale of securities within the orders submitted to the Stock Exchange prior to the beginning of trading ("Leaders"), or as part of the setoff of purchase or sale orders prior to the beginning of trading.

The Bank further confirmed that it would prevent, either directly or indirectly, any transaction in securities issued or which would be issued by banks or bank holding corporations, unless such transactions are on behalf of its customers, including provident and mutual funds.

However, the Bank noted that nothing in the above would avoid transactions effected in the ordinary course of business.

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## **EXEMPTIONS OF INDEMNIFICATION TO DIRECTORS OR FORMER DIRECTORS IN THE BANK OR INVESTEE COMPANIES OF THE BANK**

The previous version of the Articles of Association of the Bank, which was amended in March 2002, included provisions regarding the indemnification of whoever acts or has acted, at the request of the Bank, as director in another company, in which the Bank has an interest, as detailed in Note 19 C 7 a to the financial statements. Accordingly the Bank had issued at that time letters of indemnification, unlimited in amount, to the acting directors or who have acted at the request of the Bank in other companies owned by it. For details regarding exemption in advance and indemnification of Directors and other Officers of the Bank, see Note 19 C 7 C to the financial statements.

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## **COMMITMENT FOR COOPERATION DURING THE PROCESS OF SALE OF THE BANK'S SHARES**

In an Annex to the agreement dated August 29, 1991, between the Government of Israel, in the name of the State of Israel, M.I. Holdings Ltd.(hereinafter: "M.I. Holdings"), Israel Financial Holdings and IDB Holding Company Ltd., the parties thereof are M.I. Holdings and the Bank, the Bank committed to cooperate with M.I. Holdings and assist in the process of sale of the Bank's shares, this, subject to adherence to any law and the guidelines of the Supervisor of Banks, and subject to the matters detailed in the Annex. Among other things, the Annex determined that the Bank will provide information to assessors acting on behalf of M.I. Holdings and on behalf of potential buyers, everything subject to the limitations and confidentiality arrangements detailed in the Annex.

As determined in the Annex, M.I. Holdings has agreed to indemnify and/or compensate the Bank and/or any member of the Board of Directors of the Bank and/or any employee of the employees of the Bank in respect of any damage suffered by the Bank and/or any of the above, as applies, and/or any of the customers of the Bank (on condition that the Bank or any of the above would be charged in respect of any damage determined by a Court's verdict) as a result of the performance of the Annex and everything related to it; however, the commitment to indemnify and/or compensate as above, shall not apply to responsibility for or in respect of a violation of the Securities Law, 1968. It shall also not apply to damage resulting from error, misrepresentation or omission in the information, documents or presentations made by the Bank in accordance with the Annex, if it is proved that the error, misrepresentation or the omission were caused intentionally or not in good faith.

The form of the cooperation in accordance with the said agreement was later formalized in the The Bank Shares Arrangement (Temporary Provision) Law, 1993. The said agreement has been amended several time with the consent of the parties.

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## **AGREEMENTS WITH THE FIRST INTERNATIONAL BANK AS TO THE HOLDING OF MEANS OF CONTROL IN ICC**

On December 10, 2006, alongside the consummation of the agreement for the purchase of the shares in ICC held by Fishman, the Bank and the First International Bank signed an agreement securing the understandings between them and regularizing the rights and obligations towards one another as shareholders of ICC. The said agreement amends a previous agreement between the parties dated September 29, 2000. The arrangements determined in the agreement apply, respectively, also to the shares purchased from Harel.

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## LABOR CHARTER

The labor charter for Israel Discount Bank Ltd. employees was signed in 1974 and it incorporates employment terms, instructions regarding discipline, etc. For details see "Labor relations" under "Human resources" above.

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## AGREEMENT WITH THE EMPLOYEES

An agreement dated February 1, 2005, signed concurrently with the agreement for the sale of a controlling interest in the Bank, between the New Histadrut Federation of Labor, the Representative Committee of Discount Bank Employees and the Accountant General of the Ministry of Finance, which was later joined by the Bank, following approval by the Bank's authorized organs, and which will regularize certain demands raised on behalf of the Bank employees in the matter of their rights on the background of the sale of a controlling interest in the Bank by the State, everything as described in "Employees Agreement" under "Control of the Bank" above.

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## AN AGREEMENT FOR THE GRANTING OF LOANS AND SERVICES TO STATE EMPLOYEES

On May 10, 2007, the Bank signed an agreement for the granting of loans, overdraft and banking services to State employees following its success in the tender issued by the Accountant General. For further details see "Retail banking sector - household segment" in the Chapter "Activity of the Group according to principal segments of operating" and Note 19 C 18 to the financial statements.

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## THE INTERNAL AUDIT IN THE GROUP IN 2010

**Details of the internal auditor.** The Bank's internal auditor in 2010 was Mr. Shlomo Pitchon, CPA(Israel) who acted in this position since September 1, 1994. The internal auditor was not an interested party in the Bank<sup>(1)</sup>, was not an officer of the Bank, was not related to any of these persons and was not the Bank's external auditor or acting on his behalf.

The internal auditor complied with the provisions of Section 146(B) of the Companies Law and of Section 8 of the Banking Rules (Internal Audit) and the staff of the internal audit department comply with the provisions of Section 8 of the Banking Rules (Internal Audit).

In addition, as from February 1, 1994, Mr. Pitchon served also as the internal auditor of certain subsidiaries of the Bank, including: Discount Mortgage Bank Ltd. and its subsidiaries, Discount Gemel Ltd., DCMI and its subsidiaries, Tachlit, Discount Trust Ltd., Discount Leasing Ltd., BDL Computer and Administration Services Ltd. He served as internal auditor of Discount Manpikim Ltd. since April 1, 1999, and of ICC since March 1, 2008.

**The manner of appointment.** The appointment of the internal auditor was approved by the Board of Directors as a permanent appointment in its meeting of August 29, 1994. Approval of the appointment was based upon the qualifications, experience and education of Mr. Shlomo Pitchon. Mr. Pitchon is a Certified Public Accountant and an economist and prior to his appointment served for ten years as the deputy internal auditor and for six months as acting internal auditor.

**The organ in charge of the internal auditor.** The Chairman of the Board of Directors is the organizational entity in charge of the internal auditor.

**Work plan.** The internal audit operates according to the annual work plan derived from a multi-annual work plan (the multi-annual work plan covers a period of three years not including the current year).

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(1) The internal auditor holds a negligible number of shares in Discount Bank in the par value of NIS 22,727 and in the opinion of the Board such holdings have no effect on the quality of his performance.

The annual and multi-annual work plans (hereinafter: "the work plan") are prepared in accordance with the Internal Audit Law, 1992, according to the Banking Rules (Internal Audit) 1992 and according to Proper Bank Management Directives.

The work plan was designed on the basis of an overall risk survey, conducted according to new and accepted methodologies, and was influenced by local and international guidelines (including Basel II, COSO, SOX and by the draft internal audit guidelines published by the Supervisor of Banks).

The senior management of the internal audit layout are involved in the preparation of the work plan. Prior to the work plan being submitted for approval, it is forwarded to the Bank's independent auditors, to the chairman of the Board of Directors, to the Chairman of the Board's Audit Committee and to the Bank's President & CEO for lodging comments and elucidations.

The Board of Directors' Audit Committee discusses the work plan and on the basis of its recommendations the plan is brought before the Board for approval.

The work plan allows the internal auditor discretion for a 15% deviation as regards the use of human resources. A higher deviation requires prior approval of the Audit Committee.

The planned work programs for the material subsidiaries, at which the Bank's internal auditor serves also as their internal auditor, are combined with the annual work program for the internal audit of the Bank, while addressing each subsidiary separately. The scope of the work program for each subsidiary as above, is discussed by the audit committee of each subsidiary, and/or by the Board of Directors.

Most of the audit reports are graded on the basis of the audit findings. The range of grades moves from "very good" (1) to "very weak" (5). Among other things, the grade of the report serves to indicate the level of management involvement which is required in addressing the report's findings.

Each audit report is submitted by the internal auditor to the President & CEO of the Bank and to the Bank's auditors. The Chairman of the Board and the Chairman of the Audit Committee of the Board receive each audit report, except for audit reports relating to branches highly graded, in respect of which they receive an executive summary. All the audit reports with respect to low graded branches (grades 4 or 5) are submitted in full to the Chairman of the Board and the Chairman of the Audit Committee of the Board. During the reported period, material transactions (within the meaning of Proper Banking Management Directives) were effected, and these have been examined by the internal auditor on a sample basis, including the procedures for their approval.

**Audit of investee corporations in Israel and abroad.** The internal audit work plan also relates to the Bank's investee companies in Israel and abroad. Where the internal auditor of the Bank does not perform audits of investee companies, control of such companies is performed as required by Section 1(A)(3) of Banking Rules.

The Bank's internal auditor coordinates in advance with the internal auditor of the investee company as to the matters which would be audited by the internal auditor of the investee.

**Scope of employment.** The internal auditor is engaged in a full time position and the average number of staff working under him in the Group in the reported period numbered 126.1 positions (including outsourcing and overheads), of which, 36.75 positions in corporations that engage an independent internal auditor (Mercantile Discount Bank, IDB New York and Discount Bank Latin America). The number of positions in the internal audit layout is derived from the requirements of the work plan as approved by the Board of Directors.

Following are details of the average number of positions in 2009 engaged in internal audit at the Bank and in investee companies in Israel and abroad (the scope of positions manned by outsourced manpower is given in parenthesis)

The Bank itself, including outsourcing and overhead	70.3	(1.0)
Investee companies in Israel audited by the internal auditor of the Bank (including outsourcing and overhead)	14.6	(1.5)
In overseas extensions	2	-
Investee companies in Israel where the audit (including outsourcing and overhead) is performed by an independent internal auditor	23	(0.25)
Investee companies abroad where the audit (including overhead) is performed by an independent internal auditor	12	(1.5)
<b>Total</b>	<b>121.9</b>	<b>*(4.25)</b>

\* of which: the internal auditor, overheads - two positions, and public access - two positions.

**Performance of the audit.** The internal audit is carried out according to the provisions of the Internal Audit Law, 1992, Banking Rules (Internal Audit), 1993 and according to the professional standards of the Institute of Internal Auditors in Israel.

The internal auditor also acts in accordance with the instructions and guidelines of the Supervisor of Banks as reflected in Proper Banking Management Directives and in audit reports performed by the Supervisor of Banks.

In discussions regarding the work plan and audit reports of the Supervisor of Banks, members of the Audit Committee and of the Board of Directors received information as to the mode of performance of the internal auditor and they were satisfied that he acts in accordance with the requirements of the instructions mentioned above.

**Access to information.** All information and documentation required by the internal auditor is handed over to him and is granted permanent and direct access to the information systems of the Bank, including financial data. Access to information as stated above, in investee companies and foreign operations, is secured by the internal audit procedures of these entities and by guidelines of their boards of directors.

**Reports by the internal auditor.** All reports of the internal auditor are submitted in writing.

With respect to each quarter, about 45 days following the end of the quarter, the internal auditor submits a comprehensive report regarding all activities of the internal audit in Israel and abroad, for that quarter. The quarterly report discusses the material findings included in audit reports submitted in the course of the reported quarter, a concise response to the findings by the audited entities, as well as follow-ups of previous quarterly reports and prior issues that had not yet been resolved. It should be noted that all detailed audit reports are submitted to the Chairman of the Board, the Chairman of the Audit Committee, the President & CEO and the Bank's independent auditors.

The quarterly report is submitted to the Chairman of the Board, to the President & CEO and to all Board members, so that at each quarter they have a very detailed picture as to the findings of all audits performed by the internal auditor, the response to these findings and the manner in which audit findings had been treated. The audit committee of the board discusses the quarterly report.

In addition, the audit committee of the board discusses specific audit reports regarding the Bank's units, in cases where the chairman of the board, the chairman of the audit committee and/or the internal auditor consider that the findings in these reports or the significant issues which they raise require special attention.

Once a year, the internal auditor submits to the Chairman of the Board, to the President & CEO and to all Board members an annual report (in addition to the four quarterly reports). This report details the principal matters that were audited during the year, the manner in which the findings and recommendations were treated. A copy of the report is also delivered to the Auditors. The annual report is being submitted within 75 days from the end of the year to which it relates, and is being discussed by the board and by the audit committee of the board.

The quarterly and the annual reports were submitted and discussed as follows:

- Report on the activities of the internal audit in the fourth quarter of 2009, submitted on February 16, 2010, and discussed by

the Audit Committee on March 24, 2010.

- Annual report on the activities of the internal audit in 2009, submitted on March 14, 2010, and discussed by the Audit Committee on April 12, 2010 and by the Board of Directors on May 3, 2010.
- Report on the activities of the internal audit in the first quarter of 2010, submitted on May 11, 2010, and discussed by the Audit Committee on July 11, 2010.
- Report on the activities of the internal audit in the second quarter of 2010, submitted on August 15, 2010, and discussed by the Audit Committee on October 13 and 31, 2010.
- Report on the activities of the internal audit in the third quarter of 2010, submitted on November 15, 2010, and discussed by the Audit Committee on January 17, 2010.
- Report on the activities of the internal audit in the fourth quarter of 2010, submitted on February 16, 2011 and discussed by the Audit Committee on March 7, 2011.

The annual report regarding the activities of Internal Audit in 2010 is being submitted these days.

**Valuation by the Board of Directors of the internal auditor's performance.** In the opinion of the Board of Directors and of the Audit Committee, the scope, nature and continuity of the operations of the internal auditor and his work plan are reasonable under the circumstances and attain the goals set out for internal audit at the Bank.

**Remuneration.** Details of the payments to the internal auditor and of the components thereof are given hereunder under "Remuneration of the Chairman of the Board of Directors and Senior Executive Officers". In the opinion of the Board of Directors, such payments have no effect upon the internal auditor's professional judgment.

Retirement from office of the Internal Auditor

Mr. Shlomo Pitchon, Senior Executive Vice President and Internal Auditor, informed on December 13, 2009, of his decision to retire from office as the Internal Auditor of the Bank and of a number of the Bank's subsidiaries. The date of his retirement from office has not been decided at that date.

On January 27, 2010, the Internal Auditor informed that he responded favorably to the request of the newly appointed Chairman of the Board, Dr. Joseph Bachar, and to the request of the President & CEO Mr. Giora Offer, to postpone his retirement from office as internal auditor of the Bank and some of its subsidiaries until the end of 2010.

Mr. Shlomo Pitchon, Senior Vice President, terminated on December 31, 2010, his office as the Internal Auditor of the Bank (this following his announcements of December 13, 2009 and January 27, 2010).

On December 12, 2010, the Board of Directors resolved to approve the appointment of Mr. Nir Abel, CPA, as Internal Auditor of the Bank with the title of Vice President, who will assume his duties in the course of 2011. In the period until Mr. Abel assumes office, Mr. Rafi Bichler, deputy manager of the Internal Audit layout, serves as acting Internal Auditor.

## INVOLVEMENT WITH AND CONTRIBUTION TO THE COMMUNITY

Since its formation, Israel Discount Bank has been active in community affairs, having an overall management conception, according to which, activities beneficial to the community form part of a business, social and cultural obligation.

The volunteer activity within the framework of the "Lema'an" Project - Discount Employees for the Community continued during 2010, in this context, volunteer Bank employees act out the Bank's vision of people oriented banking contributing their time and compassion.

The volunteer activity is varied and provides assistance and support to a wide range of components of the population in Israel: children and youth, students, servicemen, disadvantaged sectors, old elderly, handicapped, infirm and such like.

In addition to the activities of "Lema'an - Discount Employees for the Community" project, described hereunder, the following activities were also conducted in 2010 in the culture and arts field, providing sponsorship and donations.

In 2010, the Bank continued the trend of supporting children and youth in various states of distress, and Art seeking youth.

**Monetary scope of activity.** The total volume of activities of Discount group in 2010, including the Lema'an Project, amounted to NIS 7,292 thousand, compared with NIS 7,311 thousand in 2009. In addition, the Bank has borne the cost of the staff of the social responsibility unit and the cost of additional entities at the Bank who were directly engaged with various issues of social responsibility, as part of their working hours, in a total amount of NIS 1,355 thousand in 2010, compared to NIS 1,148 thousand in 2009. Furthermore, direct current cost associate with the Visitor Center (tour guide personnel and building maintenance) amounted in 2010 to NIS 4,023 thousand, compared with NIS 3,343 thousand in 2009. Miscellaneous expenses, including expenses for production of the Corporate Social Responsibility Report, participation by Bank Management in financing of the "March for the living" visit to Poland, and financing staff visits to the capital Jerusalem (in 2009), amounted in 2010 to NIS 445 thousand, compared to NIS 1,057 thousand in 2009.

The social activity and involvement in the community was carried out by the Bank in the following areas:

## DONATIONS

Donations are directed mainly to associations, clubs, education establishments, health organizations and others, that focus on children and personal welfare. Among the donations granted in 2010, noteworthy are those granted to following associations: Yad Ezer Lachaver, Warm Home for Children requiring Artificial Respiration, Yad Sarah, Ilan, Akim, The Institute for Advancement of Education in Jaffa, College for All, Alut - the Israeli Society for Autistic Children, the Israel Multiple Sclerosis Society, Variety, Reuth Medical Center, "Migdal-or" Association, Nachum Gutman Museum, The Foundation for Advancement of Druze Community Members, and more.

## THE "LEMA'AN" PROJECT - DISCOUNT EMPLOYEES FOR THE COMMUNITY

This project was launched at the end of March 2002. The project constitutes the joint effort of management and the employees' committee, whereby Bank employees volunteered for activities for the community. In the course of 2010, the effort was focused on volunteer activities in aid of children and youth at risk and distress situations, senior citizens, the sick, special needs and more. Presented below is a selection of examples of the projects and activities within the framework of the "Lema'an" Project:

**Unit volunteer activity.** During the year, additional units at the Bank joined the volunteer activity within the framework of the unit, including:

- **Doron House in Ramat-Gan** - the foreign currency department of the Diamond Exchange branch has elected to adopt the Doron House in Ramat-Gan. Assistance to pensioner citizens is focused on the teaching of English and computers;
- **After-school club for children of families in distress** - The Kfar-Saba branch has joined the volunteer circle by adopting an after-school club for children of distressed families. The connection began during the holiday period and continued by addressing the needs of the club, such as contribution of equipment, repair of existing equipment and more;
- **"Lilach" Children Clubs in Tel Aviv** - the Human Resources Department of the Corporate Banking Division warmly adopts the children of the Club;
- **The Na'amat Home "Feigale" in Ashklon** (a multi-purpose home for children at risk) - adopted by the staff of the Ashkelon branch;
- **The Na'amat Home "Oshiyot" in Rehovot** (a multi-purpose home for children at high risk) - adopted by the staff of the Rehovot branch;
- **The Na'amat Home Amidar in Bat Yam** - adopted by the Securities Products Management Department;
- **The Shalva Home for children with special needs** - adopted by the Kanfei Nesharim branch in Jerusalem;
- **The Talpiot Village in Hadera** - adopted by the Hadera branch;
- **A warm Home for Children at risk in Yavneh** - adopted by the staff of the Yavneh branch;
- **"A Warm Home for Every Soldier"** - adopted by the Shay Agnon branch in Jerusalem;

- A unique project has also started in Be'er Sheva in cooperation with employees of the Branch, a special care high school class and the Be'er Sheva Association.

**"Tu Be'shvat" holiday activities.** The Bank purchased packages of dried fruit for distribution by Bank employees who engage in voluntary work. Distribution took place in activity centers for the adult population, including servicemen, senior citizens, Holocaust survivors, hospitals etc.

**"Purim" holiday activities.** Volunteer Bank employees organized Purim celebrations at centers at which they are active. Worthy of mention is the activity held at the Schneider Children Hospital in Petach Tikva (where some 200 children are hospitalized), in which sixty volunteers from various units and branches of the Bank participated. The activity included a party for the children with twenty clowns, giant dolls and inflatable dolls, various game stations, a rich buffet, distribution of candy boxes and visits to the children wards together with the clowns and volunteers of the Bank.

**Hanukkah events at volunteering venues.** Bank employees conducted Chanukah parties at centers in which they work as volunteers; children clubs, senior citizen clubs, schools, a shelter for battered women, drug rehabilitation center, Chimes - Rehabilitation Work Centers (adult population having special needs), children with special needs, hospitals etc.

**"Adopt a combat soldier" Project.** Discount Bank continued its support to the enterprise established by the Friends of the IDF. Within this framework the Bank decided to continue its adoption of "Squadron 916" of the Israel Navy, which is entrusted with Israel's southern coastline. In February 2010, the ceremony of renewal of the adoption of the Squadron for an additional period of three years was held in the presence of the president & CEO of the Bank, VP of Human Resources and volunteers from the Bank's Ashdod branch, officers and soldiers of the Squadron and representatives of the Aguda Lemaan Hachayal - The association for the wellbeing of Israeli soldiers.

The bank supports the Squadron with a monetary contribution as well as with voluntary work. The contribution is a yearly amount of NIS 100 thousand intended for financing activities for the welfare of the soldiers.

In addition to a monetary contribution, the Bank incorporates volunteer activity of the Ashdod Branch employees. Furthermore, naval servicemen participate in various events of the Bank. Among other things, the squadron's servicemen were invited to visit the Discount Visitors' Center and enjoy an interactive tour of the place (see below "HerzLilinblum").

**Purchase of computers for the Dana Children Hospital.** Two laptop computers were donated to the hospital for use by bedridden hospitalized children. The computers were especially modified for the needs of the children.

**Adoption of Ethiopian families.** Following the initiative of the staff of the Operations and Information Division and in conjunction with the "Latet" Association, two Ethiopian families, with considerable socioeconomic and medical obstacles were chosen. These families received assistance in various areas: house renovations, donation of equipment, donation of food, examination of financial help for medical treatment through the "Discount Fund" ("Ezra Lemarpeh" Association) and more. The adoption is aimed at assisting these families to rehabilitate their life, to offer a sympathetic ear to their problems and to serve as a "supporting family".

**"Our Children's Horizon" project.** For the fourth year in a row, the Bank has engaged, during the summer months visually impaired youth, through the "Our Children's Horizon" Association - a nationwide association of parents of blind and visually impaired children.

As preparation for work at the Bank, the youth were trained prior to commencing work. Training took place on two dates at the Discount College, where the youth were accompanied by representatives of the Association. The training included tools on the subject of qualification and expertise at work as well as instruction on banking subject, body image and more.

**Bazaar for the sale of products made by persons with special needs.** In the past year, the Bank assisted several times in setting up a bazaar (on premises of the Bank) for the sale of items produced by persons with special needs cared for by various associations, such as: invalids of the IDF, Alut, Enosh and others. Proceeds of the sales were contributed to the continued activity of the associations caring for the handicapped.

**"Discount Fund" at the "Ezra LeMarpe" Association.** The Bank continued its support of the Fund, whose goal is to offer financial assistance, for the third year running. Approaches in the matter of health received by the Bank are referred to the Association for

examination of the case and its various aspects. Where the case is found deserving of assistance it is awarded out of the Fund.

**Assistance to needy families towards the Jewish New Year and Passover holidays.** In line with the Bank's tradition, the Bank rallied once again to assist needy families. The Bank has purchased charged food cards in the value of NIS 300 each, respectively, and Bank employees distributed them directly to needy families, in coordination with the welfare departments of municipalities and local authorities, within the boundaries of which the Bank operate branches.

Distribution this year also included IDF servicemen, youth from the "Discount Start-up" Project and battered women - all from needy families.

**Packaging and distribution of food parcels to needy families.** The volunteering coordinators of the Technologies and Planning Division and of the Operations and Logistics Division initiated an effort for the packaging of food parcels distributed to needy families all over the country. Forty of the employees of the said two Divisions participated in this voluntary effort, which was conducted in cooperation with the "Latet" Association.

**Collecting clothing items for needy families.** During August and September, a clothing collection effort was conducted at the Discount premises at 160, Herzl Street in Tel Aviv. Thanks to the extensive response on the part of Bank employees, nearly 200 boxes of clothing, footwear and similar items have been collected. These were distributed all over the country to needy families by the "Eged-Beged" Association.

**A project in aid of Holocaust survivors.** As part of the activity of helping needy Holocaust survivors families, 120 volunteers from among the Bank's employees from all over the country were recruited to aid Holocaust survivors once a month by providing them with foodstuffs and a coupon for purchasing medication. The project operates in collaboration with the "Latet" Association.

**Promotion of Education in Yaffo Association.** The cooperation with this Association continues, including volunteer work by Bank employees at the clubs of the Association and a financial contribution by the Bank. The Association provides a variety of education programs, welfare and enrichment to thousand of children in risk situations. The assistance is provided to families of a low socio-economic background giving them higher prospects of success in life.

**Launching of the "For the Community" website.** The "For the community" website was launched this year on the employee Intranet site. The site includes up-to-date contents regarding the activities of the Bank in aid of the community, details regarding volunteer work performed by the Bank's various units as well as details regarding additional areas of volunteer work which may be joined.

**Election of volunteer of the month.** As an additional acknowledgement of volunteers of the Bank, starting in February 2010, an excelling volunteer whose activity for the community deserves commendation, will be elected each month. The name of the volunteer of the month will be publicized on the Bank's "Lema'an" Intranet site.

## "SPRINT FOR THE FUTURE" - DISCOUNT BANK'S FLAG SHIP PROJECT

In 2005 Israel Discount Bank joined forces with "Sprint for the Future" Association adopting the program focused on school age children from peripheral regions with difficulties in their studies.

The program's objective is to provide assistance to school children so that they will be able to graduate high school, attaining a full matriculation certificate, enabling them to continue with higher education. The name of the program is "Discount Start Up".

The Bank is a party to both the financial support of the Association as well as to promoting and advancing its activities. Representatives of the Bank's management are members of the executive board of the Association and employees of the Bank have started voluntary activity in the framework of the Association's programs, among other things, in the form of the adoption by nearby Bank branches and Banks units of schools participating in the project.

**Tenth anniversary of the "Discount Start-up" project.** An event was held on April 21, 2010, at the Herzliyah Arts Center to celebrate the tenth anniversary of the "Discount Start-up" project, the Bank's leading educational project. Students from all over the country, as well as public figures, representatives of the Bank's Management and volunteers from among the Bank's employees participated in the event.

**The late Nissim Alagem Fund.** In January 2007 the Bank inaugurated a scholarship fund for academic studies. The Fund is named after the late Nissim Alagem, who passed away in 2006. Mr. Alagem worked at the Bank for 40 years, in his last post serving as Executive Vice President head of the Commercial Banking Division. Within the framework of the Fund, the Bank grants an annual contribution to finance the academic studies of young persons, graduates of the "Discount Startup" Project, who successfully completed their matriculation studies. The Fund will enable graduates of the "Discount Start-up" Project to continue their academic studies at higher education institutions. Five scholarships were granted in 2010.

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## INVOLVEMENT IN AND CONTRIBUTION TO THE COMMUNITY BY THE PRINCIPAL SUBSIDIARIES

Following are descriptions of several prominent projects carried out by the principal subsidiaries:

**Dreamnight at the Zoo.** An international social project, originating in the Rotterdam Zoo in Holland in 1996, and operating today in some 23 countries around the world over. Zoos that have joined the project open their gates at no entrance fee for a special evening. ICC has undertaken to lead this project in Israel, this being its flag project. In 2009, some one thousand children from Tel-Hashomer, Schneider, Dana and Assaf Harofeh hospitals, Edith Wolfson Medical Center as well as children of AKIM - Israel National Association for the Habilitation of the Mentally Handicapped were invited to the event.

**"Another lesson".** In 2010, ICC joined the "Another lesson: Association, which directs publicly held knowledge towards enrichment classes held at different schools, tutored by employees of the public and business sectors. ICC employees joined the volunteer group of the Association and provided children of the "Hadarim" school in Or Yehudah a taste of the corporate business world in general and of the financial world in particular.

**Carmel coast settlements.** ICC participated in assisting the Carmel coast settlements damaged by the giant fire that raged on Mount Carmel, by providing loans at zero interest for a period of six months. ICC employees also came to the help of the inhabitants by collecting and donating books to the library of the "Yemin Orde" boarding school and also distributing various personal items donated by ICC and others to the 500 pupils at the boarding school.

**A start-up project in the Arab sector.** In 2010, Mercantile Discount Bank continued the educational project launched in 2008, jointly with "Sprint for the Future" Association, within the framework of which this bank granted this year 72 scholarships for studies at academic institutions to Arab sector students who were found deserving of these scholarships, in return for their commitment to contribute time to community work. The cost of this project amounted to NIS 0.6 million in 2010.

**"A computer for every child".** Mercantile Discount Bank, through the "A computer for every child" Association (under the patronage of the Government of Israel) has donated this year as well, 50 computer kits to children of low income families.

**Participation in an educational project.** Mercantile Discount Bank has been participating also in 2010 in a project conducted by "Yad Eliezer" Association, within the framework of which this bank has granted 400 scholarships to Yeshiva students in consideration for their commitment to serve as tutors to children of disadvantaged families in the ultra-orthodox sector.

**"Adopt a combat soldier" Project.** Discount Mortgage Bank has also joined the project, adopting Regiment 405 of the Artillery Corps. Accordingly, Discount Mortgage Bank is committed to make an annual donation of NIS 100 thousands for three years, starting with 2007. In addition to the monetary contribution, Discount Mortgage Bank employees participate in special events held by the Regiment and support the activities of the Regiment and its servicemen. Discount Mortgage Bank has decided to continue adopting the Regiment for an additional period of three years.

**Volunteer activities at Discount Mortgage Bank.** During the Jewish High Holidays, employees of Discount Mortgage Bank distributed pre-paid magnetic cards for the purchase of foodstuff to needy families all over the country. In addition, for the past two years discount Mortgage Bank is engaged in a joint project with the Mishlama for the development of Jaffa (an agency of the Tel Aviv-Jaffa Municipality focused on the development of Jaffa). As part of the project, Discount Mortgage Bank operates on a weekly basis, a learning assistance station for the benefit of children of the Ethiopian community in Jaffa.

## EMPLOYMENT OF HANDICAPPED PERSONNEL

As part of its personnel recruitment policy, the Bank offers disabled persons, who generally are not accepted by employers, the opportunity of being integrated into positions at the Bank suitable to their ability and according to the requirements of the Bank. This offers such persons the opportunity to function as regular citizens who provide for themselves with self respect

## "HERZELILINBLUM" - BANKING AND TEL AVIV NOSTALGIA MUSEUM

The Herzlillienblum Museum of Banking and Tel Aviv Nostalgia forms an additional layer of the longstanding tradition of contribution to the community. The museum provides the possibility of a close study of the history and economics of Israel since the beginning of the last century. The Museum is located in a one hundred years old preserved building, one of the first houses of Ahuzat Bait. Great emphasis had been put on the restoration of the original house, "Schieff House", built originally as a dwelling house.

**Visitors.** Since its opening in May 2009, the Museum hosted some 65,000 visitors of various populations: organized groups, young people, servicemen, students and more.

**Guided tours.** About 2,300 tours of the Museum were held until the end of 2010. The Museum offers to the general public various types of tours, such as:

- History focused tours;
- Economic-banking focused tours;
- Tours that include guided tours of the vicinity of the Museum (the Ahuzat Bait area);
- Tours including various lectures;
- Guided tours of changing exhibitions.

**"Monopoly - Life as an Illusion"** - an exhibit presented during April to June 2010, which highlighted the life in the Theresienstadt Ghetto between the years 1941-1945. The exhibit presented documents, reports and drawings showing the two sides of life in the Ghetto: the management of a bank and organization of work in the Ghetto as well as a look into the life of children under the horror of the Nazi regime, this against the life of children in Tel Aviv during those same years. The connecting line between the two sides of the exhibit was the monopoly game played by Ghetto and Tel Aviv children at that time.

**Conferences and events.** The museum hosts conferences and various events initiated by the Bank, a large part of which are designed for the Bank's customers. During 2010, the Museum held 18 events for customers of the Bank, 8 events for Bank employees and 15 events for corporations, associations and other organizations.

**Changing exhibitions.** The Museum presents changing exhibitions, including works from the art collection of the Bank. Among the more outstanding exhibitions held in 2010, the following may be mentioned:

**"Fire Mark"**. The exhibition refers to a number of topics in the history of Israel: development of the insurance industry, development of the firefighting and rescue services since before the foundation of the State, and preservation of old buildings. "Fire marks" were the means by which insurance companies identified insured buildings, and were introduced to the country towards the end of the 19th century. Such a fire mark was also fixed to the "Schieff House", which houses the Museum.

**Children "money" seminars.** During 2010, the Museum held 220 "money" seminars for children dealing with the development of payment means from the barter trade period to the present time.

**Herzl day** took place on April 25, 2010, in commemoration of the 150th birthday of the visionary of the State of Israel. In collaboration with the Society for the Preservation of Israeli Heritage Sites, the museum organized on that date an impressive event for seventh grade pupils, emphasizing Theodore Herzl's vision regarding an independent local economy through the establishment of the economy in Palestine and its perpetuation in Tel Aviv.

**"Houses from Within"**. In May 2010, the "Houses from within" event took place, where some 150 houses and institutions in Tel Aviv opened their doors to the public. During this event the museum held 13 short guided tours for some 400 visitors.

**A white night in Tel Aviv.** In July 2003, UNESCO declared the white city of Tel Aviv as a historical unique world cultural heritage site.

Since then Tel Aviv Yaffo celebrates the declaration by UNESCO in a "white night" events, which take place in the summer annually. Within the framework of the white night events, the Museum projected to the general public four video-art presentations taken from the art collection of Discount Bank: Dancing for Maya, by the artist Sigalit Landau; Earthquake in Kamtschatka, by the artist Gal Weinstein; Three Cities, by the artist Romi Achituv; and Reverting to her Bad Ways, by the artist Tali Navon. The projections were made on plasma screens inside the Museum, watched by the public standing on the pavements of Herzl Street and also inside the Museum hall. Within the framework of the "white night" events, the Museum also opened its gates and hosted 560 visitors.

## "MA'ALEH" RATING FOR 2010

In June 2010, "Ma'aleh" published its rating for 2010. The Bank has been rated, for the third year in a row, under the "Platinum" category, relating to companies having the highest grades.

The "Ma'aleh" rating relates to the market's largest public and private corporations, and is based on their social responsibilities characteristics. The rating measures the corporations in five areas: business ethics, human rights and employment environment, involvement with the community, environmental protection and corporate governance.

78 corporations took part in the rating in 2010, the total financial turnover of which comprised 58% of Israel's business product.

**The new Ma'aleh index.** The Tel Aviv Stock Exchange has updated the composition of the "Ma'aleh Index for Corporate Responsibility", based on the rating for 2010. According to a resolution of the Stock Exchange, starting from 2010, the index will include all public companies participating in the rating and not only the leading twenty public companies according to the index, as was the practice hitherto.

In September 2010, the Bank joined the Global Compact initiative of the United Nations.

The Global Compact is a strategic policy initiative by corporations which have committed to accept, support and apply within the framework of their area of influence, a set of basic values regarding human rights, standards for work and environment conditions and fight in corruption.

As part of its participation in this initiative, the Bank has declared its support of the ten universal principles of this initiative and its commitment to turn the Global Compact and its principles into a part of the Bank's strategy, organizational culture and daily operations.

## "THE MARCH OF THE LIVING"

In April 2010, a delegation of Discount Bank employees participated for the eighth time in the "March of the Living" from Auschwitz to Birkenau that takes place every year on the memorial day for the Holocaust and Heroism. The delegation numbered 70 of the Bank's staff. This continued a tradition started in 2003, of participation of a Discount Group delegation in the "March of the Living", the Bank and the Employee Union participating in the cost thereof.

## ARTS

**Lending works of art.** Cooperation with various museums continued in 2010. Within in this framework the Bank lent the following works from its art collection:

Two artifacts from the Bank's collection, produced by the successful artist Tal Matzliach, have been loaned the Tel Aviv Museum of Art to be exhibited as part of a solo exhibit, opened on March, 2010, by the artist named "The concept has gone for a walk".

A work of art by Garry Goldstein was lent to the "Specific events" Exhibition held at the Tel Aviv Museum of Art.

A work of art by Larry Abramson was lent to a retrospective exhibition of works by the artist held at the Tel Aviv Museum of Art.

Two works from the art collection of the Bank by the artists Adam Berg and Joseph Crispell were presented in individual exhibition

of their work held at the Palazzo Medici Ricardi Museum in Venice.

In October, the Bank lent three works of the artist Nahum Gutman to the "Magic of Galilee" exhibition held at the Nahum Gutman Museum.

**Exhibits from the Bank's collection.** The exhibit "Our country's landscapes", being a selection of Israeli works of art collected by Discount Bank, was presented at the Herzlilinblum Museum in January 2010. The exhibit demonstrates, in painting, several generations of artists' outlooks of the land of Israel.

The exhibit "Women in Israeli art" was held in March 2010, in connection with the International Woman's Day. This exhibit provided an opportunity to experience the development of art in Israel through the work of Israeli female artists. A special part of the exhibit was devoted to the work of outstanding young artists in the field of modern art.

Within the framework of a farewell party in honor of the retiring President & CEO, Mr. Giora Offer, and the appointment of Mr. Reuven Spiegel as the new President & CEO of the Bank, new acquisitions to the art collection of the Bank have been exhibited to guests and customers invited to participate in the event.

**Discount Art Album No.15.** Within the framework of the "Loving art making art" events held in Tel Aviv in October 2010, the Bank launched the Discount Art Album No. 15. Taking part in the album were three artists: Orit Hofshi, Nurit David and Sharon Poliakin.

**"Portraits" Exhibition.** The "Portraits" Exhibition was opened in the beginning of July 2010, presenting a selection of works from the art collection of Discount bank. The exhibition was presented at the "Herzllilienblum" Hall, within the framework of which aspects of image and look were examined.

**Decade of operations in London.** A short film showing the art collection of the Bank had been produced for the annual event held in London celebrating a decade of operations of Discount Bank in London. The film was screened to guests at the event.

**"Another place" Exhibition.** Within the framework of the "Artist Wall" project for the encouragement of creation, an exhibition was held of the works of the artist Judith Englerad at the Gallery of the Discount Tower. The exhibition was opened in the beginning of July 2010.

**Sponsorship.** In May 2010, the Bank sponsored an exhibit of the artist Joseph Shaltiel, presented at the artist village of Ein Hod.

**Guided public tours.** Guided tours of the Bank's art collection, open to the public, are conducted on Friday mornings at the Discount Tower. Over fifty guided tours of the Bank's art collection were conducted during the year.

**The Discount Museum website.** The art collection of the bank is considered on of the qualit collections of Israeli art. The Bank attributes great importance to the maintenance and cultivation of its art collection and is proud to exhibit a selection of the works included therein to the public at large through the Discount Museum website. The works selected for presentation are arranged according to themes in a manner that enables the public to learn about the structure of the collection and the contribution of the Bank to cultural and community life in Israel.

The address of the site is: <http://www.discountbank.co.il/museum>.

## CULTURAL EVENTS

Following the success of the unforgettable appearance of the singer Leonard Cohen in 2009, and as part of the marketing campaign "It's worthwhile to be a customer of Discount", the Bank granted sponsorship in 2010 to the following two leading cultural events:

**Elton John.** The Bank sponsored the performance of the British singer Elton John, which took place on June 17, 2010 at the Ramat-Gan stadium. Forty-eight thousand spectators were present at the performance most of whom customers of the Bank, who enjoyed tickets at attractive prices and reserved seating. Beside the performance, the Bank entertained selected business customers and leading market and economic figures at an especially constructed VIP area.

**"Nabucco at the foot of Masada".** The Bank in conjunction with the Israeli Opera sponsored two premiere performances of the

opera "Nabucco" held at the foot of the Masada fortress. Organized transport to Masada was arranged for the Bank's customers and employees, who partook in an extraordinary and exciting cultural experience.

## SPONSORSHIPS

During 2010, the Bank granted sponsorship to entities and activities promoting social, sporting, cultural, artistic and educational and business goals.

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### CULTURAL, ARTISTIC AND EDUCATIONAL SPONSORSHIPS

**Testimony Theatre.** This is the third year running in which the Bank sponsors the project of Testimony Theatre, which commemorates the stories of Holocaust survivors on the theatre stage, and afterwards in an inter-generation meeting between high school students and Holocaust survivors.

**Zichron Ya'acov Festival.** The Bank sponsors this festival held during the Passover Holiday week and included the appearance of Pavlo Rosenberg and Mosh Ben-Ari.

**Theatronetto Festival.** Sponsorship of the festival that took place in Jaffa and around the country in April under the motto of coexistence.

**"Galilean window for literature and poetry".** Within the framework of this project the Bank sponsored an evening in memory of the poet Natan Yonatan.

**Art exhibit of Yosef Shaaltiel.** The Bank sponsored an exhibition held at the Janco Dada Museum in Ein Hod in honor of Ein Hod's artist. Presented at the exhibit were a selection of stained glass works and layout for such work created by the artist since the sixties.

**The Alternativa LaOleh.** Sponsorship for a fundraising event, including the appearance of the singer Matti Caspi.

**Epos - International Art film Festival.** Sponsorship for the Festival which was held all over the country in November 2010. Over 9,000 viewers saw the films; most of which were screened for the first time.

**Haliol Hinuch (education is everything) Association.** Sponsorship for a gala evening of the Association, which promotes education in Israel, held in September 2010, in the presence of the President of the State of Israel.

Sponsorship for the **Israel Bridge Federation.**

**Lions Organization, Nazareth.** Sponsorship for the Organization which supports varied associations and other bodies engaged with weak populations and in holding social and cultural events for the multi-cultural population of this city.

**Alut.** Sponsorship for the Alut Organization and for the promotion of the unique art produced by persons sheltered by the Organization, through the purchase of rights to a painting that was reproduced on the New Year greeting cards sent by the Bank to its customers.

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### SPORTS SPONSORSHIPS

**Israeli Athletic Association.** Sponsorship was granted to competitions within the framework of the Israeli Athletic Championships contests held at the Hadar Yosef Stadium at the end of June 2010.

Sponsorship of the Tel Aviv University Sports club. The Bank sponsors this club which offers a wide range of sport facilities to the Tel Aviv university students.

## ENVIRONMENTAL PROTECTION, SCIENCE, AND BUSINESS SPONSORSHIPS

**The Aravah research and Development Convention.** Sponsorship for an Open Day in the Aravah Valley held in January 2010, where the best of the agricultural products grown in the Aravah Valley were on show.

**Bird watching.** Sponsorship for the Society for the Protection of Nature in Israel in its activity in the field of bird watching, through a mobile exhibit of bird paintings "The Hula Valley as painted by artists for nature". The exhibition was presented at the Knesset and concluded the festival held in the Hula Valley; and in a film dedicated to swallows (a project on this topic is also presented at the HerzLilinblum Museum).

**The Herzliya Convention.** The Bank sponsored the Herzliya Convention on Governance, Society and Culture held between January 31, 2010 and February 3, 2010. The Bank was presented by the President & CEO who participated in the session on the subject of "Regulation in the capital market and pension savings".

**Innovation in Business Conference.** Sponsorship of a conference held in November 2010, at the initiative of the magazine "Computers and People". Within its framework, the Bank presented various aspects pertaining to solutions and banking innovation in the cellular phone field.

**Institute of Internal Auditors in Israel.** Sponsorship of the Jubilee Conference held in December 2010.

## AUDITORS' REMUNERATION<sup>(1)(2)</sup>

Below are particulars of the remuneration that was paid to the auditors (in NIS thousands):

	Consolidated		The Bank	
	For the year ended December 31			
	2010	2009	2010	2009
For Auditing <sup>(3)</sup> :				
To the joint auditors	19,108	*18,750	7,598	7,315
For Other Services:				
Audit related services <sup>(4)</sup> :				
To the joint auditors	5,368	2,913	4,784	2,363
Taxation Services <sup>(5)</sup> :				
To the joint auditors	2,927	*2,188	3,231	586
Other Services:				
To the joint auditors	2,133	454	1,173	79
Total	10,428	5,555	6,832	3,028
<b>Total Auditors' Remuneration</b>	<b>29,536</b>	<b>24,305</b>	<b>14,430</b>	<b>10,343</b>

\* Reclassified.

Footnotes:

- (1) The auditors' remuneration includes payments to partnerships and corporations under their control and also includes payments pursuant to the VAT law.
- (2) Includes remuneration that has been paid and remuneration that has been accrued.
- (3) Auditing annual financial statements and reviewing interim financial statements. Also includes audit - internal control over financial reporting (SOX 404).
- (4) Includes mainly audit work and special examinations.
- (5) Including mainly annual tax reconciliation statements paid for as part of the audit fees and attributed to tax services based on estimate, tax assessments and tax consultations.

## REMUNERATION OF INTERESTED PARTIES AND SENIOR OFFICERS AND TRANSACTIONS WITH CONTROLLING SHAREHOLDERS

### REMUNERATION OF INTERESTED PARTIES AND SENIOR OFFICERS

#### REMUNERATION OF THE CHAIRMAN OF THE BOARD AND OF SENIOR OFFICERS

2010

Details of the recipient				Remuneration* for services							
Name	Position	Extent of corporation's position	Rate of holdings in the capital	Employer's payments and Supplemental provisions <sup>(1)</sup>			Supplemental reserve <sup>(2)</sup>	Total payroll, awards and employer's payment <sup>(3)</sup>	Share based payment <sup>(3)</sup>	Total	Loans granted under regular terms
				Salary	Awards						
in NIS thousands											
Dr. Joseph Bachar	Chairman of the Board	100%	-	<sup>(4)</sup> 1,814	<sup>(4)</sup> 500	2,007	-	4,321	6,414	10,735	-
Giora Offer <sup>(5)</sup>	President & CEO of the Bank	100%	0.02%	2,415	-	1,236	146	3,797	(2,193)	1,604	-
Reuven Spiegel <sup>(6)</sup>	President & CEO of IDB New York	100%	-	3,043	<sup>(7)</sup> 5,788	530	-	9,361	-	9,361	-
Jacob Tennenbaum	President & CEO of Mercantile Discount Bank	100%	-	1,728	1,330	947	-	4,005	-	4,005	-
Isreal David	President & CEO of ICC	100%	-	1,292	644	2,198	-	4,134	376	4,510	-
Ilyse Baum	Executive Vice President and Chief Lending Officer of IDB New York	100%	-	1,860	605	739	-	3,204	-	3,204	-
Noam Hanegbi <sup>(8)</sup>	Senior Executive Vice President, Head of Retail Banking Division	100%	-	1,093	-	320	8	1,421	376	1,797	-
Shlomo Pitchon <sup>(9)</sup>	Senior Executive Vice President, Internal Auditor	100%	<sup>(10)</sup> -	1,080	-	320	12	1,412	313	1,725	-
Esther Deutsch	Senior Executive Vice President, Legal Adviser	100%	-	921	-	237	5	1,163	548	1,711	-

(8) Until March 31, 2010, acted as head of the Retail Banking Division at the Bank (today: the Banking Division).

## 2009

Details of the recipient				Remuneration* for services							
Name	Position	Extent of corporation's position	Rate of holdings in the capital	Employer's payments and Supplemental reserve <sup>(2)</sup>					Total payroll, awards and employer's payment <sup>(3)</sup>	Share based payment <sup>(3)</sup>	Loans granted under regular terms
				Salary	Awards	provisions <sup>(1)</sup>	Supplemental reserve <sup>(2)</sup>	employer's	Total		
in NIS thousands											
Shlomo Zohar	Chairman of the Board	100%	0.02%	2,119	3,985	2,216	16	8,336	(477)	7,859	-
Giora Offer	President and CEO of the Bank	100%	0.02%	2,119	3,985	1,131	212	7,447	1,715	9,162	135
Reuven Shpiegel	President and CEO of IDB New York	100%	-	2,885	2,201	1,831	-	6,917	-	6,917	-
Boaz Chechik	President and CEO of ICC	100%	-	1,322	3,005	322	-	4,649	-	4,649	49
Jacob Tennenbaum	President and CEO of Mercantile Discount Bank	100%	-	1,697	950	768	26	3,441	-	3,441	-
Noam Hanegbi	Senior Executive Vice President, Head of Information Systems Division	100%	-	986	<sup>(6)</sup> 1,214	295	31	2,526	395	2,921	-
Isreal David	Senior Executive Vice President, Head of Retail Banking Division	100%	-	1,034	<sup>(6)</sup> 844	361	38	2,277	395	2,672	-
Shlomo Pitchon	Senior Executive Vice President, Internal Auditor	100%	<sup>(5)</sup> -	974	<sup>(6)</sup> 706	339	119	2,138	329	2,467	-

\* The amounts of the remuneration are in cost terms to the Bank (do not include tax on payroll).

- (1) Including an adaptation award, severance and provident pay, further education fund, vacation pay and National Insurance contributions.
- (2) Supplementing reserves due to changes in remuneration.
- (3) The expense was computed on the basis of the value determined on date of grant of the options.
- (4) On March 23, 2011, the Board of Directors decided to approve the appointment of Mr. Abraham (Avi) Levy as member of Management, with the title of Vice President to the position of Head of the Customer Assets Division that is being established. The appointment is subject to approval of the Supervisor of Banks.
- (5) Mr. Pitchon held shares of the Bank in a negligible amount of NIS 21,583 par value.
- (6) The differential component existing in awards to be granted to members of Management in respect of 2009, is included in the above Table in accordance with the decision of the President & CEO, which at date of the initial publication of the data, have not yet been approved by the Board of Directors (see Note 16 G to the financial statements).

## Notes:

- (a) In determining the remuneration and awards, the following factors have, among other things, been taken into consideration: the scope of the Bank's business, its proportionate share of the banking industry, the rate of return on capital and the contribution of the Officer to the operations and profitability of the Bank as well as the duties assumed by him.
- (b) The terms applying to senior officers in respect of their personal bank accounts held at the Bank, including all the operations therein, are similar to those granted to all other employees, and generally such terms are not preferable to those applying to

regular customers of their kind whose operations are of a similar volume

- (c) Remuneration of all types is included in the item "Payroll and related expenses" in the financial statements. The total benefits granted to officers of the Bank represent a negligible amount.
- (d) The Directors of the Bank, excluding the Chairman, are entitled to remuneration which is in line with accepted practice and payable according to the Companies Regulations (Rules regarding remuneration and expenses to an outside director), 2000, as detailed in Note 22 Q to the financial statements.  
Furthermore, Dr. Sharir serves also as director of the subsidiary Israel Discount Capital Markets and Investments and is entitled to remuneration which is in line with accepted practice, being identical to the remuneration paid by that subsidiary to other directors who are not senior executives of the Bank. Since March 14, 2010, Dr. Sharir serves as Chairman of the Board of Discount Capital Markets. See Note 22 R to the financial statements for details regarding the approval of the terms of remuneration payable to him in respect of his duties.
- (e) For details regarding insurance, exemption and indemnification of directors and other senior executives, see Note 19 C (7) (L) and (M) to the financial statements.

**Dr. Joseph Bachar** - serves as Chairman of the Board of Directors since January 3, 2010. For details regarding the terms of engagement of Dr. Bachar, see Note 22 G and H to the financial statements. For details regarding the phantom option plan granted to Dr. Bachar, see Note 13 E 1 to the financial statements.

**Mr. Reuven Spiegel**, on January 1, 2011, Mr. Spiegel assumed office as President & CEO of the Bank. For details regarding the terms of engagement of Mr. Spiegel, see Note 22 G and H to the financial statements. For details regarding the phantom option plan granted to Mr. Spiegel, see Note 13 E 1 to the financial statements.

Mr. Spiegel served as President & CEO of IDB New York until February 28, 2011. Mr Spiegel was employed by the subsidiary under a personal agreement. The period of employment was until June 30, 2012, following which the agreement was supposed to be automatically renewed each time for a period of one year which may be terminated by either of the parties with a prior notice of six months. Upon termination of his employment, Mr. Spiegel was entitled to a payment equal to one year salary. Mr. Spiegel's monthly salary was reviewed by IDB New York every year and could have been updated at the end of each year in accordance with the rise in the consumer price index in the US. Mr. Spiegel was entitled to social benefits (National Insurance contributions, pension within the framework of the pension plans in effect at the subsidiary, at the rate of 1.5% per each year of employment, on condition that he completes at least five years of employment), as well as to life assurance, medical care and loss of work ability. Mr. Spiegel, as the other members of management of IDB New York, was entitled to an annual award on condition that IDB New York reaches 80% of the forecasted annual earnings in accordance with the annual work plan, in addition, a long-term remuneration plan for management members exists, whereby an additional award is paid for attaining the profitability target for three consecutive years. IDB New York provided Mr. Spiegel with an appropriate motor vehicle and he was also entitled to an annual home leave in Israel.

**Mr. Giora Offer**, acted as the President & CEO of the Bank in the period from since March 2, 2001 to December 31, 2010. Mr. Offer was employed under a personal agreement. For details regarding the terms of employment of Mr. Offer, including entitlement to an annual award, see Note 22 I to the financial statements. For details regarding Mr. Offer's stock option plan, see Note 13 E (3) to the financial statements. Mr. Offer waived 10% of his gross remuneration (excluding as regards provisions and related benefits) for a period of one year, starting February 2009.

**Mr. Jacob Tennenbaum**. The President & CEO of the subsidiary Mercantile Discount Bank (hereinafter: "Mercantile") is employed under a personal employment agreement. The period of employment is a determined period of five years ending in July 2011. Subsequent to that date (and provided the employment is not terminated prior to this date by either of the parties), the employment agreement shall continue in effect for an indeterminate period until Mr. Tennenbaum reaches retirement age, during which period either of the parties is entitled to terminate the agreement giving a prior notice of six months. In the event that Mercantile decides to terminate the employment of Mr. Tennenbaum in the course of the determined period, then Mercantile is obligated to pay to Mr. Tennenbaum until

the end of the determined period, his full salary including the related benefits or his full salary excluding the related benefits but with the addition of 15%, as elected by Mercantile. Mr. Tennenbaum shall be prohibited from competing against Mercantile during a period of three months following the termination of employment, unless otherwise agreed by the parties. Mr. Tennenbaum is entitled to annual vacation, sick leave, recreation pay, appropriate motor vehicle, social benefits (severance benefits as determined by law, provident payments, loss of ability to work insurance and further education fund) as well as other benefits. Upon retirement from office, Mr. Tennenbaum is entitled under the agreement to severance payment in accordance with the law. In addition, he is entitled to a special award upon termination of his employment (whether by Mercantile or by himself), as follows: if termination of employment occurs within the five year determined period he is entitled to an award equal to a six months salary; if termination of employment occurs after six years he is entitled to an award equal to a nine months salary; if termination of employment occurs after seven years he is entitled to an award equal to a twelve months salary. Alternatively, if his employment is terminated following the sale of Mercantile, transfer of the control thereof or merger thereof, Mr. Tennenbaum will be entitled to a special award of twelve months salary. In the event that Mercantile offers shares to the public, within the framework of which shares and/or share options will be allotted to employees, then Mr. Tennenbaum will be entitled to a similar allotment at rates and under terms to be decided by Mercantile's board of directors considering his office as President & CEO. In 2009, Mr. Tennenbaum waived 7% of his annual remuneration.

**Mr. Israel David**, serves as President & CEO of Israel Credit Cards (ICC) since April 1, 2010. He is employed by ICC under a personal employment agreement for a fixed period starting on April 1, 2010 and ending December 31, 2014. Thereafter, the agreement shall become a non-fixed term agreement until Mr. David reaches retirement. Mr. David is entitled to vacation pay, paid sick leave, recreation pay, an appropriate car, social benefits (severance pay under the law, provident contributions, loss of work ability and further education fund contributions) as well as additional benefits. Upon termination of office, Mr. David is entitled according to the agreement to severance pay under the law. In addition, if ICC decides to terminate his employment, Mr. David will be entitled to adaptation award, as follows: if his employment is terminated before the end of the fixed period and before the end of two years since beginning of his employment, he will be entitled to an award equal to nine months pay with the addition of 23.33% in lieu of social benefits contributions; If his employment is terminated before the end of the fixed period but after the end of two years since beginning of his employment, he will be entitled to an award equal to six months pay with the addition of the said 23.33%; If his employment is terminated after the end of the fixed period, he will be entitled to an award equal to six months pay. The non-competition period is three months since the termination of employment, unless otherwise agreed by the parties.

Mr. David served as Deputy President and Head of the Retail Banking Division (at present, the Banking Division) until March 31, 2011. Mr. David was employed under a personal employment agreement for an indeterminate period, which either of the parties could terminate giving a prior notice of four months. According to the agreement, Mr. David was prohibited from competing against the Bank for a period of six months following the termination of employment, unless otherwise agreed by the parties. His salary was linked to the CPI, and in the event of the CPI falling, his salary was not changed until such time that the rise in the CPI offsets the rate of the fall. The salary of Mr. David has been updated as from April 2008.

Mr. David was entitled to annual vacation, sick leave, recreation pay, appropriate motor vehicle, social benefits (severance benefits, provident payments, loss of ability to work insurance and further education fund) as well as other benefits. Upon retirement from office, Mr. David is entitled to severance payment in accordance with the law as well as to a retirement award equal to six months salary. Mr. David is among management members entitled to awards according to the award plan, as stated in Note 16 G to the financial statements as well as to option warrants in accordance with the option plan for senior executives at the Bank, as detailed in Note 13 E (2) to the financial statements. The entitlement of Mr. David to the option warrants shall not be impaired by his termination of office at the Bank, as according to the terms of the plan, changing into an employee of a subsidiary of the Bank in Israel, he is considered for the purpose of the plan, as if his employment by the Bank had not been terminated. Mr. David received a retirement award as well as a prior notice in the amount equal to eight monthly salaries.

Mr. David waived 7.5% of his gross remuneration (excluding as regards provisions and related benefits) for a period of one year, starting February 2009.

**Ms. Ilyse Baum**, Executive Vice President and Chief Lending Officer of IDB New York, is employed by the subsidiary as an “employee at will.” Ms. Baum’s salary is reviewed and approved annually by IDB New York’s Compensation Committee of the Board of Directors. Ms. Baum enjoys the customary benefits granted to all members of IDB New York’s Senior Management. Ms. Baum participates in IDB New York’s Pension Plan, 401(k) Plan, and Deferred Compensation Plan. Under the terms of IDB New York’s Severance Plan, Ms. Baum is entitled to a severance payment equal to one year’s salary if terminated.

**Mr. Noam Hanegbi**, employed by the Bank as Senior Executive Vice President Head of the Strategy, Marketing and Service Division. (up to January 11, 2011 - as Head of the Retail Banking Division; up to April 26, 2010 - as Head of the Operations and Information Systems Division). Mr. Hanegbi is employed under a personal employment agreement for an indeterminate period, which either of the parties may terminate giving a prior notice of four months. According to the agreement, Mr. Hanegbi is prohibited from competing against the Bank for a period of six months following the termination of employment, unless otherwise agreed by the parties. His salary is linked to the CPI, and in the event of the CPI falling, his salary will not change until such time that the rise in the CPI offsets the rate of the fall. Mr. Hanegbi is entitled to annual vacation, sick leave, recreation pay, appropriate motor vehicle, social benefits (severance benefits, provident payments, loss of ability to work insurance and further education fund) as well as other benefits. Upon retirement from office, Mr. Hanegbi is entitled to severance payment in accordance with the law as well as to a retirement award equal to three months salary. Mr. Hanegbi is among management members entitled to awards according to the award plan, as stated in Note 16 G to the financial statements as well as to option warrants in accordance with the option plan for senior executives at the Bank, as detailed in Note 13 E (2) to the financial statements.

Mr. Hanegbi waived 7.5% of his gross remuneration (excluding as regards provisions and related benefits) for a period of one year, starting February 2009. On October 28, 2009, the Board of Directors decided to approve a special award of NIS 500 thousand to Mr. Hanegbi in appreciation of his unique contribution in leading the Ofek project - one of the largest and most complex computer projects ever undertaken in Israel, and in bringing it to its successful completion.

**Mr. Shlomo Pitchon**, was employed by the Bank as Senior executive Vice President and acted as the Internal Auditor until December 31, 2010 (termination of employer/employee relations on March 31, 2011). Mr. Pitchon was employed under a personal employment agreement for an indeterminate period, which either of the parties may terminate giving a prior notice of six months. According to the agreement, Mr. Pitchon is prohibited from competing against the Bank for a period of six months following the termination of employment, unless otherwise agreed by the parties. His salary was linked to the CPI, and in the event of the CPI falling, his salary will not change until such time that the rise in the CPI offsets the rate of the fall. Mr. Pitchon was entitled to annual vacation, sick leave, recreation pay, appropriate motor vehicle, social benefits (severance benefits, provident payments, loss of ability to work insurance and further education fund) as well as other benefits. Upon retirement from office, Mr. Pitchon is entitled to severance payment in accordance with the law as well as to a retirement award equal to six months salary. Mr. Pitchon is among management members entitled to awards according to the award plan, as stated in Note 16 G to the financial statements as well as to option warrants in accordance with the option plan for senior executives at the Bank, as detailed in Note 13 E (2) to the financial statements. All the option warrants under the plan expired in the course of 2009.

Mr. Pitchon waived 7.5% of his gross remuneration (excluding as regards provisions and related benefits) for a period of one year, starting with February 2009.

**Ms. Esther Deutch**, employed by the Bank as Senior Executive Vice President, Chief Legal Advisor. Ms. Deutch is employed under a personal employment agreement for an indeterminate period, which either of the parties may terminate giving a prior notice of four months. According to the agreement, Ms. Deutch is prohibited from competing against the Bank for a period of six months following the termination of employment, unless otherwise agreed by the parties. Her salary is linked to the CPI, and in the event of the CPI falling, her salary will not change until such time that the rise in the CPI offsets the rate of the fall. Ms. Deutch is entitled to annual vacation, sick leave, recreation pay, appropriate motor vehicle, social benefits (severance benefits, provident payments, loss of ability to work insurance and further education fund) as well as other benefits. Upon retirement from office, Ms. Deutch is entitled to severance payment in accordance with the law as well as to a retirement award equal to three months

salary. Ms. Deutch is among management members entitled to awards according to the award plan, as stated in Note 16 G to the financial statements. Ms. Deutsch is entitled to phantom options, as detailed in Note 13(e)(4) to the financial statements.

**Mr. Shlomo Zohar**, acted as Chairman of the Board in the period from January 31, 2006 to December 31, 2009. Mr. Zohar was engaged under a personal engagement agreement. For details regarding the terms of engagement of Mr. Zohar, including entitlement to an annual award, see Note 22 I to the financial statements. For details regarding the option plan granted to Mr. Zohar, see Note 13 E 3 to the financial statements.

In February 2009, Mr. Zohar informed that he agrees to forgo 10% of his salary (excluding as regards provisions and related benefits) for a period of 12 months starting in February 2009.

According to information detailed to the Bank, a consultation agreement has been signed between Mr. Zohar and a company of the Bronfman Group, whereby upon termination of office at the Bank, Mr. Zohar will provide that company business and financial advisory services for a period of two years, for a total consideration of US\$1 million.

**Mr. Boaz Chechik**, acted as President & CEO of the subsidiary ICC until March 31, 2010. Mr. Chechik was employed under a personal agreement, for an indeterminable period, which might have been terminated by either of the parties with a prior notice of four months. The non-competition period fixed in the agreement was three months from date of termination of office, unless otherwise agreed by the parties. Mr. Chechik's salary was linked to the CPI, where in case of a decrease in the CPI, the salary will remain unchanged until the rise in the CPI offsets the decline. Mr. Chechik was entitled to vacation pay, sick leave, recreation payment, an appropriate motor vehicle, social benefits (severance pay, provident payments, loss of work ability and further education fund) as well as other benefits. According to the agreement, upon termination of office, Mr. Chechik was entitled to severance pay according to the law.

According to the terms of the original agreement with Mr. Chechik, he was entitled to a special retirement award equal to three months salary. During 2008, the agreement was amended whereby the monthly salary was increased and a mechanism was established for an annual award and a special award in the years 2008 to 2011. If Mr. Chechik's office was terminated in the course of any of the said years, he was entitled to a proportionate part of the annual award in respect of the year of termination. The annual award was equal to an amount not to exceed 20 monthly salaries (hereinafter: "the ceiling of the overall award"), and would be paid only in a year in which the financial statements will reflect net earnings. The annual award was computed on the basis of five indices described in the amendment to the agreement, each index being attributed a part of the ceiling of the overall award. In addition, a minimum objective, a target objective and a maximum objective were established.

The Special award was in respect of the entire period (2008-2011) and it should have been paid according to one of the following alternatives: if the shares of ICC are listed for trading, Mr. Chechik will be granted the option to receive, at no consideration, ordinary shares of ICC comprising 0.14% of the issued and paid-up share capital of the company, on a fully diluted basis. The right to this share will vest in full at no consideration, at the end of four years (namely: on December 31, 2011), provided Mr. Chechik is still employed by ICC at that time.

So long as the shares of ICC are not listed for trade, Mr. Chechik will be entitled to a deferred award, accumulated in each year, payable on December 31, 2011, provided Mr. Chechik is still employed by ICC at that time, and if until that date the ICC shares are not listed for trade. The amount of the deferred special award will be equal to one half of the total annual awards to which Mr. Chechik would be entitled in respect of the years 2008 to 2011.

In addition, Mr. Chechik was entitled to a special award in respect of foreign operations conducted by Israel Credit Card (International) Ltd. (hereinafter: "ICC International"; formerly ICC (Properties) Ltd.), in accordance with the remuneration plan for senior employees of ICC. According to the said plan, in the event of a public issue of shares or a sale to a third party of at least 25% of the equity interest in ICC International and also in the event of sale, merger or reorganization of the said company into another company or the sale of most of its assets, Mr. Chechik would have been entitled to an award equaling 4% of the betterment of ICC International computed on the basis of a formula specified in the agreement, and everything in the period until the end of 2011, which may be shortened by ICC. Following the merger of ICC International into ICC (see Note 33 A to the

financial statements), the said remuneration plan has been cancelled.

As stated, Mr. Chechik's tenure of office was terminated on March 31, 2010. In view of this, discussions are being held with Mr. Chechik with respect to the economic aspects involved in the termination of his office.

## TRANSACTIONS WITH CONTROLLING SHAREHOLDERS.

### NEGLIGIBLE TRANSACTIONS

#### **General - Amendment of the Securities Regulations - Immediate report regarding transactions with controlling shareholders.**

According to law, the Bank must submit immediate and periodic reports with respect to any exceptional transaction entered into by the Bank. The Companies Law states that an "extraordinary transaction" is "a transaction not in a company's ordinary course of business, a transaction that is not undertaken in market conditions or a transaction that is likely substantially to influence the profitability of a company, its property or liabilities".

The Amendment of the Securities Regulations (Periodic and Immediate Reports), 1970, (hereinafter: "the Amendment") came into effect on August 6, 2008. Pursuant to this Amendment, a reporting corporation is required, among other things, to submit an immediate report with respect to "details regarding a transaction with the controlling shareholder, or in which the controlling shareholder has a personal interest in its approval, including principal details of the transaction or of the engagement, details of the Organ approving the transaction and a summary of the grounds for its approval; in this Section - "transaction" - excluding a transaction where other transactions of its kind, have been determined as negligible in the most recent financial statements".

The term "negligible transaction" originates in Regulation 64(3) of the Securities Regulations (Preparation of Annual Financial Statements), 1993 (hereinafter: "financial statements regulations") which deals with disclosure in financial statements of transactions of the corporation with an interested party therein. This Regulation determined the extent of the disclosure which is required regarding such transactions, and it also grants an exemption from providing the disclosure where a negligible transaction is involved.

Whereas the financial statements regulations do not apply to banks, where instead directives of the Supervisor of Banks as to preparation of financial statements apply, the Union of Banks referred to the Israel Securities Authority the question as to how the instruction regarding a "negligible transaction" should apply to banks. In its reply to the Union of Banks dated August 6, 2008, the Israel Securities Authority informed that it will not interfere in cases where no disclosure will be given in an immediate report to banking transactions that do not constitute extraordinary transactions, as defined in Section 1 to the Companies Law, provided the following are fulfilled:

- The upcoming quarterly financial statements as of September 30, 2008 (and thereafter the periodic statements) shall include a general description of the transactions, their characteristics and the criteria determined for defining the transactions as negligible or as such that are not extraordinary, providing details of the facts, reasons and explanations for such determinations;
- The audit committee of the corporation is to establish criteria for determining a transaction as unusual or negligible;
- Within the framework of describing the engagement with a controlling shareholder as regards office and employment, a general description shall be included as to his financing transactions with the bank (if any) and their characteristics.

**Disclosure and reporting outline.** The Securities Authority has issued a guideline to the Bank with respect to the disclosure to be included in a Prospectus of the Bank and thereafter in annual financial statements, in the following format:

- (a) With respect to banking transactions with controlling shareholders that are not considered extraordinary transactions, the Bank shall report in the Prospectus as well as in periodic reports the balances of credit granted and of deposits made in accordance with the format appearing in the following tables;
- (b) As from the annual financial statements for 2009, the Bank is required to disclose the highest balance during the period of deposits made by controlling shareholders;
- (c) As from the annual financial statements for 2009, the disclosure provided in the credit table should be given separately for

the balance of credit granted to a controlling shareholder and the balance of credit granted to relatives of the controlling shareholder (on a cumulative basis). Disclosure as to credit granted to each reporting corporation related to a controlling shareholder shall be provided on a consolidated basis at the level of each such reporting corporation.

**Criteria for extraordinary and for negligible transactions.** For the purpose of implementing the guideline of the Securities Authority, as stated above, the Bank is required to determine criteria for the definition of a "negligible transaction" - with respect to non-banking transactions, "negligible transaction" - with respect to banking transactions and "market terms", as well as to the manner of approval and disclosure of debt transactions to which Proper Banking Management Directive No. 312 does not apply. Accordingly, the Audit Committee of the Board of Directors decided on August 27, 2009, as follows:

**"Negligible transaction"** - a transaction, other than a banking transaction that complies with the criteria detailed hereunder, is considered a "negligible transaction":

- (1) A transaction for the purchase of retail products from a controlling shareholder or a transaction for the purchase of retail products in which the controlling shareholder has a personal interest - a transaction in the ordinary course of business undertaken in market conditions the volume of which does not exceed NIS 2.5 million, provided that the total of the transactions of its kind in any one calendar year shall not exceed 0.1% of the regulatory shareholders' equity as defined in Directive No. 312 of Proper Banking Management Directives (hereinafter: "regulatory shareholders' equity"). The said amount shall not apply to individual transactions the volume of each is under NIS 25,000.
- (2) A transaction for the purchase of services from a controlling shareholder or a transaction for the purchase of services in which the controlling shareholder has a personal interest, provided that it is not an engagement with a controlling shareholder or his relative concerning the terms of his office and employment, in the ordinary course of business undertaken in market conditions, the volume of which does not exceed NIS 2.5 million, provided that the total of the transactions of its kind in any one calendar year shall not exceed 0.1% of the regulatory shareholders' equity. The said amount shall not apply to individual transactions the volume of each is under NIS 25,000.
- (3) Transactions for the rental of space from a controlling shareholder or transactions for the rental of space in which the controlling shareholder has a personal interest, that have been approved in any one calendar year in the ordinary course of business, undertaken in market conditions, the total of which does not exceed 0.1% of the regulatory shareholders' equity.
- (4) Reimbursement of expenses of a controlling shareholder in the ordinary course of business and under market conditions, incurred for the purpose of participating in events representing the Bank or in customer conventions of the Bank and its subsidiaries by their invitation - expenses of up to US\$100,000 per annum.
- (5) Any other transaction in the ordinary course of business undertaken in existing market conditions the volume of which is up to NIS 250,000, provided that the total of transactions of its kind in any one calendar year shall not exceed 0.1% of the regulatory shareholders' equity. The said amount shall not apply to individual transactions the volume of each is under NIS 25,000.

**"Extraordinary transaction"**

- (a) Regarding banking transactions that are debt transactions - a debt transaction shall be considered as material if in consequence thereof the total indebtedness of the controlling shareholders will exceed 5% of the regulatory shareholders' equity, or if the increase in the indebtedness of a single borrower of the group, following such transaction, exceeds 2% of the said equity. In the event that several debt transactions have been approved to the same single borrower during any calendar year, the said debt transactions are to be measured on a cumulative basis. For this purpose, measurement of the total indebtedness shall be made separately in respect of the Bronfman Group (on a cumulative basis), with respect to the Schron Group (on a cumulative basis) and with respect to any other corporation the volume of credit granted to it is not restricted in accordance with Section 5 of Proper Banking Management Directive No. 312, at the corporation's level on a consolidated basis, so that the total indebtedness of each of those shall not exceed 5% of the said equity.

"Controlling shareholder group" - a controlling shareholder together with the private companies related to him, within the meaning the term "related party" as stated in Proper Banking Management Directive No. 312 and together with the relatives

of the controlling shareholders being members of the group and the private companies related to them. In this respect: the definition of a "controlling shareholder" according to the provisions of the Securities Law includes his next of kin living with him or where the livelihood of one depends on the other; the definition of "relative" according to the Banking Law (Licensing) includes a sibling, a parent, offspring, offspring of the spouse, and the spouse of each of these. Starting with the financial statements for 2009, the disclosure provided should be given separately for the balance of credit granted to a controlling shareholder and the balance of credit granted to relatives of the controlling shareholder (on a cumulative basis).

Furthermore, any specific provision for doubtful debts or the writing off of an amount in respect of the indebtedness of a controlling shareholder or of a corporation related to him shall be considered a material transaction.

- (b) A transaction representing the acceptance of a deposit - the acceptance of a deposit made by a controlling shareholder shall be considered a material transaction if in consequence thereof the total amount of deposits made by that group of controlling shareholders exceeds 2% of the total deposits at the Discount Bank Group. The acceptance of a deposit from a company considered a "related party" to the controlling shareholder and which is not a company under his control, shall be considered a material transaction if in consequence thereof the total amount of deposits of that company, on a consolidated basis, exceeds 2% of the total deposits at the Discount Bank Group according to the most recent annual financial statements of the Bank.
- (c) In respect of a transaction in securities or a transaction in foreign currency (which are not a debt transaction or a deposit transaction as described above) - Securities transaction or foreign currency transactions, the annual commission earned in their respect is equal to or exceeds 2% of the total annual operating income of the Discount Group (net of income from investment in shares) according to the most recent annual financial statements of the Bank.

A temporary deviation from the volumes specified in subsections (a) to (c) above, and for a period which does not exceed thirty days, shall not constitute cause for changing the classification of the transaction into an "immaterial transaction", and such deviations shall be disclosed in the annual report. It should be clarified that any change in a material transaction is in itself considered a material transaction and an immediate report shall be submitted in its respect.

"Market conditions" - conditions that are not preferable to the conditions according to which transactions similar to the transaction in question are being effected by the Bank with persons or with corporations that do not constitute controlling shareholders of the Bank, or with persons where a controlling shareholder has no personal interest in transactions with them. Market conditions with respect to banking transactions are determined in comparison to the conditions under which transactions of the same type and similar in volume are being effected, as is the practice when comparing transactions with related parties in accordance with Proper Banking Management Directive No. 312 with transactions made with customers of the Bank who are not related parties or with entities in which a controlling shareholder has no personal interest therein; market conditions with respect to transactions that are not banking transactions shall be compared with transactions of the same type entered into by the Bank with suppliers and/or with offers of other suppliers examined prior to the decision regarding the engagement. In cases where the Bank does not have other transactions of the same type, market conditions shall be compared to transactions of the same kind effected on the open market, provided that the transaction is in the ordinary course of business and that transactions of this kind have a ready market where similar transactions are effected.

**Debt transactions to which Proper Banking Management Directive No. 312 does not apply** - in the event that the Bank becomes aware of a debt transaction to which Proper Banking Management Directive No. 312 does not apply, the Bank is obliged to bring such transaction for approval in accordance with Proper Banking Management Directive No. 312 and to disclose it in its annual report. The definition of "negligible transaction" and "extraordinary transaction" with respect to the said transactions will be similar to the definition determined by the Bank for transactions to which Proper Banking Management Directive No. 312 apply. Hereunder are summarized data regarding banking transactions considered transactions with controlling shareholders.

For details regarding transactions with the controlling shareholders or in which the controlling shareholders have an interest, see Note 22 J,K and O and Note 19 C (10) (L) and (M) to the financial statements. Also see "Repayment of the State's debt in respect of the award to employees" under "Control of the Bank" above.

December 31, 2010										
Credit	Balance of credit		Balance of unutilized credit facility		Guarantees granted by the Bank to secure credit to a controlling shareholder or to a related party therein		Guarantees granted by a controlling shareholder in favor of a third party		Indebtedness of a controlling shareholder regarding transactions in derivatives <sup>(1)(2)</sup>	
	Balance at end of period	A high balance during the period	Balance at end of period	A high balance during the period	Balance at end of period	A high balance during the period	Balance at end of period	A high balance during the period	Balance at end of period	A high balance during the period
in NIS millions										
The Bronfman group	3	45	2	12	-	-	10	15	-	-
Reporting corporations related to the Bronfman group:										
Isralom properties Ltd	7	12	3	10	-	-	-	-	-	-
Shufersal Ltd	-	2	41	46	38	39	-	-	0.9	1.1
Total for reporting corporations	7	14	44	56	38	39	-	-	-	-
Total for the Bronfman group	10	59	46	68	38	39	10	15	0.9	1.1
Schron group	7	7	-	-	3	3	-	-	-	-

### Deposits

	Balance of deposits	
	Balance at end of period	A high balance during the period
Controlling shareholders, including reporting corporations related to the controlling shareholders	201	337

(1) 10% of the balance of a future transaction with the addition of mark to market.

(2) The par value of the said transactions as of December 31, 2010, amounted to NIS 9 million; the highest balance during the period amounting to NIS 11 million.

December 31, 2009										
Credit	Balance of credit		Balance of unutilized credit facility		Guarantees granted by the Bank to secure credit to a controlling shareholder or to a related party therein		Guarantees granted by a controlling shareholder in favor of a third party		Indebtedness of a controlling shareholder regarding transactions in derivatives <sup>(1)(2)</sup>	
	Balance at end of period	A high balance during the period	Balance at end of period	A high balance during the period	Balance at end of period	A high balance during the period	Balance at end of period	A high balance during the period	Balance at end of period	A high balance during the period
in NIS millions										
The Bronfman group	33	45	11	11	-	-	16	23	0.5	0.5
Reporting corporations related to the Bronfman group:										
Isralom properties Ltd	13	13	7	7	-	-	-	-	-	-
Shufersal Ltd	1	11	7	7	36	52	-	-	0.8	2
Total for reporting corporations	14	24	14	14	36	52	-	-	0.8	2
Total for the Bronfman group	47	69	25	25	36	52	16	23	1.3	2.5
Schron group	7	7	-	-	3	3	-	-	-	-

## Deposits

	Balance of deposits	
	Balance at end of period	A high balance during the period
Controlling shareholders, including reporting corporations related to the controlling shareholders	152	233

(1) 10% of the balance of a future transaction with the addition of mark to market.

(2) The nominal value at end of period of the aforementioned transactions amounted to NIS 13 million, while the highest balance for the period amounted to NIS 25 million.

## CONTROLS AND PROCEDURES

**Disclosure controls and procedures.** In the spirit of Section 302 of the Sarbanes-Oxley Act of 2002 and the instructions published in accordance therewith by the SEC in the United States, the Supervisor of Banks issued a directive regarding a declaration as to disclosure in quarterly and annual reports of banking corporations. This directive was applied for the first time in the financial

statements for the second quarter of 2005.

In order to establish these declarations, the Bank, engaging outside assistance, has examined the principal processes of production and delivery of information related to the financial statements by the various units of the Bank, as well as the controls applying to these processes. As part of this review, the processes of data communication have been mapped and documented in detail, including the controls implemented in these processes. Additional new controls have been formed, and absorbed in the work processes.

**Proper Banking Management Directive No. 309** on September 28, 2008, the Bank of Israel issued Proper Banking Management Directive No. 309, which requires bank managements to comply with the following requirements: assuring the establishment of controls and procedures regarding disclosure and internal control over financial reporting; evaluation of the effectiveness of the controls and procedures as to disclosure at the end of each quarter; evaluation of the internal control on the financial reporting at the end of each year, as well as evaluation at the end of each quarter of the changes that have occurred in internal control during the quarter, which have had or might have had a material effect on the internal control over financial reporting.

During 2010, the Bank conducted a process of validation and updating of existing processes and addition of new processes, by means of the SOX unit established within the Accounting Layout.

Based on the findings of the said examination of the effectiveness of internal control, Management of the Bank together with the President & CEO and the Chief Accountant of the Bank have assessed the effectiveness of controls in the reported period over the financial reporting of the Bank.

On the basis of this assessment, the President & CEO and the Chief Accountant of the Bank arrived at the conclusion that as of the end of the reported period, the controls and procedures regarding financial reporting are effective in order to: record, process, conclude and report the information included in the annual financial statements, in accordance with the public reporting instructions of the Supervisor of Banks and on the date prescribed by these instructions.

Furthermore, during the fourth quarter ended on December 31, 2008, no change has occurred in the internal control of the Bank over financial reporting, which materially affected, or is reasonably expected to materially affect, the internal control of the Bank over financial reporting, except for the changes at Mercantile Discount Bank and at the Bank, as detailed above.

**Changes in internal control at the Bank and at Mercantile Discount Bank.** During 2010, the Bank and Mercantile Discount Bank integrated an internal information system, developed by the Bank, used for the management and reporting of impaired debts, credit risk and provisions for credit losses (the "Chotam" system). This system implements the new Directives issued by the Supervisor of Banks in this respect and which became effective on January 1, 2011 (see also Note 1 A to the financial statements).

The new system was integrated during the fourth quarter of 2010 at the branches, head office units in the credit field and units handling special credits, and replaced the previous internal information system, which complied with the previous reporting requirements (that had been in effect until December 31, 2010).

The new system includes more detailed information and improves the existing controls, using better investigative tools and more detailed exception reports.

During the integration of the system, the Bank and Mercantile discount Bank had adopted control measures designed to assure its proper integration. Integration of the system involved changes in work procedures. Accordingly, the new work procedures included control mechanisms designed to assure the adequacy of the information produced by the new information system.

**Material weaknesses in ICC.** For details regarding material weaknesses in the internal control over financial reporting identified at ICC in 2009, which following the completion of the move taken for the remediation of controls no longer exist, see above "Israel Credit Card Company Ltd." under "Main investees companies".

The layout of internal control over financial reporting of the Bank had also been audited by the independent auditors of the Bank and found to be effective.

The opinion of the independent auditors on internal control, in the format determined by the Bank of Israel, is included in these financial statements after the Reports of the Board of Directors and Management regarding the internal control over financial reporting.

## MISCELLANEOUS

### ENVIRONMENTAL QUALITY

The Bank is a financial corporation providing various financial services to its customers, and as such, the direct environmental influences on its existing "production processes" are very limited, if any at all. This differs, for example, from industrial plants that could deal with the problems of gas emissions, sewage, toxic waste removal, etc.

Most of the environmental effects of the Bank are indirect effects stemming from the use of "administrative" resources, such as: energy, water, paper and such like. These indirect environmental effects do not expose the Bank to environmental risks (within the meaning of the term in the Securities Regulations), which have or might have a material effect upon the Bank.

One of the Bank's targets as regards the environment is to reduce the indirect effect, as stated.

Details regarding the actions taken by the Bank to reduce the said indirect effect, as stated (including: reduced use of paper, recycling of paper and plastic bottles, reducing the use of water, energy and more) are reported in the social responsibility reports issued by the Bank from time to time.

For details regarding environmental risks within their meaning in Directives of the Supervisor of Banks, see the Chapter on "Exposure to risks and the management thereof" above.

### CLARIFICATION REGARDING ENTERING INTO TRANSACTIONS

In a letter dated June 30, 2010, the Supervisor of Banks clarified that as regards the requirements of Section 9 A (c) of Proper Banking Management Directive No. 301 "The Board of Directors", in the matter of the terms required for approval of new activity from the aspect of risk management, the Supervisor expects that banking corporations shall not enter into transactions in respect of which the Chief Accounting Officer had not stated that the banking corporation is prepared to measure and present the transaction in an adequate manner, and that the internal controls over financial reporting of the transaction are effective. The Bank as completed its preparations in this respect.

### GUIDELINES AND CLARIFICATIONS REGARDING THE STRENGTHENING OF INTERNAL CONTROL OVER FINANCIAL REPORTING IN THE MATTER OF EMPLOYEE RIGHTS

On March 27, 2011, the Supervisor of Banks issued a circular in the matter of "Guidelines and clarifications regarding the strengthening of internal control over financial reporting in the matter of employee rights". The circular contains guidelines regarding the actions that the Management of a banking corporation, under the supervision of its Board of Directors, has to take as part of the overall actions required to strengthen the internal control over financial reporting in the matter of employee rights:

- Engagement of a qualified actuary – Employee rights computed on an actuarial basis are to be assessed by a qualified actuary, having practical experience in actuarial work in Israel and a member of the International Actuarial Association. An actuary who is an interested party or who is dependent upon the banking corporation may not be engaged.
- Identification and classification of employee rights – All relevant legal obligations pertaining to employee benefits shall be identified and examined by the Management of the banking corporation at date of the initial implementation of the guidelines, and at any date on which changes occur in such obligations. Management shall document the results of the examination, shall classify the identified obligations to the relevant groups as determined by the Supervisor of Banks.
- Voluntary retirement plans and non-contractual retirement awards - Banking corporations are required to maintain detailed records of employee retirement for each group of employees, as well as of the awards granted to them upon retirement.

A banking corporation that anticipates the payment of benefits to groups of employees that are in excess of the contractual terms,

shall take it into consideration, for the purpose of the actuarial computation, the rate of employees expected to retire and the benefits expected to be paid to them upon their retirement. The circular states quantitative yardsticks according to which a banking corporation will have to take into consideration the additional cost in respect of a group of employees, or, alternatively, maintain documentation based upon predicable evidence, supporting its position that the said additional cost need not be taken into consideration.

- Actuarial report – The actuary has to prepare a report presenting details of his work in assessing the obligations of the banking corporation in respect of employee benefits. Such report shall be submitted to Management of the bank and shall be appended to the annual financial statements. The regulation states the subjects to which the actuary has to refer in preparing his opinion.
- Reliance on the actuarial assessment and its validation – The actuarial assessment shall be validated by the banking corporation in accordance with guidelines of the Supervisor of Banks in the matter of "validation of models".
- Disclosure in reports to the public – Within the framework of the disclosure included in the financial statements regarding: "critical accounting policies", disclosure is to be given to the quantitative effect of the actuarial assessment in the matter of employee rights (including the items in the financial statements affected by such assessment), and a sensitivity analysis is to be included with respect to the principal assumptions used as a basis for the actuarial assessment, including: the anticipated rise in the payroll rate; the average retirement rates; adjustments made to the mortality and disability tables published by the Capital Market, Insurance and Savings Wing of the Ministry of Finance, their effect and the reasons thereto.

The new guidelines apply as from January 1, 2011. The Bank is preparing for the implementation of the guidelines.

## AMENDMENT OF THE ARTICLES OF THE BANK

On June 30, 2010 the special meeting of shareholders of the Bank approved the amendment of Article 22 of the Articles of the Bank in the matter of a legal quorum for the general meeting of shareholders, as detailed in the Immediate Report dated June 30, 2010 (Ref. No. 2010-01-538056).

## CORPORATE GOVERNANCE CODE FOR THE DISCOUNT BANK GROUP

In April 2009, an ad hoc committee of the Board of Directors was established, which proceeded to promote and complete the corporate governance code.

On September 23, 2009 the said committee completed its discussions with respect to the proposal of a corporate governance code and recommended the Bank's Board of Directors to approve in principle the proposed code. The corporate governance code of the Discount group and the declaration of principles of corporate governance at the Discount Group were approved by the Board in its meeting of October 28, 2009. The Board's resolution specified that the said documents be examined once a year in order to determine whether they are in accordance with the Bank's business and the business and regulatory environments in which it operates.

As part of the Bank's strategic plan for the years 2007-2011, the Bank has taken steps towards the adoption of the "Corporate governance code" for the Discount Bank Group. The purpose of adoption of the code is to maintain a policy of "best practice" of corporate governance principles at Group level, which will guide the Discount Group in its operations. Among other things, this code has been formulated in light of the following rules and principles and adjusted to the characteristics and unique needs of the Discount Group:

- The provisions of the law and regulations applying to the Bank;
- The Goshen Committee recommendations issued by the Securities Authority in January 2006. The Goshen Committee report included, among other things, recommendations regarding the composition of the Board of Directors and its work, including improvement of its independence, composition of the Audit Committee and its work, approval of transactions with controlling shareholders and the creation of additional control mechanisms;
- Basel II guidelines with respect to strengthening corporate governance in banking corporations - in March 2008, the Bank of Israel published a draft document in this matter, which states that corporate governance relates to the manner in which the business and issues of banking corporations are managed by their Boards of Directors and senior managements. The said draft includes a number of principles for proper corporate governance that apply to the composition of the Board of Directors, the

need to approve strategic targets and values at the Bank Group, reporting responsibility at the Bank Group, supervision over management, controls, remuneration of Directors and of senior management and transparency;

- Proper Banking Management Directives - Over the years, the Supervisor of Banks has issued instructions regarding proper banking management with respect to various issues, which apply to banking corporations and which form part of the corporate governance code, such as: Proper Banking Management Directive No.301 regarding the board of directors of a bank, Proper Banking Management Directive No.339 regarding risk management, Proper Banking Management Directive No.357 regarding information technology management, etc;
- Accepted practice in other countries around the world.

Within the framework of implementing the corporate governance plan, the Bank is acting, among other things, to determine supervision and control mechanisms intended to ensure the proper and efficient performance of the Discount Group, including with respect to the following items: activity and transactions with related parties; supervision by the Board of Directors over companies in the Group; reorganization and structural changes; formation of a group risk management policy (including Basel II); prohibition of money laundering and finance of terror activities, compliance policy, etc.

In August 2007, the Board of Directors adopted a legal opinion rendered by a prominent legal expert, according to which transactions between interested parties in the Bank and its subsidiary companies shall be approved in accordance with procedures determined by the Israeli Law with respect to approval of transactions with the Bank itself.

The actual implementation of a corporate governance code involves the formation of procedures intended to regularize the activity of the Board of Directors and its committees, approval of related party transactions, as well as work processes involving subsidiaries. The Bank is acting towards the formation of such procedures, and once these are developed, they will be brought before the Bank's Board of Directors for approval. The process of formulating the corporate governance procedures is not yet completed.

## PREPARATIONS BY THE BANK FOR CONTINUED BUSINESS OPERATIONS DURING EMERGENCIES

The Bank's Business Continuity Plan ("BCP") is designed to ensure the continuation of regular banking operations and services defined as vital, during periods of emergency on national and local levels. The plan covers and supports vital business operations, in all their chain of supply, from one end to the other: infrastructure, computer, hardware, software, communications, human resources, etc. All these will assure the continuing business operations of the Bank under extreme circumstances, while providing an array of services to customers of the Bank at a reasonable level of service.

Layouts and services supporting the corporate and retail networks are at the disposal of customers, as follows: countrywide core branches that are prepared and equipped to continue and provide service during emergencies, backup branches for those damaged, direct banking channels through telephone and internet communication. All these are designed to provide 24 hours a day banking services at any place, a "hot-line" for customers of closed branches and countrywide automatic banking machines that enable self-service banking operations. In addition, the Bank is able to operate mobile bank branches in emergency situations.

At the basis of the preparations for continued business operations is the backup system established by the Bank for the vital technological infrastructure. The backup system is based on: "hot backup" for the central computer system established at a designated distant location, a backup location for the dealing room, a backup location for direct banking operations/Discount Telebank, an active "hot backup" for the vital information systems, backup of the clearing layout through backup arrangements with other banks, and more.

The Bank implements an emergency scenario drill routine on an ongoing basis. Such drill routine comprises a vital component of the examination of the Bank's readiness to face threat scenarios and to secure compliance with the targets of service levels.

The following principal moves were made during 2010:

- Preparation for war scenario in accordance with directives of the Bank of Israel and the Home Front Command;
- Preparation for a scenario of interrupted services (shutdown of banking services) in accordance with guidelines of the Banking Ordinance;

- Mapping of information technology assets supporting vital business processes;  
Formation of a plan for alternative housing in respect of all vital units of the Bank;
- Establishing a fortified situation room;
- Training of staff for operation in emergency situations.

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## BOARD OF DIRECTORS AND MANAGEMENT

### GENERAL

A list of the members of the Board of Directors and a list of the Bank's executive officers and their areas of responsibility appear on page 4 of this report. These lists are correct as at the date hereof.

### DETAILS REGARDING MEMBERS OF THE BOARD OF DIRECTORS

**Dr. Joseph Bachar** - Serves as Director of the Bank since January 1, 2010, and as Chairman of the Board since January 3, 2010. Dr. Bachar acts as Chairman of the Credit Committee, Chairman of the Remuneration Committee, member of the Strategy Committee and member of the Risk Management and Overseas Extensions Committee.

Has accounting and financial expertise as well as professional qualifications.

Dr. Bachar is an Israeli Certified Public Accountant and has an academic education - Ph.D. in Business Administration (specializing in finance) from Berkley University, California, Master of Business Administration (specializing in finance), Berkley University, California and Bachelor of Economics and Accounting, Hebrew University, Jerusalem.

Serves as Chairman of the Board of Directors of Mercantile Discount Bank Ltd. (as Director since January 5, 2010 and as Chairman since January 25, 2010), as Director and Deputy Chairman of the Board of Israel Discount Bank of New York (since January, 2010) and as Director of Discount Bancorp Inc. (since January, 2010). Also serves as CEO and Chairman of the Board of Amiad Av. Ltd. (since July 2007) and Chairman of the Board Bachar Yossi Certified Public Accountants (since June 2002).

Served as Director General of the Ministry of Finance (November 2003 - January 2007), Head of the Tax Authority (provisional appointment) (January 2007 - April 2007), Chairman of the Advisory Committee of Klirmark Capital Ltd. (April 2009 - November 2009), non-executive Chairman of the Board of Stonehage (Israel) Financial Services Ltd. (October 2007 - December 2009) and as Chairman of the Executive Board of the Haifa University (October 2007 - January 2011).

**Ilan Biran** - Serves as Outside Director of the Bank since October 29, 2008. Mr. Biran is a member of the Audit Committee, the Financial Statements Committee, Credit Committee, Computer Committee and the Risk Management and Overseas Extensions Committee.

Acts as an Outside Director under the Companies Law, 1999, having accounting and financial expertise as well as professional qualifications.

Mr. Biran has an academic education - Bachelors in Economics and Business Administration from Bar-Ilan University and holder of a diploma/strategic studies in strategy and economics from Georgetown University, Washington DC.

Serves as Chairman of the Board of Rafael Advanced Defense Systems Ltd. and Centriton Ltd. and as Chairman of the Management Committee, Kinneret College on the Sea of Galilee (R.A.).

Served as Chairman of the Board of Beit Shemesh Engines Holdings (1997) Ltd. (2006-2007), DBS Satellite Services (1998) Ltd. (2004-2006) and as Director in Delta Three Israel Ltd. (2004 - November 2008), as Director and Chairman of the Strategic Research and Development Committee of Israel Aircraft Industries Ltd. (2005-2007), as Director of Massad Bank Ltd. (2005-2007), as Director and member of the Finance Committee of Netafim Ltd. (2004-2007), and as Venture Partner Consultant, The Challenge

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Footnote:

A director having professional qualifications is one who fulfills one of the conditions stated in Regulation No. 2 to the Companies Regulations (Terms and tests for directors having accounting and financial expertise and directors having professional qualifications), 2005.

Fund - Etgar L.P. (until December 2009).

**Eli Eliezer Gonen** - Acts as Director of the Bank since November 10, 2010. Mr. Gonen is a member of the Remuneration Committee and the Strategy Committee.

Has accounting and financial expertise as well as professional qualifications.

Mr. Gonen has an academic education - Master of Business Administration from the Hebrew University, Jerusalem, Bachelor of Economics and complementary studies from the Hebrew University, Jerusalem and has completed one year of advanced studies at the University of California, Berkeley, U.S.A.

Serves as Chairman of the Board of Go Alpha Ltd. a company owned by him (since April 2009), of Ma'ale Hachamisha Hotel (since February 2011), and of the Ghetto Fighters House - Itzhak Katzenelson Holocaust and Jewish Resistance Heritage Museum (since July 2008); partner, director and joint general manager of Terra Holdings, Management and Investments in Hotels Ltd. (since September 2009) and Director of the Jerusalem International Convention Center - Binyaney Haooma Ltd. (since 1998). Served as President of the Israel Hotel Association (2000 - December 2010) as Director of Tambour Ltd. (2002 - 2007), as Director of Crystal Machinery and Electrical Appliances Ltd. (2004 - 2006) and as General Manager of the Sheraton-Moriah Hotel Chain in Israel (1999-2009).

**Ben-Zion Granit** - Serving as Director of the Bank since January 31, 2006. Mr. Granit is a member of the Audit Committee, the Financial Statements Committee and the Computer Committee.

Serves as an Outside Director according to Directive No. 301 of the Proper Banking Management Directives and has financial and accounting expertise as well as professional qualifications.

Mr. Granit has an academic education - Bachelor of Agriculture from the Hebrew University in Jerusalem, Faculty of Agriculture in Rehovot, and a professional diploma from the Business School of the Hebrew University, Jerusalem.

Acts as a Management Consultant and Member of the Audit Committee, The Friends of Kaplan Medical Center (R.A.).

Mr. Granit was member of management of Ilan - Israeli Association for Handicapped Children (until 2009), a voluntary consultant of Nitzan Association (until 2009) and a voluntary consultant of the Rehovot Community Center Company (until 2006).

**Prof. Ben-Zion Zilberfarb** - Serves as Director of the Bank since January 31, 2006. Prof. Zilberfarb acts as Chairman of the Corporate Governance Committee, as member of the Financial Statements Committee, the Credit Committee, the Computer Committee and the Risk Management and Overseas Extensions Committee.

Serves as an Outside Director according to Directive No. 301 of the Proper Banking Management Directives and has financial and accounting expertise as well as professional qualifications.

Prof. Zilberfarb has an academic education - Professor of Economics, PhD. In Economics from the University of Pennsylvania, Master of Economics from Bar-Ilan University and Bachelor of Economics and Business Administration from Bar-Ilan University. Act as Professor of Economics at the Bar-Ilan University and holds the Edmond de Rothschild Chair for Global Asset Management at the School of Banking and Capital Market at the Netanya Academic College.

Serves as Outside Director and Chairmen of the Audit Committee of Delek Group Ltd. and of Engel Resources and Development Ltd. (since January 13, 2011) and Perrigo Company (a U.S. corporation). Serves as an outside Director and member of the audit committee and the investments committee of Infinity - Central Pension Fund Management Ltd. (since May, 2010), and of Infinity Provident Funds Management Ltd. (since January 2011). Director of Prof. Ben-Zion Zilberfarb Economic and Management Consultant Ltd. and in the Company for Locating and Retrieving Assets of People who were killed in the Holocaust Ltd.

Served as Outside Director and Chairmen of the Audit Committee of Direct Capital Investments Ltd. (until May 2009), of Brimag Digital Age Ltd. (until December 2008), and Partner Communications Company Ltd. (until February 2006), as outside director and member of the audit committee of Fundtech Ltd. (until December 2007), as an outside Director and Chairman of the Investment Committee of Clal Finance Provident and Education Fund Ltd. (until April 2006) and as Director of Tamares Hotels Ltd. (September, 2007 - December 2010).

**Ilan Cohen** - Acts as Director of the Bank since November 10, 2010. Mr. Cohen acts as Chairman of the Strategy Committee and member of the Remuneration Committee.

Acts as an outside Director in accordance with Directive No. 301 of Proper Banking Management Directives and has accounting

and financial expertise as well as professional qualification.

Mr. Cohen has an academic education - Master of business administration (summa cum laude) from INSEAD, Fontainebleau France and Bachelor of economics and management (summa cum laude) from Tel Aviv University.

Serves as Chairman of the Board of Insuline Medical Ltd. and of Mikveh Israel Alliance Israelite, as Director and deputy Chairman of Edmond de Rothschild Private Equity Management Ltd., as Director of Hadaka Hatishim Ltd., of P.O.C. Investment Company (1999) Ltd., of Tal-Ya Water Technologies Ltd., of Masa: The Project for the Encouragement of long term Programs in Israel for Jewish Young Adults Ltd. and of P.O.C. Capital Investments Ltd. (since August 1994).

President & CEO of Ilan Cohen Investment and Entrepreneurships Ltd. and of Yield-Investment Advisors Ltd.

Served as Director of the Alliance Israelite Association (2007 - November, 2009) and as Director General of the Prime Minister's Office (2004-2006).

**Edith Lusky** - Serves as Outside Director of the Bank since March 25, 2009. Ms. Lusky acts as Chairperson of the Audit Committee and Chairperson of the Committee for the review of the Financial Statements, as member of the Remuneration Committee and the Corporate Governance Committee.

Serves as an Outside Director in accordance with the Companies Law, 1999. Has financial and accounting expertise and professional qualifications.

Ms. Lusky has an academic education - Master of Economics and Bachelor of Economics and Statistics from Tel Aviv University. acts as Director of Cellcom Israel Ltd. (as from March, 2011). Served as senior executive vice president and member of management of Union Bank of Israel Ltd. (February 2004 - December 2008) and as a Director of Igud Leasing Ltd. (March 2007 - December 2008), and as a Director of Igudim Insurance Agency (1995) Ltd. (September 2005 - December 2008), Igudim Ltd. (September 2005 -December 2008) and Livluv Insurance Agency (1993) Ltd. (February 2004 - December 2008).

**Jorge Zafran** - Serves as Director of the Bank since January 31, 2006. Mr. Zafran is a member of the Audit Committee, the Corporate Governance Committee and the Risk Management and overseas Extensions Committee.

Has professional qualifications.

Mr. Zafran has an academic education - Master of Business Administration and Accounting (specialized in accounting and business administration in the marketing track) from the National University of Buenos Aires, Argentina, Faculty of Economic Science.

Serves as Director and CEO of Power Phone Marketing Ltd., Power Dialing Ltd., Inter American Marketing Services Ltd., Cadillac Properties and Building Company Ltd. and Israel Learning Systems Ltd. and as Joint Managing Director and CEO of T.M. Intertrrom Ltd.

Served as director (as well as in certain periods as Chairman of the Audit Committee and Credit Committee) at Eurotrade Bank (until July 2005).

**Ilan (Eilon) Aish** - Serves as Director of the Bank since November 1, 2008. Mr. Aish Acts as Chairman of the Risk management and of the Overseas Extensions Committee, as member of the Audit Committee, the Committee for the review of the Financial Statements, the Credit Committee, the Corporate Governance Committee and the Strategy Committee.

Serves as an Outside Director according to Directive No. 301 of the Proper Banking Management Directive and has accounting and financial expertise as well as professional qualifications.

Mr. Aish is a Certified Public Accountant and has academic education - Bachelor of Economics and Accounting from Tel Aviv University.

Serves as Joint Director and CEO Harvest Capital Markets Ltd.

Served as a Director of Harisha Tuff Lanka Private (Limited) (April 2007 - December 2009), Chairman of the Board of Tuff Merom Golan (2000) Ltd. (April 2002 - December 2008), Chairman General Partner of Tuff L.P. (April 2002 - December 2008), as Outside Director and Chairman of the Investments Committee of the Provident Fund of IBM Israel Employees Ltd. (December 2003 - September 2007) and as Outside Director and Chairman of the Risk Management Committee of Mercantile Discount Bank Ltd. (November 2000 - October 2006).

**Joseph Ciechanover-Itzhar** - Serves as Director of the Bank since June 3, 2009. Mr. Ciechanover-Itzhar acts as member of the Remuneration Committee and of the Risk Management and Overseas Extensions Committee.

Has financial and accounting expertise as well as professional qualifications.

Mr. Ciechanover-Itzhar has an academic education - Ph.D. in Philosophy and Jewish Studies, Boston University; studies at the Jewish Theological Seminary, Boston University; has an LL.M. from the Faculty of Law, Berkley University, California; Magister Juris from the Hebrew University in Jerusalem; studies towards a Masters in business Administration department, Hebrew University, Jerusalem (without qualifying); Ministry of Education Teaching Qualification, Department of Education.

Serves as Director of the Azrieli Group Ltd. (since May, 2010), as president of I.Y.Z. Investments Ltd. and of Atidim-Etgar Nihul Kranot Ltd., Director of Harel Insurance Investments and Financial Services Ltd. and of the Israel Museum. Deputy chairman of the Board of Hillel - The Israel Center for Jewish Campus Life (PBC), member and Treasurer of the Elie Wiesel - Foundation of Humanity (since 1995). Chairman of the Dr. Jacob Isler Association for Assisting the Handicapped and Bereaved Families and member of the Rashi Foundation, a Registered Association.

Served as Director of Nova Measuring Instruments Ltd. (until May 2007).

**Richard Morris Roberts** - Acts as Director of the Bank since November 10, 2010. Mr. Roberts acts as member of the Audit Committee. Has professional qualification.

Mr. Roberts is a lawyer, member of the Israeli Bar Association since 1967. Has an academic education - Bachelor of Law from the Hebrew University, Jerusalem.

Founding partner of Shibolet & Co. (in 1973) and since then serves as managing partner of the Firm. His areas of expertise are: commercial law, mergers, acquisition and corporate law. Serves as Director of Shibolet & Co. trust companies: Sharo Trustees Ltd. (since 1973), Sharo Services Ltd. (since 1973) and Shryz Trust Company Ltd. (since 1993). Owner and director of Richard Roberts Law Company (1997) Ltd. (since 1997). Serves as Director of the Interdisciplinary Center Herzliya Projects Ltd. (since 1998), and of Ed Value Ltd. (since 2001), Chairman of the executive board of A Different Lesson Association (RA) (since 2006) and member of the executive board of Docuaviv - Promotion of Documentary Films Association (RA) (since 2008). Acted as Director of Simda Ltd. (1990-2010) and of Apolonia Towers (1994) Ltd. (2005-2007).

**Zvi Streigold** - Serves as Director of the Bank since January 31, 2006. Mr. Streigold acts as member of the Credit Committee, the Computer Committee and the Corporate Governance Committee.

Serves as an Outside Director according to Directive No. 301 of the Proper Banking Management Directives and has professional qualifications.

Mr. Streigold is a lawyer and has academic education - an LL.B. Degree from Tel Aviv University and economics there without graduating.

Mr. Streigold practices law, serves as Director of Clal Finance Trust 2007 Ltd. and Zvi Streigold-Law Company Ltd. as Chairman of the General Rates Appeal Committee of the Tel Aviv-Yaffo Municipality. Served as Chairman of the Board of UBank Trust Company Ltd. (until January 2006) and Director of UBank Underwriting and Consulting Ltd. (until June 2005). Chief Legal Counsel, head of Specialized Finance Division and member of senior management of UBank Ltd. (until June 2005).

**Yali Sheffi** - Acts as Director of the Bank since November 10, 2010. Mr. Sheffi acts as member of the committee for the review of the Financial Statements, the Credit Committee, the Remuneration Committee and the Strategy Committee.

Acts as an outside Director in accordance with Directive No. 301 of Proper Banking Management Directives and has accounting and financial expertise as well as professional qualification.

Mr. Shefi is a certified public accountant since 1982 and has an academic education - Bachelor of economics and complementary studies in statistics and mathematics (summa cum laude) from the Hebrew University, Jerusalem, has a Diploma in Accounting for degree holders from Tel Aviv University (outstanding seminary work), and direct PhD. Studies in mathematical economics, the Hebrew University, Jerusalem (not completed).

Owner manager of a private business consulting company (since June, 2009), served as Chairman of the Board of the Association of Life Assurance Companies of Israel Ltd. (2008-2009). Served as President & CEO of Phoenix Insurance Company Ltd. (2005-2009) and Phoenix Holdings Ltd. (2005-2009).

**Dr. Yitzhak Sharir** - Serves as director of the Bank since December 24, 2006. Dr. Sharir acts as chairman of the Computer Committee and member of the Strategy Committee.

Has professional qualifications.

Dr. Sharir has an academic education - PhD in Materials Engineering from the Illinois Institute of Technology, Chicago, USA; Master of Materials Engineering from Ben Gurion University in the Negev; Bachelor of Mechanical Engineering from the Haifa, Technion has a non-academic diploma in Business Administration from the Israel Institute of Productivity in Tel Aviv.

Dr. Sharir engages in business and private investments. Serves as Chairman of the Board of Discount Israel Capital Markets and Investments Ltd. (since March 14, 2010, Director since April 2008), outside Director of Tzur Shamir Holdings Ltd. (since January 2000) and in M.A. Sharir Management Ltd. (since April 2009).

Served as Chairman of the Board of Revolutionaire Ltd. (September 2007 - April 2010) and Lia Chocolate Gourmet Ltd. (April 2008 - September 2008), President & CEO of Sapiens International Corporation N.V. (November 2000 - November 2005) and as Director of Israel Discount Bank Ltd. (October 1999 - August 2002).

## DETAILS REGARDING MEMBERS OF MANAGEMENT

**Mr. Reuven Spiegl** - serves as President & CEO of the Bank since January 1, 2011.

Mr. Spiegl has an academic education – Bachelor and Master of business administration from the New York Institute of technology. Serves as Chairman of the Board of Israel Credit Cards Ltd., Discount Bancorp Inc. (as from January 2011 and Director as from January 2006), of Discount Bank Latin America, and BLD Company Ltd. (since March 2011). and as Director of Israel Discount Bank of New York and of IDB (Swiss) Bank Ltd. (since March 2011).

Acted as President of Discount Bank of New York (February 2006 - December 2010) and of Discount Bancorp Inc. (April 2006 - December 2010), as Director and Chairman of the Board (President) of IDBNY Realty (Delaware), Inc. (December 2006 – December 2010), as Director of IDB Capital Corp. (November 2006 - December 2010 and as President & CEO of Discount Bank of New York (February 2006 - February 2011) and as head of the Retail Banking Division at Israel Discount Bank Ltd. (April 2001 to February 2010).

**Dorit Bensimon** - member of management since April 2, 2006, Senior Executive Vice President, Head of Finance Division.

Ms. Bensimon has an academic education - Master of Business Administration (specializing in finance) and Bachelor of Social Sciences - Economics and General Studies from the Hebrew University, Jerusalem.

Serves as Chairperson of the Board of Discount Manpikim Ltd. (since April 2006) and the Nominee Company of Israel Discount Bank Ltd. (since April 2010).

Served as the Bank's Chief Risk Manager, as Chairman of the Board of BLD company Ltd. (January 2007 to March 2007), as Director of Discount Reinsurance International Limited, Guernsey (2006 - March 2008) and of Ma'alot - The Israel Rating Company Ltd. (April 2006 - November 2007) (The current name of the company is: M.H.L.D.N. Ltd.). Served as General Manager of Gmulot and Head of the provident funds asset management unit at Bank Hapoalim Ltd. (February 2001 - January 2006).

**Joseph Beressi** - member of management since April 1, 2000, Senior Executive Vice President, Comptroller - Chief Accounting Officer and Head of the Accounting Group of the Bank.

Mr. Beressi is a Certified Public Accountant and has an academic education - Bachelor of Accounting and Economics from Tel Aviv University.

Serves as Director of Israel Discount Capital Markets & Investments Ltd. (since November 1999), Badal Computer and Management Services Ltd. (since February 2002), Nidbach Real Estate and Investments Ltd. and Discount Reinsurance International Limited, Guernsey (since March 2008) and of Israel Credit Cards Ltd. (since June 2010).

Served as Chairman of the Board of Discount Gemel Ltd. (until December 2008).

**Juval Gavish** - member of management since January 11, 2011, Senior Executive Vice President, Head of the Banking Division.

Mr. Gavish has an academic education - Bachelor of Humanities and Social Sciences from the Open University.

Mr. Gavish is a candidate for appointment as chairman of the board of Discount Mortgage Bank Ltd., subject to approval of the

Supervisor of Banks (he is to replace Mr. Noam Hanegbi).

Served as Chairman of the Board of Ace Auto Depot (September 2009 - December 2010) and of Maalot Insurance Agency (2006 -2008), as General Manager of Prisma Capital Markets Ltd. (April 2008 - August 2009) and of Leumi Mortgage Bank Ltd. (2006-2008) and as Manager of the Jerusalem Region of Bank Leumi Le'Israel B.M. (2001-2006).

**Amnon Gideon** - member of management since March 1, 2006, Senior Executive Vice President, Head of the Human Resources Layout of the Bank.

Mr. Gideon has an academic education - Bachelor of Political Sciences and Psychology from Bar-Ilan University and studies towards a Master of Human Resources Management (thesis not submitted) from Derby University. He has also taken professional courses in: Business Administration and General Management, Bar-Ilan University, Export Import Management, Berkley University, California, U.S.A and Human Resources Management, Berkley University, California, U.S.A.

Served as Director of Discount Gemel (2006 - January 2008) and as VP Human Resources at Partner Communications Company Ltd. (2001-2006).

**Esther Deutsch** - member of management since June 1, 2006, Senior Executive Vice President, Chief Legal Adviser and Head of the Legal Advisory Group of the Bank.

Ms. Deutsch is a lawyer with an LL.B. Degree from the Hebrew University, Jerusalem.

Acts as Chairperson of the Board of Discount Trust Ltd. (Chairperson since February 2008 and Director since January 2008). Served as Director of the Tel Aviv Stock Exchange Ltd. (July 2007 - June 2009) and as Manager of the Bank's Legal Consulting Department (2000 - June 2006).

**Noam Hanegbi** - member of management since November 15, 2000, Senior Executive Vice President, Head of the Strategy, Marketing and Service Division.

Mr. Hanegbi has an academic education - Bachelor of Economics and Computer Sciences from Bar-Ilan University.

Serves as Chairman of the Board of Discount Mortgage Bank Ltd. (since August 2010).

Acted as Head of the Retail Banking Division of Israel Discount Bank Ltd. (April 2010 - January 2011 at present, the Banking Division), as Head of the Operations and Information Systems Division of Israel Discount Bank Ltd. (November 2000 - April 2010), as Chairman of the Board and General Managing Director of Badal Computer and Management Services Ltd. (November 2000 - May 2010), as Chairman of the Board of Discount Provident Ltd. (December 2008 - May 2010) and of Nidbach Real Estate and Investments Ltd. (February 2009 - May 2010, prior thereto served as Director). Tzir Trading Company Ltd. (August 2009 to May 2010) and Har Levi Properties Ltd. (August 2009 to May 2010), Director of Israel Credit Cards Ltd. (March 2001 to March 2011). Mercantile Discount Bank Ltd. (July 2006 - April 2010) and of Diners Club Israel Ltd. (until December 2000), as Chairman of the Board of Banking Clearing Center Ltd. (July 2007 - March 2009; Director since November 2000), Chairman of the Board of Automatic Bank Services Ltd. (July 2007 - March 2009; Director since November 2000).

Member of the Computer Committee of the Tel Aviv Stock Exchange (December 2001 - April 2010).

**Yair Avidan** - member of management since June 9, 2010, Executive Vice President, the Bank's Chief Risk Manager and Head of the Risk Management Layout.

Mr. Avidan has an academic education -Master of Business Administration and Master of Administration and Leadership in Education from Tel Aviv University, and Bachelor of Economics and Statistics from Tel Aviv University.

Served as Director of Discount Mortgage Bank Ltd. (1998 - August, 2010), as deputy head of the Corporate Banking Division at Israel Discount Bank Ltd. (January, 2008-2010), as Manager of the Foreign Extensions and Management Information Department at Israel Discount Bank Ltd. (August, 2006 - January, 2010) and manager of the Foreign Extensions Department at Israel Discount Bank Ltd. (February, 2001 - August, 2006). External member of the investments committee of the Provident Fund of IBM, Israel Employees Ltd. (2004-2008).

**Shlomo Avidan** - member of management since April 26, 2010, Head of Operations and Logistics Division.

Mr. Avidan has an academic education - Master of Business Administration from Tel Aviv University and Bachelor of Economics and Business Administration from Bar-Ilan University.

Serves as Chairman of the Board of Discount Provident Ltd. (since May, 2010), of Nidbach Real Estate and Investment Ltd. (since May, 2010), Tzir Trading Company Ltd. (as from May 2010) and Har Levi Properties Ltd. (as from May 2010) and as Director of Badal Computer and Management Services Ltd. (since June, 2006), and of Mercantile Discount Bank Ltd. (since June, 2006). Served as Chairman of the Board of Bank Clearing Center Ltd. (April, 2009-May, 2010) and of Automatic Bank Services Ltd. (April, 2009 - May, 2010) as head of the Ofek project at the Israel Discount Bank Ltd. (2001-2006), as deputy head of the Operations and Information Systems Division in charge of business continuity at Israel Discount Bank Ltd. (2006 - April, 2010).

**Orit Alster** - Member of Management since March 11, 2011, Vice President, Head of the Corporate Banking Division. Ms. Alster has an academic education - Master of business administration from the Tel Aviv University and a Bachelor of economics and law from the Tel Aviv University.

Acted as manager of the large corporations department at Israel Discount Bank Ltd. (January 2000 to December 2006) and as Director of Mercantile Discount Bank Ltd. (July 2006 to October 2008).

**Shai Vardi** - member of management since April 26, 2010, Executive Vice President Head of IT and Planning Division.

Mr. Vardi has an academic education - Master of Business Administration from Tel Aviv University and Bachelor of Industrial Engineering and Management.

Serves as President & CEO of Badal Computer and Management Services Ltd. (since May 2010, Director since August 2004), and as Director of Discount Mortgage Bank Ltd. (since 2006) and of Discount Provident Ltd. (since 2008). Member of the computer committee of the Tel Aviv Stock Exchange (since May 2010).

Acted as deputy head of the Operations and Information Systems Division, Manager of the computer system of Israel Discount Bank Ltd. (2004 - April 2010).

## DISCLOSURE REGARDING THE PROCESS OF APPROVAL OF THE FINANCIAL STATEMENTS

**General.** On April 27, 2008, the Supervisor of Banks issued a provisional directive in the matter of "Disclosure in the Directors' Report regarding the Process of Approval of the Financial Statements". The directive adopts the guidelines of the Securities Authority on the subject issued in July 2007. According to the directive, banks must include in their quarterly and annual Directors' Reports information as to the process of approval of the financial statements.

**Companies Regulations (Directives and terms regarding the process of approval of financial statements), 2010** [hereinafter: "Companies Regulations (Financial statements approval)"]. The said Regulations, which take effect as from the annual report for 2010, state, among other things, the matters in respect of which, the committee appointed to review the financial statements will form recommendations to the Board of Directors. Among other things, the Regulations further state that the chairman of the committee reviewing the financial statements will be an outside director, most of its members will be independent directors, all its members have the ability to read and understand financial statements and at least one of the independent directors will have accounting and financial expertise. The Bank is preparing to implement the said Regulations.

**Overall control at the Bank.** The Board of Directors of the Bank is the organ entrusted with the overall control at the Bank. The committee for the review of the financial statements is the entity entrusted with the supervision, control and guidance of the process of the approval of the Bank's financial statements, and this Committee, at the conclusion of its work, submits its recommendations regarding the approval of the financial statements to the Board. The committee for the review of the financial statements is comprised of six Directors, which are Directors having accounting and financial expertise, as follows: Ms. Edith Lusky (outside director), chairman of the committee, Mr. Ilan Biran (outside director), Mr. Ben-Zion Granit, Prof. Ben Zion Zilberfarb, Mr. Ilan Aish, Mr. Yali Sheffi.

**Process of approval of the interim financial statements.** Approval of the financial statements includes the following stages and organs:

**Disclosure Committee.** As part of the implementation of the Bank of Israel directives in the matter of disclosure in the financial

statements, which are based on Section 302 of the Sarbanes Oxley Act (see hereunder), the Bank has formed a Disclosure Committee headed by the President & CEO with the participation of the following management members: Mr. Joseph Beressi, Senior Executive Vice President - Chief Accountant; Ms. Esther Deutsch, Senior Executive Vice President - Chief Legal Adviser and Legal Risks Manager; Ms. Dorit Bensimon, Senior Executive Vice President - Head of the Finance Division and Risk and Liquidity Manager of the Bank; Mr. Yair Avidan, Executive Vice President - Head of the Risk Management Layout and the Bank's Chief Risk Manager; Ms. Orit Alster, Executive Vice President - Head of the Corporate Division and Credit Risk Manager; Mr. Shai Vardi, Executive Vice President - Head of IT and Planning Division. The Bank's Corporate Secretary and other entities at the Bank are also invited to attend the meetings of the Committee. The Internal Auditor and the Bank's independent auditors are also invited to attend the meetings of the Disclosure Committee as observers. The Committee convenes once in every quarter (or more if required) and discusses material disclosure matters in accordance with principles determined within the framework of the disclosure policy adopted by the Board of the Bank.

**The committee for the review of the financial statements.** The committee for the review of the financial statements discusses the draft of the financial statements of the Bank, including matters determined in the Companies Regulations (Financial statements approval), and is making recommendations to the Board of Directors in their respect, also discusses the Bank's financial statements on a stand alone basis (not consolidated).

Prior to the discussions by the committee for the review of the financial statements, the draft financial statements are provided to the Committee members for review together with additional documents intended to assist them in understanding and analyzing the financial statements, as well as extensive details regarding problematic debts and provisions for doubtful debts. The committee for the review of the financial statements discusses the statements in detail with the participation of senior officers related to financial reporting (the President & CEO, the Chief Accountant and other entities at the Bank, where required). The independent auditors and the Internal Auditor are invited to attend the meetings as observers.

As part of the discussions, the Chief Accountant reports to the Committee on matters related to the financial statements or matters that might have an impact on the financial statements, such as new regulatory requirements that have been published or which are expected to be published.

The Committee is authorized to discuss and decide on the disclosure of critical accounting policies.

Within the framework of discussing the financial statements, the Committee also discusses cases of borrowers where the recommended provisions in respect to their debt to the Bank exceed the amount determined by the Board, and recommends to the Board the provision to be made in their respect.

The committee for the review of the financial statements as well as the Audit Committee of the Board is also informed (if required) of significant deficiencies and weaknesses found in the formation or implementation of the internal control over financial reporting, and of fraud, if any, in which the management of the Bank or other employees playing a significant role in the internal control over financial reporting are involved.

The independent auditors report findings, if any, that came up during their audit of the financial statements as well as other matters which, in their opinion, should be brought to the attention of the committee for the review of the financial statements members.

At the conclusion of the discussion, the committee for the review of the financial statements presents its recommendations to the Board with respect to the approval of the financial statements, prior to the discussion which the Board will be holding in the matter.

**The Board of Directors of the Bank.** Following the discussions by the committee for the review of the financial statements, an additional discussion regarding the approval of the financial statements is held by the full plenum of the Board. Prior to the meeting, the Directors receive an amended draft of the financial statements (which include the recommendations and decisions of the committee for the review of the financial statements) together with the documents provided to the members of the committee for the review of the financial statements for their discussion of the financial statements.

Senior officers involved in financial reporting are also asked to attend the full meeting of the Board are (the President & CEO, the Chief Accountant and other officers where required), as well as the Internal Auditor and the independent auditors of the Bank attending as observers.

The discussion includes a review of the financial statements by the President & CEO and by the Chief Accountant, and a report concerning the adoption of the recommendations of the committee for the review of the financial statements.

The independent auditors report any findings of their audit of the financial statements as well as other matters which, in their opinion, should be brought to the attention of the Board members.

During the discussion, Board members refer to management questions and requests for clarifications regarding items that have been included (or should have been included) in the financial statements to others involved in the financial reporting. At the end of the discussion, subject to satisfactory answers on the part of management, the Board approves the financial statements.

## REPORT ON DIRECTORS HAVING ACCOUNTING AND FINANCIAL EXPERTISE

According to Section 92 (a)(12) of the Companies Law, the Board of Directors must determine the required minimum number of directors having accounting and financial expertise, as this term is defined in Section 240 of the Companies Law.

In accordance with regulations enacted under the said Section 240, the evaluation of the accounting and financial expertise of a director shall be made by the board of directors, and, among other things, the following should be taken into account as part of the overall considerations: the director's education, experience and knowledge of the matters detailed in the Companies Regulations (terms and tests for a director having accounting and financial expertise and a director having professional qualifications), 2005. In March 2004 and February 2006, the Board of Directors of the Bank has resolved that the minimum number of Directors having accounting and financial expertise acting on the Board, will be three.

As stated, in accordance with the Companies Regulations (Approval of Reports), a committee for the review of the financial statements has been formed, which abides by the rules determined in the Regulations.

According to the directives of the Supervisor of Banks, a banking corporation must determine the minimum number of directors having accounting and financial expertise, who could properly serve as members of the audit committee of the board or of any other committee of the board which is empowered to discuss the financial statements of banking corporations.

In February 2006, the board determined that the minimum number of directors as abovementioned is one.

As stated, in accordance with the Companies Regulations (Approval of Reports), a committee for the review of the financial statements has been formed, which abides by the rules determined in the Regulations.

The Directors having "accounting and financial expertise", and the factual background providing the basis for attributing these qualifications to them, are as follows. It should be mentioned that according to the reporting requirements of the Bank of Israel, against each name of a director it is stated whether he is a member of the review of the financial statements committee of the board and/or a member of the audit committee of the board.

**Dr. Joseph Bachar** - is a Certified Public Accountant, Dr. of Business Administration (specializing in finance), Master of Business Administration (specializing in finance) and Bachelor of Economics and Accounting.

Served as Director General of the Ministry of Finance (November 2003 - January 2007) and as Head of the Tax Authority (provisional appointment) (January 2007 - April 2007) and as partner and manager of Luboshitz Kasierer Accounting Firm (formerly Arthur Andersen and later Ernst and Young) (April 1995 - November 2003).

Since January 2010, Dr. Bachar acts as Acting Chairman of the Board of the Bank, as Chairman of the Board of Mercantile Discount Bank Ltd., as Director and Deputy Chairman of Israel Discount Bank of New York. Dr. Bachar acts as member of the financial statements committee and as Director of Discount Bancorp Inc.

**Ilan Biran** - Bachelor of Economics and Business Administration and holder of a diploma/strategic studies in strategy and economics. Serves as Chairman of the Board of Rafael Advanced Defense Systems Ltd., Chairman, manager committee Kinneret College on the Sea of Galilee (R.A).

Serves as Director General of the Ministry of Defense (1996-1999), Bezeq the Israel Telecommunications Corp. Ltd. (1999-2003) and as Chairman of the Boards of Beit Shemesh Engines Holdings (1997) Ltd. (2006-2007) and of DBS Satellite Services (1998) Ltd. (2004-2006) and as Director in Delta three Israel Ltd. (2004-2008) as Director and Chairman of the Strategic Committee of

Israel Aircraft Industries Ltd. (2005-2007), as Director of Massad Bank Ltd. (2005-2007), as Director and member of the Finance Committee of Netafim Ltd. (2004-2007), as a consultant at Venture Partner Consultant, The Challenge Fund - Etgar L.P. (until December 2009).

Mr. Biran serves as member of the Audit Committee and the committee for the review of the financial statements.

**Eli Eliezer Gonen** - Master of Business Administration from the Hebrew University, Jerusalem, Bachelor of Economics and complementary studies from the Hebrew University, Jerusalem and has completed one year of advanced studies at the University of California, Berkeley, U.S.A.

Serves as Chairman of the Board of Go Alpha Ltd. a company owned by him (since April 2009), as Chairman of the Board of Ma'ale Hachamisha Hotel (since February 2011), and of the Ghetto Fighters House - Itzhak Katzenelson Holocaust and Jewish Resistance Heritage Museum (since July 2008); partner, director and joint general manager of Terra Holdings, Management and Investments in Hotels Ltd. (since September 2009) and Director of the International Convention Center I.C.C. Jerusalem - Binyaney Haooma Ltd. (since 1998). Served as President of the Israel Hotel Association (2000 - December 2010) as Director of Tambour Ltd. (2002-2007), of Crystal Machinery and Electrical Appliances Ltd. (2004-2006), of Yahav Bank for State Employees Ltd. (1989-1992), of Massad Bank Ltd. (1987-1989), of Granite Hacarmel Investments Ltd. (during the eighties); served as General Manager of the Sheraton-Moriah Hotel Chain in Israel (1999-2009), of Koor Tourism Ltd. (1998-1996), of Histour Altiv (1996-1997) and of the Ministry of Tourism (1992-1996); held various executive positions at the Hebrew University, Jerusalem, the last of which was Director General of the University (1975-1992).

**Ben-Zion Granit** - Bachelor of Agricultural Sciences from Hebrew University with a minor in Agricultural Economics. Studied senior business management at the Business School of the Hebrew University and took courses on a wide range of financial subjects. Served as chief internal auditor of Union Bank of Israel Ltd. ("Union Bank") and its subsidiaries (1993-2000), as executive vice president, member of management and head of the operations division at Union Bank (2000-2004), as risk manager (market and credit risks) of Union Bank (in 2004). In addition he served as CEO of Union - Systems Ltd. (2000-2004) and as director of Carmel Igud Mortgages and Investments Ltd. and of Igudim Ltd. (2000-2004).

Mr. Granit serves as member of the Audit Committee and the committee for the review of the financial statements.

**Prof. Ben-Zion Zilberfarb** - Professor of Economics, PhD. in Economics, Master of Economics, and Bachelor of Economics and Business Administration.

Serves as Professor of Economics at Bar-Ilan University and holds the Edmond de Rothschild Chair for Global Asset Management at the School of Banking and Capital Markets at the Netanya Academic College, and as Outside Director and Chairman of the audit committee of Delek Group Ltd. and of Engel Resources and Development Ltd. (since February, 2011). Serves as an Outside Director and member of the Audit Committee of Perrigo Company (an American company), as Director and member of the investments committee of Infinity - Central Pension Fund Management Ltd., and of Infinity Provident Funds Management Ltd. (since January 2011), and as Director in the Company for Locating and Retrieving Assets of People who were killed in the Holocaust Ltd.

Served as Outside Director and Chairman of the audit committee of Direct Capital Investments Ltd. (until May 2009) in Brimag Digital Age Ltd. (until December 2008), and in Partner Communications Company (until February 2006) as an outside Director of Fundtech Ltd. (until December 2007), as an outside Director and Chairman of the investment committee in Clal Provident Fund and Education Fund Financing Ltd. (until April 2006) and as Director of Tamares Hotels Ltd (September, 2007 - December, 2010).

Served as Chairman of the Board of Directors of Karnit (1998-2002) and of Eurotrade Bank Ltd. (2000-2001).

Served as director of the Economic Planning Authority (1982-1985) and as Director General of the Ministry of Finance (1998-1999).

Partner Communications Company Ltd. reported him as having financial expertise under the U.S. Securities Regulations. As a member of the audit committee of Fundtech Ltd., of Partner Communications Company Ltd. and of PERRIGO, accompanied and accompanying the process implementing requirements under the Sarbanes-Oxley Act. Is proficient in accounting matters pertaining to GAAP and to the recognition of earnings and other subjects relating to the communications sector.

Prof. Zilberfarb serves as member of the committee for the review of the financial statements.

**Ilan Cohen** - Master of business administration (summa cum laude) from INSEAD, Fontainebleau France and Bachelor of economics and management (summa cum laude) from Tel Aviv University.

Serves as Chairman of the Board of Insuline Medical Ltd. and of Mikveh Israel Alliance Israelite. Serves as Director and deputy Chairman of Edmond de Rothschild Private Equity Management Ltd., as Director of Hadaka Hatishim Ltd., of P.O.C. Investment Company (1999) Ltd. and of Tal-Ya Water Technologies Ltd.

President & CEO of Ilan Cohen Investment and Entrepreneurship Ltd. and of Yield Investment Advisors Ltd.

Served as Director of the Alliance Israelite Association (2007 - November, 2009) and as Director General of the Prime Minister's Office (2004-2006).

**Edith Lusky** - Master of Economics and Bachelor of Economics and Statistics.

Served as Senior vice president and member of management of Union Bank of Israel Ltd. (2004-2008) which areas of responsibility were: Head of the retail, customer assets and advisory services department, Head of the retails banking and risk management department and in addition in charge of marketing, advertising and mortgages.

Served as President & CEO of Mishcan Bank, a subsidiary of Bank Hapoalim Ltd. (2001-2004) and as Manager of the direct banking wing at Bank Hapoalim Ltd. (November 1995 - March 2001). Her responsibilities were: establishment and marketing the Bank's internet sites, establishment and management of "Poalim Direct" - the bank's telephone centers, responsibility for self-service machines and automatic branches.

Ms. Lusky serves as Chairman of the Audit Committee and as Chairman of the committee for the review of the financial statements.

**Ilan (Eilon) Aish** - Certified Public Accountant, Bachelor of Economics and Accounting.

Serves as Joint Managing Director, Harvest Capital Markets Ltd.

Served as a partner in the accounting firm of Yigal Brightman & Co. (1984-1992) and in the accounting firm of Vulcan, Weinberg, Aish & Co. (1993-2000) and as consulting partner in the accounting firm of Goldstein, Sabu, Tevet (2001-2004).

Served as Outside Director and chairman of the Investments Committee of the Provident Fund of IBM Israel Employees Ltd. (December 2003 - September 2007), and as Outside Director and chairman of the Risk Management Committee of Mercantile Discount Bank Ltd. (November 2000 - October 2006). In addition acted as Director of Harisha Tuff Lanka (Private) Ltd., (April 2007 - December 2009), Chairman and General Partner in Tuff Industries (April 2002 - December 2008) and as Chairman of the Board of Tuff Merom Golan (2000) Ltd. (April 2002 - December 2008).

Mr. Aish serves as member of the Audit Committee and of the committee for the review of the financial statements.

**Dr. Joseph Ciechanover-Itzhar** - has a Ph.D. in Philosophy and Jewish Studies from Boston University; studies at the Jewish Theological Seminary at Boston University. Has an L.L.M. from the Berkley University Law School, California, and a Magister Juris from the Hebrew University Law School, and studies towards a Masters Degree at the Business Administration Department at the Hebrew University (no degree).

Serves as Director of the Azrieli Group Ltd., of Harel Insurance Investments and Financial Services Ltd. and of the Israel Museum, president of I.Y.Z. Investments Ltd. and of Atidim-Etgar Nihul Kranot Ltd. and as Deputy Chairman of Hillel - The Foundation for Jewish Campus Life in Israel (NPO). In addition, a member and treasurer of the Elie Wiesel Foundation for Humanity and Chairman of the Dr. Jacob Isler Fund for Assisting the Handicapped and Bereaved Families.

Served as Chairman of El-Al Israel Airlines Ltd. (1995-2002). Between the years 1985 and 1995 served as President and member of the Board of PEC - Israel Economic Corporation Ltd. and member of the Board and of the Executive Committee of IDB Holding Company Ltd.

Served as Chairman of Israel Discount Bank Ltd. and was a member of the Advisory Committee of the Bank of Israel (1986-1991).

Acted as Director General of the Foreign Ministry (1978-1980), as Head of the Defense Ministry Delegation to the United States (1974-1978), as Legal Advisor to the Defense Ministry (1968-1974) and has served in various positions in public service (1957-1978).

**Yali Sheffi** - Certified public accountant, Bachelor of economics and complementary studies in statistics and mathematics (summa cum laude) from the Hebrew University, Jerusalem. Has a Diploma in Accounting for degree holders from Tel Aviv University (outstanding

seminary work). Direct PhD. studies in mathematical economics, at the Hebrew University, Jerusalem (not completed). Owner manager of a private business consulting company (since June, 2009). Served as Chairman of the Board of the Association of Life Assurance Companies of Israel Ltd. (2008-2009). Served as President & CEO of Phoenix Insurance Company Ltd. and Phoenix Holdings Ltd. (2005-2009), acted as member of the Barnea Committee (2000-2001), served in several roles with Almagor & Co. CPA's (partner 1983-1987, managing partner 1987-1999) thereafter served as managing partner of Deloitte - Briteman Almagor & Co. CPA's (1999-2004). Acted as member of the accounting principles committee of the Institute of Certified Public Accountants in Israel (1995-1998) and of the Israeli Accounting Standards Institute founded by the Institute of Certified Public Accountants in Israel and the Israeli Securities Authority (1998-2001).

Mr. Sheffi is a member of the committee for the review of the financial statements.

## CHANGES IN THE BOARD OF DIRECTORS AND MANAGEMENT

### CHANGES IN THE BOARD OF DIRECTORS

The tenure of office as Directors of Mr. Bezalel Iger, Dr. Arieh Ovadia, Mr. Itzhak Forrer, CPA, and Ms. Gittit Guberman, ended with the General Meeting of Shareholders of September 2, 2010.

The three year tenure of office as outside Director of Prof. Dafna Schwartz ended on December 27, 2010, in accordance with Proper Banking Management Directive No. 301.

The Chairman of the Board and the Directors thank Directors, who have ended their tenure of office, for their contribution to the Bank during their service.

In a special Meeting of Shareholders held on November 10, 2010, it was decided to appoint Messrs. Ilan Cohen, Yali Sheffi, Richard Morris Roberts and Eli Eliezer Gonen as Directors in the Bank's Board of Directors.

### TERMINATION OF OFFICE OF THE BANK'S PRESIDENT AND CEO

On July 5, 2010, the President & CEO Mr. Giora Offer, informed of his decision to retire from office on the date specified in the personal agreement signed with him, namely, the end of January 2011, having declined requests to continue in office for a further period. Mr. Offer informed that he found it proper to make his decision known earlier than required so as to allow the process of electing a new President & CEO in a proper manner and not under pressure of time.

The Chairman and the Board of Directors thanked Mr. Offer for his significant contribution to the development and advancement of the Bank in the past decade.

On August 25, 2010, the Board of Directors resolved to adopt the recommendation of the special committee of the Board, headed by the Chairman of the Board, which was appointed to locate candidates for the office of President & CEO of the Bank, and appointed Mr. Reuven Spiegel to the office of the Bank's President & CEO.

### CHANGES IN MANAGEMENT

On November 14, 2010, the Bank's Board of Directors decided to recommend to IDB New York Board of Directors the appointment of Mr. Ehud Arnon, Senior VP and the Head of the Corporate Division, to the office of President & CEO of IDB New York, replacing Mr. Reuven Spiegel, who has been appointed as the President & CEO of the Bank. On December 31, 2010, Mr. Arnon retired from office at the Bank. Mr. Shlomo Pitchon, Senior Vice President, terminated on December 31, 2010, his office as the Internal Auditor of the Bank (this following his announcements of December 13, 2009 and January 27, 2010).

On December 12, 2010, the Board of Directors resolved to approve the appointment of Mr. Nir Abel, CPA, as Internal Auditor of the Bank with the title of Vice President. Mr. Abel is to assume office during 2011.

On December 27, 2010, the Board of Directors adopted resolutions regarding the appointment of senior executives and changes in the organizational structure. In this context it was decided:

- To approve the appointment of Mr. Yuval Gavish as member of Management with the title of Senior Vice President, to the position of Head of the Retail Banking Division (presently the Banking Division) Mr. Gavish took office on January 11, 2011 replacing Mr. Noam Hanegbi;
- To approve the appointment of Mr. Noam Hanegbi, Senior Vice President, to the Position of Head of Division responsible for strategic and marketing issues, and among other things, for the coordination and Group management of strategy and marketing areas.

On January 23, 2011, the Board of Directors resolved to approve the appointment of Ms. Orit Alster, as the Head of the Corporate Banking Division and member of Management with the title of Executive Vice President. On March 21, 2011, after obtaining the consent of the Supervisor of Banks, Ms. Alster assumed office as head of the Bank's Corporate Banking Division.

On March 23, 2011, the Board of Directors decided to approve the appointment of Mr. Abraham (Avi) Levy as member of Management, with the title of Vice President to the position of Head of the Customer Assets Division that is being established. The appointment is subject to approval of the Supervisor of Banks.

The Board of Directors, the President & CEO and Management thank Messrs. Arnon and Pitchon for their efforts and contribution during their tenure of office at the Bank and wish success to the new members of Management.

## MEETINGS OF THE BOARD OF DIRECTORS AND ITS COMMITTEES

In 2010, the Board of Directors held 38 meetings. In addition, 89 meetings of committees of the Board of Directors were held. The Board of Directors wishes to thank the President & CEO, the members of Management, the Bank's employees and employees of the Group's companies and their management for their work towards the advancement of the Bank and the Group.

March 31, 2011

Dr. Joseph Bachar  
Chairman of  
the Board of Directors

Reuven Spiegel  
President &  
Chief Executive Officer

THE BOARD OF DIRECTORS AND MANAGEMENT OF THE BANK EXPRESS THEIR DEEP SORROW OVER THE UNTIMELY DEATH OF MRS. IRIS BARTOV CPA OF BLESSED MEMORY.

MRS. BARTOV WAS A SENIOR PARTNER IN THE ACCOUNTING FIRM OF KPMG SOMEKH CHAIKIN, AND IN THIS ROLE ACCOMPANIED THE BANK AND SEVERAL OF ITS SUBSIDIARIES IN RECENT YEARS.

MAY HER SOUL REST IN PEACE

## MANAGEMENT REVIEW

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## SCHEDULE "A" - CONSOLIDATED BALANCE SHEET - MULTI-PERIOD DATA

### REPORTED AMOUNTS

	As at December 31				
	2010	2009	2008	2007	2006
	In NIS millions				
<b>Assets</b>					
Cash and deposits with banks	18,187	24,583	21,554	19,850	25,100
Securities	37,176	36,338	31,535	37,278	38,977
Securities borrowed or purchased under resale agreements	45	336	25	346	-
Credit granted to the public	118,666	114,426	116,456	101,731	89,901
Credit granted to the Government	1,556	1,820	1,491	374	324
Investments in affiliated companies	1,684	1,795	1,827	1,935	1,367
Buildings and equipment	3,138	3,178	3,039	2,780	2,614
Other assets	5,362	5,341	5,904	4,184	4,044
<b>Total assets</b>	<b>185,814</b>	<b>187,817</b>	<b>181,831</b>	<b>168,478</b>	<b>162,327</b>
<b>Liabilities and Shareholders' Equity</b>					
Deposits from the public	138,011	141,825	139,232	130,518	130,517
Deposits from banks	3,387	3,724	4,555	5,072	8,099
Deposits from the Government	461	284	206	125	119
Securities loaned or sold under buy-back arrangements	7,227	7,651	7,194	5,895	-
Subordinated capital notes	12,294	11,529	9,373	7,437	6,302
Other liabilities	12,865	12,512	12,248	10,080	8,923
<b>Total liabilities</b>	<b>174,245</b>	<b>177,525</b>	<b>172,808</b>	<b>159,127</b>	<b>153,960</b>
Minority interest	328	298	226	147	402
Shareholders' equity	11,241	9,994	8,797	9,204	7,965
<b>Total liabilities and shareholders' equity</b>	<b>185,814</b>	<b>187,817</b>	<b>181,831</b>	<b>168,478</b>	<b>162,327</b>

## SCHEDULE "B" - CONSOLIDATED STATEMENT OF INCOME - MULTI-PERIOD DATA

## REPORTED AMOUNTS

	As at December 31				
	2010	2009	2008	2007	2006
	in NIS millions				
<b>Financing Income</b>					
Income from financing activities before provision for doubtful debts	4,830	4,757	4,127	4,225	3,790
Provision for doubtful debts	821	998	780	447	570
<b>Income from financing activities after provision for doubtful debts</b>	<b>4,009</b>	<b>3,759</b>	<b>3,347</b>	<b>3,778</b>	<b>3,220</b>
<b>Operating and other Income</b>					
Operating commissions	2,547	*2,633	*2,504	*2,481	*2,303
Net income on investment in shares	31	197	51	58	65
Other income	83	*261	*18	*112	*62
<b>Total operating and other income</b>	<b>2,661</b>	<b>3,091</b>	<b>2,573</b>	<b>2,651</b>	<b>2,430</b>
<b>Operating and other Expenses</b>					
Salaries and related expenses	3,190	3,175	3,106	3,030	3,202
Maintenance and depreciation of buildings and equipment	1,148	*1,032	*951	*857	*699
Other expenses	1,293	*1,279	*1,291	*1,258	*1,190
<b>Total operating and other expenses</b>	<b>5,631</b>	<b>5,486</b>	<b>5,348</b>	<b>5,145</b>	<b>5,091</b>
Operating income before taxes	1,039	1,364	572	1,284	559
Provision for taxes on operating income	467	507	169	566	350
Operating income after taxes	572	857	403	718	209
Bank's share in operating income (loss) net of tax effect of affiliated companies	186	158	(70)	45	188
Minority interest, after taxes, in the operating income of consolidated subsidiaries	(70)	(72)	(78)	(56)	(82)
Net operating income	688	943	255	707	315
Cancellation of provision for impairment in value of investment in affiliated companies	-	-	-	-	173
Net income (loss) from extraordinary items, net of taxes	36	(20)	(10)	558	348
<b>Net income</b>	<b>724</b>	<b>923</b>	<b>245</b>	<b>1,265</b>	<b>836</b>
<b>Earnings per share of NIS 0.1 (in NIS)<sup>(1)</sup>:</b>					
Net operating income	0.69	**0.95	0.26	**0.71	0.32
Net income (loss) from extraordinary items, net of taxes <sup>(1)</sup>	0.04	(0.02)	(0.01)	**0.56	**0.52
<b>Net income</b>	<b>0.73</b>	<b>0.93</b>	<b>0.25</b>	<b>1.27</b>	<b>0.84</b>
<b>Total number of shares used for the above computation (in thousands)</b>	<b>997,578</b>	<b>**993,979</b>	<b>**993,979</b>	<b>**993,979</b>	<b>**993,979</b>

\* Reclassified.

\*\* Restated in order to reflect the benefit component of the rights issue - see note 13 D.

Footnote:

(1) December 31, 2006: Including a cancellation of provision for impairment in value of investment in an affiliated company.

## SCHEDULE "C" - RATES OF FINANCING INCOME AND EXPENSES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES<sup>(1)</sup>

### REPORTED AMOUNTS

	2010				2009			
	Rate of income (expense)				Rate of income (expense)			
	Average	Financing	Excluding	Including	Average	Financing	Excluding	Including
	balance <sup>(2)</sup>	income	effect of	effect of	balance <sup>(2)</sup>	income	effect of	effect of
	(expense)	derivatives	derivatives <sup>(3)</sup>		(expense)	derivatives	derivatives <sup>(3)</sup>	
	in NIS millions		%		in NIS millions		%	
<b>Unlinked Israeli Currency:</b>								
Assets <sup>(4)(5)</sup>	86,189	3,737	4.34		79,428	2,928	3.69	
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	-	-			57	16		
Embedded and ALM derivatives	56,032	1,066			54,884	1,585		
<b>Total assets</b>	<b>142,221</b>	<b>4,803</b>		<b>3.38</b>	<b>134,369</b>	<b>4,529</b>		<b>3.37</b>
Liabilities <sup>(5)</sup>	(78,306)	(953)	(1.22)		*(76,536)	(638)	(0.83)	
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	-	-			(60)	(15)		
Embedded and ALM derivatives	(55,996)	(1,006)			(52,798)	(1,502)		
<b>Total liabilities</b>	<b>(134,302)</b>	<b>(1,959)</b>		<b>(1.46)</b>	<b>(129,394)</b>	<b>(2,155)</b>		<b>(1.67)</b>
Interest margin			3.12	1.92			2.86	1.70
<b>Israeli Currency Linked to the CPI:</b>								
Assets <sup>(4)(5)</sup>	28,341	1,635	5.77		27,978	2,211	7.90	
Effect of derivatives: <sup>(3)</sup>								
Embedded and ALM derivatives	342	(3)			322	22		
<b>Total assets</b>	<b>28,683</b>	<b>1,632</b>		<b>5.69</b>	<b>28,300</b>	<b>2,233</b>		<b>7.89</b>
Liabilities <sup>(5)</sup>	(22,158)	(1,311)	(5.92)		(21,309)	(1,635)	(7.67)	
Effect of derivatives: <sup>(3)</sup>								
Embedded and ALM derivatives	(5,159)	(369)			(6,016)	(645)		
<b>Total liabilities</b>	<b>(27,317)</b>	<b>(1,680)</b>		<b>(6.15)</b>	<b>(27,325)</b>	<b>(2,280)</b>		<b>(8.34)</b>
Interest margin			(0.15)	(0.46)			0.23	(0.45)

\* Reclassified.  
For footnotes see page \_\_\_\_\_.

**SCHEDULE "C" - RATES OF FINANCING INCOME AND EXPENSES OF THE BANK  
AND ITS CONSOLIDATED SUBSIDIARIES<sup>(1)</sup> (CONTINUED)**
**REPORTED AMOUNTS**

	2010				2009			
	Rate of income (expense)				Rate of income (expense)			
	Average	Financing	Excluding	Including	Average	Financing	Excluding	Including
	balance <sup>(2)</sup>	income	effect of	effect of	balance <sup>(2)</sup>	income	effect of	effect of
	(expense)	derivatives	derivatives <sup>(3)</sup>		(expense)	derivatives	derivatives <sup>(3)</sup>	
	in NIS millions		%	in NIS millions		%		
<b>Foreign Currency:<sup>(6)</sup></b>								
Assets <sup>(4)(5)</sup>	61,485	(2,311)	(3.76)		69,492	2,912	4.19	
<b>Effect of derivatives:<sup>(3)</sup></b>								
Hedging derivatives	-	-			1,655	264		
Embedded and ALM derivatives	48,235	(1,925)			39,414	1,160		
<b>Total assets</b>	<b>109,720</b>	<b>(4,236)</b>		<b>(3.86)</b>	<b>110,561</b>	<b>4,336</b>		<b>3.92</b>
Liabilities <sup>(5)</sup>	(68,346)	4,171	6.10		(73,413)	(1,402)	(1.91)	
<b>Effect of derivatives:<sup>(3)</sup></b>								
Hedging derivatives	-	-			(1,740)	(284)		
Embedded and ALM derivatives	(44,201)	1,388			(36,590)	(1,005)		
<b>Total liabilities</b>	<b>(112,547)</b>	<b>5,559</b>		<b>4.94</b>	<b>(111,743)</b>	<b>(2,691)</b>		<b>(2.41)</b>
Interest margin			2.34	1.08			2.28	1.51

For footnotes see page \_\_\_\_.

**SCHEDULE "C" - RATES OF FINANCING INCOME AND EXPENSES OF THE BANK  
AND ITS CONSOLIDATED SUBSIDIARIES<sup>(1)</sup> (CONTINUED)**

**REPORTED AMOUNTS**

	2010			2009				
	Rate of income (expense)			Rate of income (expense)				
	Average balance <sup>(2)</sup>	Financing income (expense)	Excluding effect of derivatives	Including effect of derivatives <sup>(3)</sup>	Average balance <sup>(2)</sup>	Financing income (expense)	Excluding effect of derivatives	Including effect of derivatives <sup>(3)</sup>
	in NIS millions		%	in NIS millions		%		
<b>Total:</b>								
Monetary assets which generated financing income <sup>(4)(5)</sup>	176,015	3,061	1.74	176,898	8,051	4.55		
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	-	-		1,712	280			
Embedded and ALM derivatives	104,609	(862)		94,620	2,767			
<b>Total assets</b>	<b>280,624</b>	<b>2,199</b>	<b>0.78</b>	<b>273,230</b>	<b>11,098</b>	<b>4.06</b>		
Monetary liabilities which generated financing expenses <sup>(5)</sup>	(168,810)	1,907	1.13	(171,258)	(3,675)	(2.15)		
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	-	-		(1,800)	(299)			
Embedded and ALM derivatives	(105,356)	13		(95,404)	(3,152)			
<b>Total liabilities</b>	<b>(274,166)</b>	<b>1,920</b>	<b>0.70</b>	<b>(268,462)</b>	<b>(7,126)</b>	<b>(2.65)</b>		
Interest margin			2.87			2.40	1.41	
In respect of options		131			83			
In respect of other derivatives (excluding options, hedging derivatives, ALM and detached embedded derivatives) <sup>(3)</sup>		(3)			32			
Commissions on financing operations and other financing income <sup>(7)</sup>		593			691			
Other financing expenses		(10)			(21)			
Income from financing activities before provision for doubtful debts		4,830			4,757			
Provision for doubtful debts (including general and supplemental provisions)		(821)			(998)			
Income from financing activities after provision for doubtful debts		4,009			3,759			

For footnotes see next page.

**SCHEDULE "C" - RATES OF FINANCING INCOME AND EXPENSES OF THE BANK  
AND ITS CONSOLIDATED SUBSIDIARIES<sup>(1)</sup> (CONTINUED)**
**REPORTED AMOUNTS**

	2010	2009
	Average balance <sup>(2)</sup>	
	in NIS millions	
<b>Total:</b>		
Monetary assets which generated financing income <sup>(4)(5)</sup>	176,015	176,898
Assets related to derivative instruments <sup>(8)</sup>	2,017	2,677
Other monetary assets <sup>(5)(9)</sup>	3,003	2,641
General and supplemental provisions for doubtful debts	(665)	(605)
<b>Total monetary assets</b>	<b>180,370</b>	<b>181,611</b>
<b>Total:</b>		
Monetary liabilities which generated financing expenses <sup>(5)</sup>	(168,810)	(171,258)
Liabilities related to derivative instruments <sup>(8)</sup>	(3,021)	(3,407)
Other monetary liabilities <sup>(5)</sup>	(3,294)	*(3,315)
<b>Total monetary liabilities</b>	<b>(175,125)</b>	<b>(177,980)</b>
Surplus of monetary assets over		
monetary liabilities	5,245	3,631
Non-monetary assets	6,253	6,422
Non-monetary liabilities	(718)	(409)
<b>Total capital resources</b>	<b>10,780</b>	<b>9,644</b>

\* Reclassified.

Footnotes:

- (1) The data in this table is presented before and after the effect of derivative instruments (including off-balance sheet effect of derivative instruments).
- (2) Based on monthly opening balances, and after deduction of the average balance of the specific provisions for doubtful debts.
- (3) Hedging derivative instruments (excluding options), detached embedded derivatives and derivatives (ALM) constituting a part of the asset and liability management system of the Bank.
- (4) The average balance of assets is net of/ (includes) the average balance of non-realized gains/ (losses) on adjustments to fair value of trading bonds and gains/losses in respect of available-for-sale securities, included in shareholders equity under other cumulative comprehensive income, in the item "Adjustments for the presentation of available-for-sale securities at fair value": 2010 - NIS 188 million in the unlinked segment, NIS 136 million in the CPI linked segment and NIS (110) million in the foreign currency segment; 2009 - NIS 189 million in the unlinked segment, NIS 68 million in the CPI linked segment and NIS (545) million in the foreign currency segment.
- (5) Excluding derivative instruments.
- (6) Including Israeli currency linked to foreign currency.
- (7) Including gains/losses on sale of investments in bonds and adjustment to fair value of trading bonds.
- (8) Average balances of derivative instruments (excluding average off-balance sheet balances of derivative instruments).
- (9) The average balance of non-realized profits/losses on adjustment to fair value of bonds that was deducted/added as detailed in item (4) above, was added to/ deducted from other financial assets.

**SCHEDULE "C" - RATES OF FINANCING INCOME AND EXPENSES OF THE BANK  
AND ITS CONSOLIDATED SUBSIDIARIES<sup>(1)</sup> (CONTINUED)**

**REPORTED AMOUNTS**

	2010				2009			
	Rate of income (expense)				Rate of income (expense)			
	Average	Financing	Excluding	Including	Average	Financing	Excluding	Including
	balance <sup>(2)</sup>	income	effect of	effect of	balance <sup>(2)</sup>	income	effect of	effect of
	in US\$ millions*	(expense)	derivatives	derivatives <sup>(3)</sup>	in US\$ millions*	(expense)	derivatives	derivatives <sup>(3)</sup>
			%				%	
<b>Foreign Currency -</b>								
<b>Nominal in US\$<sup>*(6)</sup></b>								
Assets <sup>(4)(5)</sup>	16,318	478	2.93		17,469	609	3.49	
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	-	-			443	72		
Embedded and ALM derivatives	13,175	199			10,140	199		
<b>Total Assets</b>	<b>29,493</b>	<b>677</b>		<b>2.30</b>	<b>28,052</b>	<b>880</b>		<b>3.14</b>
Liabilities <sup>(5)</sup>	(18,223)	(155)	(0.85)		(18,662)	(243)	(1.30)	
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	-	-			(464)	(78)		
Embedded and ALM derivatives	(12,168)	(217)			(9,345)	(167)		
<b>Total liabilities</b>	<b>(30,391)</b>	<b>(372)</b>		<b>(1.22)</b>	<b>(28,471)</b>	<b>(488)</b>		<b>(1.71)</b>
Interest margin		305	2.08	1.08		392	2.19	1.43

\* Nominal Israeli Shekel amounts translated to U.S. Dollars at the representative rate of exchange.

Footnotes:

- (1) The data in this table is presented before and after the effect of derivative instruments (including off-balance sheet effect of derivative instruments).
- (2) Based on monthly opening balances and after deduction of the average balance of the specific provisions for doubtful debts.
- (3) Hedging derivative instruments (excluding options), detached embedded derivatives and derivatives (ALM) constituting a part of the asset and liability management system of the Bank.
- (4) The average balance of assets is net of/ (includes) the average balance of non-realized gains/ (losses) on adjustments to fair value of trading bonds and gains/ (losses) in respect of available-for-sale securities: 2010 - in amount of US\$(28) million, 2009 - in the amount of US\$(128) million.
- (5) Excluding derivative instruments.
- (6) Including Israeli currency linked to foreign currency.

## SCHEDULE "D" - EXPOSURE TO CHANGES IN INTEREST RATES - CONSOLIDATED

## REPORTED AMOUNTS

As at December 31, 2010					
	On demand or within 1 month	Over 1 month and up to 3 months	Over 3 months and up to 1 year	Over 1 year and up to 3 years	Over 3 years and up to 5 years
in NIS millions					
<b>Non linked Israeli currency</b>					
Financial assets and amounts receivable in respect of derivative instruments					
Financial assets*	68,590	7,434	5,998	3,005	1,162
Derivative financial instruments (except for options)	9,777	21,975	12,939	5,934	2,131
Options (in terms of base assets)	538	842	929	212	67
<b>Total fair value</b>	<b>78,905</b>	<b>30,251</b>	<b>19,866</b>	<b>9,151</b>	<b>3,360</b>
Financial liabilities and amounts payable in respect of derivative instruments					
Financial liabilities*	62,392	5,848	8,676	3,430	1,627
Derivative financial instruments (except for options)	13,877	22,092	9,409	6,463	2,192
Options (in terms of base assets)	614	974	1,124	111	4
Off-balance sheet financial instruments	-	-	2	-	-
<b>Total fair value</b>	<b>76,883</b>	<b>28,914</b>	<b>19,211</b>	<b>10,004</b>	<b>3,823</b>
Financial instruments, net					
Exposure to changes in interest rates in the segment	2,022	1,337	655	(853)	(463)
<b>Cumulative exposure in the segment</b>	<b>2,022</b>	<b>3,359</b>	<b>4,014</b>	<b>3,161</b>	<b>2,698</b>
<b>CPI linked Israeli currency</b>					
Financial assets and amounts receivable in respect of derivative instruments					
Financial assets*	808	571	4,248	8,091	7,465
Derivative financial instruments (except for options)	101	21	168	200	196
Options (in terms of base assets)	1	2	22	11	6
<b>Total fair value</b>	<b>910</b>	<b>594</b>	<b>4,438</b>	<b>8,302</b>	<b>7,667</b>
Financial liabilities and amounts payable in respect of derivative instruments					
Financial liabilities*	782	1,271	3,875	5,862	3,886
Derivative financial instruments (except for options)	39	76	310	1,526	1,414
Options (in terms of base assets)	10	11	42	87	28
Off-balance sheet financial instruments	-	-	1	-	-
<b>Total fair value</b>	<b>831</b>	<b>1,358</b>	<b>4,228</b>	<b>7,475</b>	<b>5,328</b>
Financial instruments, net					
Exposure to changes in interest rates in the segment	79	(764)	210	827	2,339
<b>Cumulative exposure in the segment</b>	<b>79</b>	<b>(685)</b>	<b>(475)</b>	<b>352</b>	<b>2,691</b>

\* Not including balances of derivative financial instruments and fair value of off-balance sheet financial instruments.

\*\* Weighted average by fair value of average effective duration.

\*\*\* Including shares listed under "No fixed maturity".

\*\*\*\* Including Israeli currency linked to foreign currency.

\*\*\*\*\* Reclassified.

As at December 31, 2010							As at December 31, 2009			
Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	No fixed maturity date	Total fair value	Internal rate of return In %	Effective average duration In years	Total fair value	Internal rate of return In %	Effective average duration In years	
in NIS millions										
2,983	399	(1)	984	90,554	4.81%	0.82	85,510	3.95%	0.73	
4,865	-	-	-	57,621		1.30	46,860		1.50	
113	123	-	-	2,824		0.01	2,133		0.16	
7,961	522	(1)	984	150,999		**0.99	134,503		**0.99	
1,049	81	-	-	83,103	1.81%	0.31	78,941	0.91%	0.38	
4,769	15	-	-	58,817		1.20	46,824		1.37	
33	-	20	-	2,880		0.01	1,982		0.02	
-	-	-	-	2		0.50	14		0.50	
5,851	96	20	-	144,802		**0.66	127,761		**0.74	
2,110	426	(21)	984	6,197			6,742			
4,808	5,234	5,213	6,197							
5,625	1,873	14	86	28,781	2.45%	3.85	29,611	2.51%	3.73	
206	21	-	-	913		3.32	292		2.27	
5	1	-	-	48		0.01	229		0.02	
5,836	1,895	14	86	29,742		**3.83	30,132		**3.69	
5,603	1,957	-	-	23,236	1.69%	4.03	24,123	1.92%	3.87	
1,098	135	-	-	4,598		3.88	5,649		3.78	
7	1	-	-	186		0.01	263		0.50	
-	-	-	-	1		0.50	8		0.50	
6,708	2,093	-	-	28,021		**3.98	30,043		**3.83	
(872)	(198)	14	86	1,721			89			
1,819	1,621	1,635	1,721							

General notes:

- (1) Data by period in this table represent the present value of future cash flows for each financial instrument, discounted at such interest rate as to discount them to the fair value included in the financial instrument, in a manner consistent with assumptions used in calculation of the fair value of said financial instrument.  
(For details see "Interest rate exposure" under "Exposure to risks and risk management").
- (2) The internal rate of return is the interest rate used to discount the expected cash flows from a financial instrument to its fair value.
- (3) The average effective duration of a group of financial instruments is an approximation of the change, in percentiles, in fair value of said group of financial instruments resulting from a small change (0.1% increase) in the internal rate of return of each of the financial instruments.

## SCHEDULE "D" - EXPOSURE TO CHANGES IN INTEREST RATES - CONSOLIDATED (CONTINUED)

## REPORTED AMOUNTS

	As at December 31, 2010				
	On demand or within 1 month	Over 1 month and up to 3 months	Over 3 months and up to 1 year	Over 1 year and up to 3 years	Over 3 years and up to 5 years
in NIS millions					
Foreign currency****					
Financial assets and amounts receivable in respect of derivative instruments					
Financial assets*	23,525	13,945	7,702	4,673	2,578
Derivative financial instruments (except for options)	17,473	16,772	8,622	1,761	1,678
Options (in terms of base assets)	4,684	2,956	3,988	217	97
Off-balance sheet financial instruments	-	-	1	-	-
<b>Total fair value</b>	<b>45,682</b>	<b>33,673</b>	<b>20,313</b>	<b>6,651</b>	<b>4,353</b>
Financial liabilities and amounts payable in respect of derivative instruments					
Financial liabilities*	36,751	10,208	8,419	4,755	2,366
Derivative financial instruments (except for options)	12,625	12,945	11,967	2,697	1,972
Options (in terms of base assets)	4,566	2,813	3,769	223	133
<b>Total fair value</b>	<b>53,942</b>	<b>25,966</b>	<b>24,155</b>	<b>7,675</b>	<b>4,471</b>
Financial instruments, net					
Exposure to changes in interest rates in the segment	(8,260)	7,707	(3,842)	(1,024)	(118)
<b>Cumulative exposure in the segment</b>	<b>(8,260)</b>	<b>(553)</b>	<b>(4,395)</b>	<b>(5,419)</b>	<b>(5,537)</b>
Total exposure to changes in interest rates					
Financial assets and amounts receivable in respect of derivative instruments					
Financial assets* **	92,923	21,950	17,948	15,769	11,205
Derivative financial instruments (except for options)	27,351	38,768	21,729	7,895	4,005
Options (in terms of base assets)	5,223	3,800	4,939	440	170
Off-balance sheet financial instruments	-	-	1	-	-
<b>Total fair value</b>	<b>125,497</b>	<b>64,518</b>	<b>44,617</b>	<b>24,104</b>	<b>15,380</b>
Financial liabilities and amounts payable in respect of derivative instruments					
Financial liabilities*	99,925	17,327	20,970	14,047	7,879
Derivative financial instruments (except for options)	26,541	35,113	21,686	10,686	5,578
Options (in terms of base assets)	5,190	3,798	4,935	421	165
Off-balance sheet financial instruments	-	-	45	-	-
<b>Total fair value</b>	<b>131,656</b>	<b>56,238</b>	<b>47,636</b>	<b>25,154</b>	<b>13,622</b>
Financial instruments, net					
Exposure to changes in interest rates in the segment	(6,159)	8,280	(3,019)	(1,050)	1,758
<b>Cumulative exposure in the segment</b>	<b>(6,159)</b>	<b>2,121</b>	<b>(898)</b>	<b>(1,948)</b>	<b>(190)</b>

\* Not including balances of derivative financial instruments and fair value of off-balance sheet financial instruments.

\*\* Weighted average by fair value of average effective duration.

\*\*\* Including shares listed under "No fixed maturity".

\*\*\*\* Including Israeli currency linked to foreign currency.

\*\*\*\*\* Reclassified.

As at December 31, 2010							As at December 31, 2009			
Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	No fixed maturity date	Total fair value	Internal rate of return In %	Effective average duration In years	Total fair value	Internal rate of return In %	Effective average duration In years	
in NIS millions										
2,302	2,011	261	1,033	58,030	3.38%	1.60	*****65,050	*****3.49%	1.07	
1,302	90	-	-	47,698		0.66	38,912		0.75	
11	266	18	-	12,237		0.01	11,308		0.01	
-	-	-	-	1		0.50	1		0.50	
3,615	2,367	279	1,033	117,966		**1.05	115,271		**0.86	
2,252	15	-	217	64,983	1.25%	0.69	72,272	0.98%	0.66	
1,583	211	-	-	44,000		0.86	34,184		1.11	
86	388	(2)	-	11,976		0.01	11,308		0.02	
3,921	614	(2)	217	120,959		**0.69	117,764		**0.73	
(306)	1,753	281	816	(2,993)			(2,493)			
(5,843)	(4,090)	(3,809)	(2,993)							
10,910	4,283	274	2,796	178,058	3.96%	1.57	180,884	3.55%	1.35	
6,373	111	-	-	106,232		1.03	86,064		1.16	
129	390	18	-	15,109		0.01	13,670		0.03	
-	-	-	-	1		0.50	1		0.50	
17,412	4,784	292	2,796	299,400		**1.30	280,619		**1.23	
8,904	2,053	-	217	171,322	1.58%	0.96	175,336	1.08%	0.97	
7,450	361	-	-	107,415		1.18	86,657		1.43	
126	389	18	-	15,042		0.01	13,553		0.03	
-	-	-	-	45		0.03	56		0.20	
16,480	2,803	18	217	293,824		**0.99	275,602		**1.07	
932	1,981	274	2,579	5,576			5,017			
742	2,723	2,997	5,576							

General notes:

- (1) Data by period in this table represent the present value of future cash flows for each financial instrument, discounted at such interest rate as to discount them to the fair value included in the financial instrument, in a manner consistent with assumptions used in calculation of the fair value of said financial instrument.  
(For details see "Interest rate exposure" under "Exposure to risks and risk management").
- (2) The internal rate of return is the interest rate used to discount the expected cash flows from a financial instrument to its fair value.
- (3) The average effective duration of a group of financial instruments is an approximation of the change, in percentiles, in fair value of said group of financial instruments resulting from a small change (0.1% increase) in the internal rate of return of each of the financial instruments.

## SCHEDULE "E" - CREDIT RISK CLASSIFIED BY ECONOMIC SECTORS ON A CONSOLIDATED BASIS

## REPORTED AMOUNTS

	December 31, 2010				
	Balance sheet credit risk <sup>(1)</sup>	Off-balance sheet credit risk <sup>(2)</sup>	Total credit risk	Annual expense on specific provision for doubtful debts	Balance of problematic debt <sup>(3)</sup>
in NIS millions					
<b>1. Lending Activity in Israel</b>					
Agriculture	813	233	1,046	14	45
Industry	12,265	6,643	18,908	103	1,065
Construction and real estate <sup>(6)</sup>	14,560	10,840	25,400	91	1,701
Electricity and water	988	552	1,540	1	9
Commerce	8,715	2,535	11,250	71	395
Hotels, hotel services and food	1,943	252	2,195	(28)	446
Transportation and storage	2,868	669	3,537	7	62
Communications and computer services	2,529	395	2,924	9	287
Financial services	9,190	2,997	12,187	(3)	80
Other business services	6,401	2,273	8,674	72	267
Public and community services	1,452	584	2,036	6	280
Private individuals - housing loans	17,953	359	18,312	-	367
Private individuals - other loans	17,436	16,990	34,426	205	711
<b>Total</b>	<b>97,113</b>	<b>45,322</b>	<b>142,435</b>	<b>548</b>	<b>5,715</b>
Less a deposit abroad linked to the credit risk of the borrower	(53)	-	(53)	-	-
<b>Total</b>	<b>97,060</b>	<b>45,322</b>	<b>142,382</b>	<b>548</b>	<b>5,715</b>
<b>Credit Risk Included in the Various Economic Sectors:</b>					
Agricultural Settlement Movements <sup>(4)</sup>	254	22	276	-	105
Local authorities <sup>(5)</sup>	148	59	207	-	4

## Footnotes:

- (1) Credit to the public of NIS 119,334 million, investments in bonds, assets relating to derivative instruments of NIS 2,853 million, created with the public of NIS 306 million.
- (2) Credit risk in off-balance sheet financial instruments as calculated for purposes of borrower liability limitation. Due to lack of data, only partial information regarding unutilized credit lines is included in respect of a consolidated subsidiary.
- (3) The balance of problematic debts net of credit covered by collateral allowed for setoff for the purpose of a borrower or a group of borrowers liability limitation. Includes the components of off-balance sheet risk.
- (4) Kibbutzim and moshavim, regional and national organizations and corporations controlled by the agricultural settlement movements.
- (5) Including corporations under their control.
- (6) Including housing loans granted to certain acquisition groups that are in the midst of construction processes, in the amount of NIS 256 million as well as off-balance sheet credit risk in the amount of NIS 553 million.
- Credit risk and the balance of problematic debts are presented after deducting specific provisions for doubtful debts.

## SCHEDULE "E" - CREDIT RISK CLASSIFIED BY ECONOMIC SECTORS ON A CONSOLIDATED BASIS (CONTINUED)

### REPORTED AMOUNTS

	December 31, 2010				
	Balance sheet credit risk <sup>(1)</sup>	Off-balance sheet credit risk <sup>(2)</sup>	Total credit risk	Annual expense on specific provision for doubtful debts	Balance of problematic debt <sup>(3)</sup>
in NIS millions					
<b>2. Lending Activity Outside of Israel</b>					
Agriculture	147	116	263	(1)	-
Industry	4,625	4,070	8,695	(2)	103
Construction and real estate	7,861	1,778	9,639	117	2,069
Electricity and water	390	265	655	-	-
Commerce	3,512	3,023	6,535	(4)	179
Hotels, hotel services and food	1,035	50	1,085	10	228
Transportation and storage	733	670	1,403	-	42
Communications and computer services	173	56	229	(8)	1
Financial services	3,638	2,784	6,422	18	474
Other business services	2,266	926	3,192	53	127
Public and community services	26	48	74	-	6
Private individuals - housing loans	18	-	18	-	-
Private individuals - other loans	1,009	668	1,677	10	13
<b>Total</b>	<b>25,433</b>	<b>14,454</b>	<b>39,887</b>	<b>193</b>	<b>3,242</b>
	122,493	59,776	182,269	741	8,957

Footnotes:

- (1) Credit to the public of NIS 119,335 million, investments in bonds, assets relating to derivative instruments of NIS 2,852 million, created with the public of NIS 306 million.
  - (2) Credit risk in off-balance sheet financial instruments as calculated for purposes of borrower liability limitation. Due to lack of data, only partial information regarding unutilized credit lines is included in respect of a consolidated subsidiary.
  - (3) The balance of problematic debts net of credit covered by collateral allowed for setoff for the purpose of a borrower or a group of borrowers liability limitation. Includes the components of off-balance sheet risk.
  - (4) Kibbutzim and moshavim, regional and national organizations and corporations controlled by the agricultural settlement movements.
  - (5) Including corporations under their control.
  - (6) Including housing loans granted to certain acquisition groups that are in the midst of construction processes, in the amount of NIS 256 million as well as off-balance sheet credit risk in the amount of NIS 454 million.
- Credit risk and the balance of problematic debts are presented after deducting specific provisions for doubtful debts.

## SCHEDULE "E" - CREDIT RISK CLASSIFIED BY ECONOMIC SECTORS ON A CONSOLIDATED BASIS (CONTINUED)

## REPORTED AMOUNTS

	December 31, 2009				
	Balance sheet credit risk <sup>(1)</sup>	Off-balance sheet credit risk <sup>(2)</sup>	Total credit risk	Annual expense on specific provision for doubtful debts	Balance of problematic debt <sup>(3)</sup>
	in NIS millions				
<b>1. Lending Activity in Israel</b>					
Agriculture	853	267	1,120	12	54
Industry	11,422	7,931	19,353	116	906
Construction and real estate <sup>(6)</sup>	*14,233	*10,054	*24,287	162	*2,104
Electricity and water	1,150	332	1,482	-	9
Commerce	7,805	2,907	10,712	59	324
Hotels, hotel services and food	1,740	227	1,967	16	770
Transportation and storage	*1,764	*609	*2,373	4	*82
Communications and computer services	2,595	500	3,095	40	464
Financial services	*8,005	3,861	*11,866	90	*228
Other business services	*7,606	*2,361	*9,967	57	317
Public and community services	1,459	629	2,088	3	275
Private individuals - housing loans	*15,749	*870	*16,619	1	397
Private individuals - other loans	*16,794	16,368	*33,162	192	785
<b>Total</b>	91,175	46,916	138,091	752	6,715
Less a deposit abroad linked to the credit risk of the borrower	(59)	-	(59)	-	-
<b>Total</b>	91,116	46,916	138,032	752	6,715
<b>Credit Risk Included in the Various Economic Sectors:</b>					
Agricultural Settlement Movements <sup>(4)</sup>	243	17	260	-	*105
Local authorities <sup>(5)</sup>	193	52	245	-	7

\* Reclassified.

Footnotes:

(1) Credit to the public of NIS 115,015 million, investments in bonds, assets relating to derivative instruments of NIS 2,329 million, created with the public of NIS 430 million.

(2) Credit risk in off-balance sheet financial instruments as calculated for purposes of borrower liability limitation. Due to lack of data, only partial information regarding unutilized credit lines is included in respect of a consolidated subsidiary.

(3) The balance of problematic debts net of credit covered by collateral allowed for setoff for the purpose of a borrower or a group of borrowers liability limitation. Includes the components of off-balance sheet risk.

(4) Kibbutzim and moshavim, regional and national organizations and corporations controlled by the agricultural settlement movements.

(5) Including corporations under their control.

(6) Including housing loans granted to certain acquisition groups that are in the midst of construction processes, in the amount of NIS 296 million as well as off-balance sheet credit risk in the amount of NIS 454 million.

Credit risk and the balance of problematic debts are presented after deducting specific provisions for doubtful debts.

## SCHEDULE "E" - CREDIT RISK CLASSIFIED BY ECONOMIC SECTORS ON A CONSOLIDATED BASIS (CONTINUED)

### REPORTED AMOUNTS

	December 31, 2009				
	Balance sheet credit risk <sup>(1)</sup>	Off-balance sheet credit risk <sup>(2)</sup>	Total credit risk	Annual expense on specific provision for doubtful debts	Balance of problematic debt <sup>(3)</sup>
	in NIS millions				
<b>2. Lending Activity Outside of Israel</b>					
Agriculture	46	1	47	1	2
Industry	3,549	4,351	7,900	22	284
Construction and real estate	8,514	1,237	9,751	123	*1,550
Electricity and water	421	388	809	-	-
Commerce	3,242	3,447	6,689	40	173
Hotels, hotel services and food	1,177	71	1,248	22	*277
Transportation and storage	536	585	1,121	*6	44
Communications and computer services	252	28	280	9	10
Financial services	4,882	2,596	7,478	8	*164
Other business services	2,952	1,054	4,006	46	220
Public and community services	37	50	87	-	-
Private individuals - housing loans	20	-	20	-	-
Private individuals - other loans	930	839	1,769	*2	9
<b>Total</b>	26,658	14,647	41,305	279	2,733
	117,774	61,563	179,337	1,031	9,448

\* Reclassified.

Footnotes:

- (1) Credit to the public of NIS 115,014 million, investments in bonds, assets relating to derivative instruments of NIS 2,329 million, created with the public of NIS 431 million.
- (2) Credit risk in off-balance sheet financial instruments as calculated for purposes of borrower liability limitation. Due to lack of data, only partial information regarding unutilized credit lines is included in respect of a consolidated subsidiary.
- (3) The balance of problematic debts net of credit covered by collateral allowed for setoff for the purpose of a borrower or a group of borrowers liability limitation. Includes the components of off-balance sheet risk.
- (4) Kibbutzim and moshavim, regional and national organizations and corporations controlled by the agricultural settlement movements.
- (5) Including corporations under their control.
- (6) Including housing loans granted to certain acquisition groups that are in the midst of construction processes, in the amount of NIS 296 million as well as off-balance sheet credit risk in the amount of NIS 454 million.

Credit risk and the balance of problematic debts are presented after deducting specific provisions for doubtful debts.

SCHEDULE "F" - EXPOSURE TO FOREIGN COUNTRIES - ON A CONSOLIDATED BASIS<sup>(1)</sup>

## REPORTED AMOUNTS (IN NIS MILLIONS)

A. Information regarding the total exposure to foreign countries and to countries where the total exposure to each country amounts to over 1% of total consolidated assets or over 20% of shareholders' equity, the lower of the two.

December 31, 2010			
Balance sheet exposure			
Across the border balance sheet exposure			
The Country	To governments <sup>(3)</sup>	To banks	to Others
United States	1,437	1,848	2,019
United Kingdom	-	1,468	102
PIGS <sup>(5)</sup>	-	208	47
Other	200	2,798	5,040
<b>Total exposure to foreign countries</b>	<b>1,637</b>	<b>6,322</b>	<b>7,208</b>
<b>Includes - Total exposure to LDC countries</b>	<b>35</b>	<b>546</b>	<b>895</b>
December 31, 2009			
United state	1,145	2,683	1,904
United kingdom	-	565	173
Netherlands <sup>(6)</sup>	11	50	2,200
Germany <sup>(6)</sup>	23	688	706
PIGS <sup>(5)</sup>	2	429	62
Other	73	2,248	3,002
<b>Total exposure to foreign countries</b>	<b>1,254</b>	<b>6,663</b>	<b>8,047</b>
<b>Includes - Total exposure to LDC countries</b>	<b>53</b>	<b>321</b>	<b>1,313</b>

## Notes:

- (1) Based on the final risk, net of the effect of guarantees and liquid collateral.
- (2) Credit risk of off-balance sheet financial instruments as computed for the purpose of borrower indebtedness limitations.
- (3) Governments, official institutions and central banks.
- (4) Outstanding problematic debts, net of debts secured by collateral that are deductible for the purpose of borrower and group of borrowers indebtedness limitation, excluding off-balance sheet risk components.
- (5) Portugal, Ireland, Greece and Spain.
- (6) Exposure to Holland and Germany as of December 31, 2010, has not exceeded the upper limit and therefore is not separately presented.

The item "Total LDC countries" includes the total exposure to countries defined as less developed countries (LDC) in Proper Banking Management Directive No. 315 regarding "Additional provision for doubtful debts".

Balance sheet exposure to a foreign country includes across the border balance sheet exposure and balance sheet exposure of overseas extensions of the banking corporation to local resident customers, across the border balance sheet exposure includes balance sheet exposure of the banking corporation offices in Israel to residents of a foreign country and the balance sheet exposure of the overseas extensions of the banking corporation to customers who are not residents of the co extension is located.

Balance sheet exposure of extensions of the banking corporations in a foreign country to local resident customers includes the balance sheet exposure of extensions of the banking corporation in that foreign country to residents of that country, net of the extensions (deduction of liabilities should not exceed the amount of exposure).

December 31, 2010

Balance sheet exposure				Off-balance sheet exposure <sup>(2)</sup>				Balance sheet exposure Across the border	
Balance sheet exposure to local resident customers of extensions of a banking corporation in a foreign country									
Balance sheet exposure before deduction of local liabilities	Deduction in respect of local liabilities	Net balance sheet exposure after deduction of local liabilities	Total balance sheet exposure	Outstanding problematic debts <sup>(4)</sup>	Total off-balance sheet exposure	Of which problematic off-balance sheet credit risk	Due up to one year	Due over one year	
27,125	11,758	15,367	20,671	643	8,794	-	3,127	2,177	
1,457	199	1,258	2,828	131	5,042	-	955	615	
-	-	-	255	23	-	-	236	19	
1,344	1,284	60	8,098	1,330	2,118	-	4,682	3,356	
29,926	13,241	16,685	31,852	2,127	15,954	-	9,000	6,167	
965	965	-	1,476	2	276	-	1,053	423	

December 31, 2009

30,620	11,925	18,695	24,427	1,086	9,023	9	3,705	2,027
1,659	264	1,395	2,133	49	860	-	462	276
-	-	-	2,261	57	5	-	674	1,587
-	-	-	1,417	-	68	31	1,106	311
-	-	-	493	12	-	-	296	197
1,464	1,314	150	5,473	46	650	1	3,887	1,436
33,743	13,503	20,240	36,204	1,250	10,606	41	10,130	5,834
982	982	-	1,687	2	473	-	856	831

B. Information regarding countries the amount of exposure in respect of each amounts to between 0.75% and 1% of total consolidated assets or between 15% and 20% of shareholders' equity, whichever is lower.

As of December 31, 2010 and 2009 the Bank had no such exposure.

C. Information regarding exposure to foreign countries having liquidity problems for the periods of three month and for the year ended December 31, 2010

A. Changes in the amount of balance sheet exposure to foreign countries having liquidity problems

	Outstanding balances	
	For the year ended December 31, 2010	
	Greece	Ireland
	in NIS millions	
Amount of exposure at the beginning of year	34	276
Net changes in the short-term exposure amount	(2)	(75)
Amounts collected	(30)	(57)
Other changes (including provisions and write-offs)	-	(47)
<b>Amount of exposure at period end</b>	<b>2</b>	<b>97</b>

## SCHEDULE "G" - CONDENSED CONSOLIDATED BALANCE SHEET FOR END OF EACH QUARTER

### REPORTED AMOUNTS

Quarter	2010				2009			
	4	3	2	1	4	3	2	1
In NIS millions								
<b>Assets</b>								
Cash and deposits with banks	18,187	16,636	21,944	23,731	24,583	23,083	21,466	22,584
Securities	37,176	39,605	38,012	36,566	36,338	35,866	37,751	35,948
Securities borrowed or purchased under resale agreements	45	130	324	338	336	513	308	24
Credit granted to the public	118,666	119,129	116,935	114,316	114,426	115,533	116,831	120,397
Credit granted to the Government	1,556	1,547	1,529	1,507	1,820	1,833	1,809	1,802
Investments in affiliated companies	1,684	1,662	1,840	1,844	1,795	1,783	1,735	*1,675
Buildings and equipment	3,138	3,101	3,138	3,167	3,178	3,062	3,057	3,040
Other assets	5,362	5,221	5,903	5,698	5,341	5,555	6,665	7,611
<b>Total assets</b>	<b>185,814</b>	<b>187,031</b>	<b>189,625</b>	<b>187,167</b>	<b>187,817</b>	<b>187,228</b>	<b>189,622</b>	<b>193,081</b>
<b>Liabilities and Shareholders' Equity</b>								
Deposits from the public	138,011	137,810	140,720	139,887	141,825	*140,370	*143,054	*146,619
Deposits from banks	3,387	4,960	5,093	3,797	3,724	5,200	5,155	5,344
Deposits from the Government	461	361	359	1,403	284	*275	*245	*230
Securities loaned or sold under buy-back arrangements	7,227	7,585	7,667	7,432	7,651	7,639	8,866	9,929
Subordinated capital notes	12,294	12,291	12,235	11,348	11,529	10,837	9,834	9,318
Other liabilities	12,865	12,900	12,709	12,672	12,512	12,638	12,668	*12,433
<b>Total liabilities</b>	<b>174,245</b>	<b>175,907</b>	<b>178,783</b>	<b>176,539</b>	<b>177,525</b>	<b>176,959</b>	<b>179,822</b>	<b>183,873</b>
Minority' interest	328	358	338	327	298	283	263	243
Shareholders' equity	11,241	10,766	10,504	10,301	9,994	9,986	9,537	8,965
<b>Total liabilities and shareholders' equity</b>	<b>185,814</b>	<b>187,031</b>	<b>189,625</b>	<b>187,167</b>	<b>187,817</b>	<b>187,228</b>	<b>189,622</b>	<b>193,081</b>

\* Reclassified.

## SCHEDULE "H" - CONSOLIDATED STATEMENT OF INCOME FOR EACH QUARTER - MULTI QUARTER DATA

## REPORTED AMOUNTS

Quarter	2010			
	4	3	2	1
	In NIS millions			
<b>Financing Income</b>				
Income from financing activities before provision for doubtful debts	1,293	1,331	1,091	1,115
Provision for doubtful debts	274	169	261	117
Income from financing activities after provision for doubtful debts	1,019	1,162	830	998
<b>Operating and other Income</b>				
Operating commissions	646	635	632	*634
Net income (loss) from investment in shares	31	(16)	21	(5)
Other income	27	40	5	*11
<b>Total operating and other income</b>	<b>704</b>	<b>659</b>	<b>658</b>	<b>640</b>
<b>Operating and other Expenses</b>				
Salaries and related expenses	849	738	754	*849
Maintenance and depreciation of buildings and equipment	324	*286	*267	*271
Other expenses	387	*292	*337	*277
<b>Total operating and other expenses</b>	<b>1,560</b>	<b>1,316</b>	<b>1,358</b>	<b>1,397</b>
Operating income before taxes	163	505	130	241
Provision for taxes on operating income	107	230	7	123
Operating income after taxes	56	275	123	118
Bank's share in operating income net of tax effect of affiliated companies	87	32	22	45
Minority interest in the operating income after taxes of consolidated companies	(13)	(20)	(17)	(20)
Net operating income	130	287	128	143
Net income from extraordinary items, net of taxes	5	1	30	-
<b>Net income</b>	<b>135</b>	<b>288</b>	<b>158</b>	<b>143</b>
<b>Earnings per share of NIS 0.1 (in NIS):</b>				
Net operating income	0.13	0.29	0.13	0.15
Net income from extraordinary items, net of taxes	-	-	0.03	-
<b>Net income</b>	<b>0.13</b>	<b>0.29</b>	<b>0.16</b>	<b>0.15</b>
<b>Total number of shares used for the above computation (in thousands)</b>	<b>1,008,123</b>	<b>**994,109</b>	<b>**994,088</b>	<b>**993,979</b>

\* Reclassified.

\*\* Restated in order to reflect the benefit component of the rights issue - see note 13 D.

**SCHEDULE "H" - CONSOLIDATED STATEMENT OF INCOME FOR EACH QUARTER -  
MULTI QUARTER DATA (CONTINUED)**

**REPORTED AMOUNTS**

Quarter	2009			
	4	3	2	1
	In NIS millions			
<b>Financing Income</b>				
Income from financing activities before provision for doubtful debts	*1,235	*1,326	*1,259	*937
Provision for doubtful debts	269	246	231	252
Income from financing activities after provision for doubtful debts	966	1,080	1,028	685
<b>Operating and other Income</b>				
Operating commissions	*654	*669	*656	*654
Net income on investment in shares	99	65	31	2
Other income	*36	*80	*73	*72
<b>Total operating and other income</b>	<b>789</b>	<b>814</b>	<b>760</b>	<b>728</b>
<b>Operating and other Expenses</b>				
Salaries and related expenses	861	812	722	780
Maintenance and depreciation of buildings and equipment	*261	*260	*253	*258
Other expenses	*354	*303	*306	*316
<b>Total operating and other expenses</b>	<b>1,476</b>	<b>1,375</b>	<b>1,281</b>	<b>1,354</b>
Operating income before taxes	279	519	507	59
Provision for taxes (tax savings) on operating income	30	252	311	(86)
Operating income after taxes	249	267	196	145
Bank's share in operating income (loss) net of tax effect of affiliated companies	(78)	46	162	28
Minority interest, after taxes, in the operating income of consolidated subsidiaries	(15)	(21)	(20)	(16)
Net operating income	156	292	338	157
Net loss from extraordinary items, net of taxes	(2)	-	(1)	(17)
<b>Net income</b>	<b>154</b>	<b>292</b>	<b>337</b>	<b>140</b>
Earnings (losses) per share of NIS 0.1 (in NIS):				
Net operating income	0.16	0.30	0.34	0.16
Net loss from extraordinary items, net of taxes	-	-	-	(0.02)
<b>Net income</b>	<b>0.16</b>	<b>0.30</b>	<b>0.34</b>	<b>0.14</b>
<b>Total number of shares used for the above computation (in thousands)</b>	<b>**993,979</b>	<b>**993,979</b>	<b>**993,979</b>	<b>**993,979</b>

\* Reclassified.

\*\* Restated in order to reflect the benefit component of the rights issue - see note 13 D.

## CERTIFICATION

I, Reuven Spiegel, certify that:

1. I have reviewed the quarterly report of Israel Discount Bank Ltd. (hereinafter: "the Bank") as of December 31, 2010 (hereinafter: "the Report");
2. Based on my knowledge, the Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made therein, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the Report;
3. Based on my knowledge, the financial statements, and other financial information included in the Report, fairly present in all material respects the financial condition, results of operations, changes in shareholders' equity and cash flows of the Bank as of, and for, the periods presented in this report;
4. Other officers of the Bank providing this certification and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting (as defined in the public reporting instructions regarding "Directors' Report"), and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Bank, including its consolidated subsidiaries, is made known to us by others within the Bank and those entities, particularly during the period of preparing this report;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accepted accounting principles and directives and guidelines of the Supervisor of Banks;
  - (c) Evaluated the effectiveness of the Bank's disclosure controls and procedures and presented in the Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the Report based on such evaluation; and
  - (d) Disclosed in the Report any change in the Bank's internal control over financial reporting that occurred during this quarter that has materially affected, or is reasonably likely to materially affect, the Bank's internal control over financial reporting.
5. The other officers of the Bank providing this certification and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Bank's Auditors, to the Board of Directors, to the audit committee of the Board of Directors, and to the committee for the review of the financial statements of the Board of Directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Bank's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Bank's internal control over financial reporting.

Nothing in that stated above derogates my responsibility or the responsibility of any other person under any law.

Reuven Spiegel,  
President & Chief Executive Officer

March 31, 2011

## CERTIFICATION

I, Joseph Beressi, certify that:

1. I have reviewed the quarterly report of Israel Discount Bank Ltd. (hereinafter: "the Bank") as of December 31, 2010 (hereinafter: "the Report");
2. Based on my knowledge, the Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made therein, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the Report;
3. Based on my knowledge, the financial statements, and other financial information included in the Report, fairly present in all material respects the financial condition, results of operations, changes in shareholders' equity and cash flows of the Bank as of, and for, the periods presented in this report;
4. Other officers of the Bank providing this certification and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting (as defined in the public reporting instructions regarding "Directors' Report"), and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Bank, including its consolidated subsidiaries, is made known to us by others within the Bank and those entities, particularly during the period of preparing this report;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accepted accounting principles and directives and guidelines of the Supervisor of Banks;
  - (c) Evaluated the effectiveness of the Bank's disclosure controls and procedures and presented in the Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the Report based on such evaluation; and
  - (d) Disclosed in the Report any change in the Bank's internal control over financial reporting that occurred during this quarter that has materially affected, or is reasonably likely to materially affect, the Bank's internal control over financial reporting.
5. The other officers of the Bank providing this certification and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Bank's Auditors, to the Board of Directors, to the audit committee of the Board of Directors, and to the committee for the review of the financial statements of the Board of Directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Bank's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Bank's internal control over financial reporting.

Nothing in that stated above derogates my responsibility or the responsibility of any other person under any law.

Joseph Beressi  
Senior Executive Vice President  
Chief Accountant

March 31, 2011

## REPORT OF THE DIRECTORS AND MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Board of Directors and Management of Israel Discount Bank Ltd. (hereinafter - "the Bank") are responsible for establishing and maintaining effective internal control over financial reporting (as defined in the public reporting instructions regarding "Directors' Report"). The internal control system of the Bank has been designed to provide reasonable assurance to the Board of Directors and Management regarding the preparation and the fair presentation of financial statements published in accordance with generally accepted accounting principles in Israel and directives and guidelines of the Supervisor of Banks. Regardless of the quality of their level of design, all internal control systems have inherent limitations. Therefore, even if these systems are determined effective, they can provide only a reasonable degree of assurance regarding the preparation and presentation of the financial report.

Management, under the supervision of the Board of Directors, maintains a comprehensive system of controls intended to ensure that transactions are made in accordance with authorization of Management, assets are protected and the accounting records are reliable. In addition, Management, under the supervision of the Board of Directors, takes the necessary actions to ensure that communication and information channels are effective and monitor performance, including performance of internal control procedures.

Management, under the supervision of the Board of Directors, assessed the effectiveness of the Bank's internal control over financial reporting as of December 31, 2009, based on the framework set forth in the Internal Control model of the Committee Sponsoring Organizations of the Treadway Commission (COSO). Based on that assessment, Management believes that as of December 31, 2009, the Bank's internal control over financial reporting is effective.

The effectiveness of the Bank's internal control over financial reporting as of December 31, 2009 has been audited by the independent auditors of the Bank, Messrs. Somekh Chaikin and Ziv Haft, Certified Public Accountants, as stated in their report presented on page 389, which includes an unqualified opinion regarding the effectiveness of the Bank's internal control over financial reporting as of December 31, 2010.

	Dr. Joseph Bachar	Reuven Spiegel	Joseph Beressi
	Chairman of the	President &	Senior Executive Vice President,
March 31, 2011	Board of Directors	Chief Executive Officer	Chief Accountant

## FINANCIAL STATEMENTS

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Somekh Chaikin



**REPORT OF THE INDEPENDENT AUDITORS TO THE SHAREHOLDERS OF ISRAEL DISCOUNT BANK LTD.  
IN ACCORDANCE WITH THE PUBLIC REPORTING DIRECTIVES OF THE SUPERVISOR OF BANKS  
REGARDING INTERNAL CONTROL OVER FINANCIAL REPORTING**

We have audited the internal control over financial reporting of Israel Discount Bank Ltd. and subsidiary companies (hereinafter together: "the Bank") as of December 31, 2010, based on criteria established in Internal Control - Integrated Framework issued by the Treadway Commission of the Committee of Sponsoring Organizations (hereinafter: "COSO"). The Bank's Board of Directors and Management are responsible for maintaining effective internal control over financial reporting and for their assessment of the effectiveness of internal control over financial reporting, included in the accompanying Directors' and Management's reports on internal control over financial reporting. Our responsibility is to express an opinion on the Bank's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB) in the United States regarding audit of the internal control over financial reporting, as adopted by the Institute of Certified Public Accountants in Israel. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

The internal control of a bank over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in Israel (Israeli GAAP) and directives and guidelines of the Supervisor of Banks. The internal control of a bank over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the bank (including their removal from control); (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statement in accordance with generally accepted accounting principles in Israel (Israeli GAAP) and directives and guidelines of the Supervisor of Banks, and that receipts and expenditures of the bank are being made only in accordance with authorizations of the Board of Directors and Management of the bank; (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition (including removal from control) of the bank's assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of conclusions to future periods on the basis of current evaluation of effectiveness are subject to the risk that controls may become inadequate because of changes in circumstances, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Bank maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control - Integrated Framework issued by COSO.

We have also audited, in accordance with accepted auditing standards in Israel and certain auditing standards applied in the audit of banking corporations as determined by guidelines of the Supervisor of Banks, the financial statements of the Bank and consolidated as of December 31, 2010 and 2009 and for each of the years in the three-year period ended on December 31, 2010, and our report dated March 31, 2011, expressed an unqualified opinion on these financial statements.

Somekh Chaikin  
Certified Public Accountants (Isr.)  
March 31, 2011

Ziv Haft  
Certified Public Accountants (Isr.)



Somekh Chaikin



## AUDITORS' REPORT TO THE SHAREHOLDERS OF ISRAEL DISCOUNT BANK LTD. - ANNUAL FINANCIAL STATEMENTS

We have audited the financial statements of Israel Discount Bank Limited (hereinafter: "the Bank") and the consolidated financial statements of the Bank and its consolidated subsidiaries: Balance sheets as at December 31, 2010 and December 31, 2009, statements of income, statement of changes in shareholders' equity and statements of cash flows for the three years, the last of which ended December 31, 2010. These financial statements are the responsibility of the Bank's Board of Directors and Management. Our responsibility is to express an opinion on these financial statements based on our audit.

We did not audit the financial statements of certain affiliated companies, the investment in which amounted to NIS 68 million and NIS 67 million at December 31, 2010 and 2009, respectively, and the share of the Bank in their results is an Income of NIS 11 million, a loss of NIS 10 million and a loss of NIS 37 million, for the years ended December 31, 2010, 2009 and 2008, respectively. The financial statements of those companies were audited by other auditors, whose reports were furnished to us, and our opinion, insofar as it relates to amounts included in respect of those companies, is based on the reports of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards in Israel, including those prescribed under the Israeli Auditors' Regulations (Auditor's Mode of Performance), 1973 and certain auditing standards applied in the audit of banking corporations as determined by directives and guidelines of the Supervisor of Banks. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examination, on a test basis, of evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Bank's Board of Directors and Management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position - of the Bank and consolidated - as at December 31, 2010 and 2009, and the results of operations, the changes in shareholders' equity and cash flows - of the Bank and consolidated - for the three years the last of which ended December 31, 2010, according to generally accepted accounting principles in Israel (Israeli GAAP). Furthermore, in our opinion, the abovementioned financial statements were prepared in accordance with the directives and guidelines of the Supervisor of Banks.

Without qualifying our above opinion, we call attention to the Note 19 C items 11.6 and 12 concerning motion to approve certain lawsuits as class action suits against the Bank and a consolidated company and item 14 as regards to the Antitrust Commissioner's decision.

We have also audited in accordance with the standards of the U.S. PCAOB regarding the audit of internal control over financial reporting, as adopted by the Institute of Certified Public Accountants in Israel, the internal control of the Bank over financial reporting as of December 31, 2010, based on criteria established within the integrated framework issued by COSO, and on our report dated March 31, 2011, which included an unqualified opinion on the effectiveness of internal control over financial reporting at the Bank.

Somekh Chaikin  
Certified Public Accountants (Isr.)

Ziv Haft  
Certified Public Accountants (Isr.)

March 31, 2011

## BALANCE SHEET AS AT DECEMBER 31

### REPORTED AMOUNTS

	Notes	Consolidated		The Bank	
		2010	2009	2010	2009
in NIS millions					
<b>Assets</b>					
Cash and deposits with banks	2,15	18,187	24,583	29,617	31,534
Securities	3,15	37,176	36,338	15,345	13,451
Securities borrowed or purchased under resale agreements		45	336	45	336
Credit granted to the public	4	118,666	114,426	68,170	67,541
Credit granted to Governments	5	1,556	1,820	1,551	1,818
Investment in investee companies (consolidated - affiliated companies)	6	1,684	1,795	10,212	10,051
Buildings and equipment	7	3,138	3,178	2,315	2,382
Other assets	8	5,362	5,341	3,798	3,563
<b>Total assets</b>		<b>185,814</b>	<b>187,817</b>	<b>131,053</b>	<b>130,676</b>
<b>Liabilities and Shareholders' Equity</b>					
Deposits from the public	9	138,011	141,825	104,109	105,922
Deposits from banks	10	3,387	3,724	3,365	3,964
Deposits from the Government		461	284	177	159
Securities loaned or sold under buy-back arrangements		7,227	7,651	-	-
Debentures and subordinated capital notes	11	12,294	11,529	4,013	3,638
Other liabilities	12	12,865	12,512	8,148	6,999
<b>Total liabilities</b>		<b>174,245</b>	<b>177,525</b>	<b>119,812</b>	<b>120,682</b>
Minority interest		328	298	-	-
Shareholders' equity	13	11,241	9,994	11,241	9,994
<b>Total liabilities and shareholders' equity</b>		<b>185,814</b>	<b>187,817</b>	<b>131,053</b>	<b>130,676</b>

The notes to the financial statements are an integral part thereof.

Dr. Yossi Bachar  
Chairman of the Board  
of Directors

Reuven Shpigel  
President &  
Chief Executive Officer

Joseph Beressi  
Executive Vice President  
Chief Accountant

March 31, 2011

## STATEMENT OF INCOME FOR THE YEAR ENDED DECEMBER 31

## REPORTED AMOUNTS

	Notes	Consolidated		
		2010	2009	2008
In NIS millions				
<b>Financing Income</b>				
Income from financing activities before provision for doubtful debts	23	4,830	4,757	4,127
Provision for doubtful debts	4c	821	998	780
Income from financing activities after provision for doubtful debts		4,009	3,759	3,347
<b>Operating and other Income</b>				
Operating commissions	24	2,547	*2,633	*2,504
Net income on investment in shares	25	31	197	51
Other income	26	83	*261	*18
<b>Total operating and other income</b>		2,661	3,091	2,573
<b>Operating and other Expenses</b>				
Salaries and related expenses	27	3,190	3,175	3,106
Maintenance and depreciation of buildings and equipment		1,148	*1,032	*951
Other expenses	28	1,293	*1,279	*1,291
<b>Total operating and other expenses</b>		5,631	5,486	5,348
Operating income before taxes		1,039	1,364	572
Provision for taxes on operating income	29	467	507	169
Operating income after taxes		572	857	403
Bank's share in operating income (loss) net of tax effect of affiliated companies	6b	186	158	(70)
Minority interest, after taxes, in the operating income of consolidated subsidiaries		(70)	(72)	(78)
Net operating income		688	943	255
Net income (loss) from extraordinary items, net of taxes	30	36	(20)	(10)
<b>Net income</b>		724	923	245
Earnings (losses) per share of NIS 0.1 (in NIS)	13, 35			
Net operating income		0.69	**0.95	0.26
Net income (loss) from extraordinary items, net of taxes		0.04	(0.02)	(0.01)
Net income		0.73	0.93	0.25
<b>Total number of shares used for the above computation (in thousands)</b>		997,578	**993,979	**993,979

\* Reclassified.

\*\* Restated in order to reflect the benefit component of the rights issue - see note 13 D.  
The notes to the financial statements are an integral part thereof.

STATEMENT OF INCOME FOR THE YEAR ENDED DECEMBER 31 (CONTINUED)

REPORTED AMOUNTS

	Notes	The Bank		
		2010	2009	2008
in NIS millions				
<b>Financing Income</b>				
Income from financing activities before provision for doubtful debts	23	3,056	2,746	2,564
Provision for doubtful debts	4c	524	654	547
Income from financing activities after provision for doubtful debts		2,532	2,092	2,017
<b>Operating and other Income</b>				
Operating commissions	24	1,150	*1,182	*1,145
Net income (loss) on investment in shares	25	(10)	143	(2)
Other income	26	128	*285	*61
<b>Total operating and other income</b>		1,268	1,610	1,204
<b>Operating and other Expenses</b>				
Salaries and related expenses	27	2,034	2,055	2,043
Maintenance and depreciation of buildings and equipment		823	*727	*669
Other expenses	28	517	*469	*573
<b>Total operating and other expenses</b>		3,374	3,251	3,285
Operating income (loss) before taxes		426	451	(64)
Provision for taxes (tax savings) on operating income	29	180	155	(50)
Operating income (loss) after taxes		246	296	(14)
Bank's share in operating income net of tax effect of investee companies	6b	442	647	269
Net operating income		688	943	255
Net income (loss) from extraordinary items, net of taxes	30	36	(20)	(10)
<b>Net income</b>		724	923	245

\* Reclassified.

For footnotes see next page.

The notes to the financial statements are an integral part thereof.

## STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

## REPORTED AMOUNTS

	Share capital	Share premium	Capital reserves	
			Benefit in respect of equity-based compensation transactions	Other
in NIS millions				
Balance at December 31, 2007	658	2,939	35	212
<b>Changes in 2008:</b>				
Initial application of IFRS in affiliated companies	-	-	-	-
Initial application of new accounting principles in a subsidiary abroad	-	-	-	-
Net Income for the year	-	-	-	-
Dividend	-	-	-	-
Benefit in respect of equity based compensation transactions	-	-	15	-
Net adjustments for the presentation of available-for-sale securities at fair value	-	-	-	-
Net adjustments for the presentation of available-for-sale securities reclassified to the income statement	-	-	-	-
Related tax effect	-	-	-	-
Financial statements translation adjustments	-	-	-	-
<b>Balance at December 31, 2008</b>	<b>658</b>	<b>2,939</b>	<b>50</b>	<b>212</b>
<b>Changes in 2009:</b>				
Net Income for the year	-	-	-	-
Benefit in respect of equity based compensation transactions	-	-	2	-
Option expiration <sup>(3)</sup>	-	*3	*(3)	-
Net adjustments for the presentation of available-for-sale securities at fair value	-	-	-	-
Net adjustments for the presentation of available-for-sale securities reclassified to the income statement	-	-	-	-
Related tax effect	-	-	-	-
Financial statements translation adjustments	-	-	-	-
<b>Balance at December 31, 2009</b>	<b>658</b>	<b>2,942</b>	<b>49</b>	<b>212</b>

\* Reclassified.

Footnotes:

(1) Translation adjustments of foreign operations, primarily from a consolidated subsidiary Israel Discount Bank of New York in amount of NIS 231 million, which was treated until December 31, 1994, in the financial statements of the Bank as a unit having a functional currency that differs from the reporting currency.

Accordingly this item included the financing sources of this investment and the related tax effect until that date.

(2) Including an amount of NIS 2,704 million that is not available for distribution, (see note 13 F 2).

(3) In respect of 6,472,220 expired option warrants in 2010 (784,511 in 2009).

The notes to the financial statements are an integral part thereof.

Other cumulative comprehensive income (loss)					Total shareholders' equity
Total share capital and reserves	Adjustment for presentation of available for sale securities at fair value	Translation adjustments <sup>(1)</sup>	Retained earnings <sup>(2)</sup>	in NIS millions	
3,844	196	(234)	5,398	9,204	
-	-	-	1	1	
-	-	-	(4)	(4)	
-	-	-	245	245	
-	-	-	(250)	(250)	
15	-	-	-	15	
-	(873)	-	-	(873)	
-	249	-	-	249	
-	231	-	-	231	
-	-	(21)	-	(21)	
3,859	(197)	(255)	5,390	8,797	
-	-	-	923	923	
2	-	-	-	2	
-	-	-	-	-	
-	1,014	-	-	1,014	
-	(556)	-	-	(556)	
-	(205)	-	-	(205)	
-	-	19	-	19	
3,861	56	(236)	6,313	9,994	

## STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (CONTINUED)

## REPORTED AMOUNTS

	Share capital	Share premium	Capital reserves	
			Benefit in respect of equity-based compensation transactions	Other
in NIS millions				
Balance at December 31, 2009	658	2,942	49	212
Changes in 2010:				
Net Income for the year	-	-	-	-
Issue of Shares	7	443	-	-
Benefit in respect of equity based compensation transactions	-	-	*	-
Option expiration <sup>(3)</sup>	-	13	(13)	-
Exercise of options <sup>(4)</sup>	*	12	(12)	-
Net adjustments for the presentation of available-for-sale securities at fair value	-	-	-	-
Net adjustments for the presentation of available-for-sale securities reclassified to the income statement	-	-	-	-
Related tax effect	-	-	-	-
<b>Balance at December 31, 2010</b>	<b>665</b>	<b>3,410</b>	<b>24</b>	<b>212</b>

\* An amount lower than NIS 1 million.

Footnotes:

(1) Translation adjustments of foreign operations, primarily from a consolidated subsidiary Israel Discount Bank of New York in amount of NIS 231 million, which was treated until December 31, 1994, in the financial statements of the Bank as a unit having a functional currency that differs from the reporting currency.

Accordingly this item included the financing sources of this investment and the related tax effect until that date.

(2) Including an amount of NIS 2,704 million that is not available for distribution.

(3) In respect of 6,472,220 expired option warrants in 2010 (784,511 in 2009).

(4) In respect of 2,876,540 option warrants exercised into 348,994 ordinary "A" shares of NIS 0.1 par value each.

The notes to the financial statements are an integral part thereof.

	Other cumulative comprehensive income (loss)				
	Total share capital and reserves	Adjustment for presentation of available for sale securities at fair value	Translation adjustments <sup>(1)</sup>	Retained earnings <sup>(2)</sup>	Total shareholders' equity
	in NIS millions				
	3,861	56	(236)	6,313	9,994
	-	-	-	724	724
	450	-	-	-	450
	*	-	-	-	*
	-	-	-	-	-
	-	-	-	-	-
	-	457	-	-	457
	-	(351)	-	-	(351)
	-	(33)	-	-	(33)
	4,311	129	(236)	7,037	11,241

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31

## REPORTED AMOUNTS

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
	in NIS millions					
<b>Cash Flows from Operating Activities</b>						
Net income for the period	724	923	245	724	923	245
Adjustments necessary to present cash flows from current operations:						
Bank's share in undistributed income (loss) of investee companies	(132)	(131)	73	(355)	(645)	(272)
Minority interest in income of consolidated subsidiaries	70	*72	78	-	-	-
Depreciation of buildings and equipment	567	484	417	426	355	308
Amortization of goodwill	25	33	34	-	-	-
Financial Statements translation adjustments	-	-	(21)	-	-	-
Provision for impairment of securities held for investment	83	120	380	28	10	76
Provision for doubtful debts	1,114	1,049	838	709	703	602
Gain (loss) on sale of available-for-sale securities	(297)	(524)	(161)	(187)	(363)	(91)
Realized and non realized gain (loss) from adjustment to fair value of trading securities	(9)	(18)	65	(10)	(33)	41
Gain on sale of activity in an investee company	(6)	-	-	-	-	-
Loss on realization of investment in an investee company	(28)	17	-	-	-	-
Benefit with respect to the allotment of options	-	2	15	-	2	15
Provision for impairment in value of buildings	4	6	11	4	6	11
Loss on sale of buildings and equipment	(2)	2	22	(2)	-	16
Dividend from Visa Europe	-	-	(33)	-	-	(7)
Net deferred taxes	(78)	195	(415)	(60)	31	(209)
Severance pay - decrease (increase) in excess of deposits over the provision	23	(149)	267	8	(157)	240
Inflation adjustment component of investing and financing activities	2,128	*590	988	462	164	303
<b>Changes in Balance Sheet Items:</b>						
Other assets, net	(3)	515	(1,569)	(185)	628	(1,728)
Other liabilities, net	265	63	2,423	1,101	(833)	2,084
<b>Net Cash Flows from Operating Activities</b>	<b>4,447</b>	<b>3,249</b>	<b>3,657</b>	<b>2,664</b>	<b>791</b>	<b>1,634</b>

\* Reclassified.

The notes to the condensed financial statements are an integral part thereof.

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31 (CONTINUED)

### REPORTED AMOUNTS

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
	in NIS millions					
<b>Cash Flows from Asset Transactions:</b>						
Acquisition of held-to-maturity bonds	(2,319)	(986)	(640)	-	-	-
Proceeds from redemption of held-to-maturity bonds	1,661	952	1,820	-	-	-
Acquisition of available-for-sale securities	(24,116)	(23,528)	(15,676)	(10,958)	(6,048)	(2,733)
Proceeds from sale of available-for-sale securities	14,058	13,678	17,093	8,230	6,302	5,225
Proceeds from redemption of available-for-sale securities	7,956	5,837	1,120	281	229	870
Net deposits with banks	(1,014)	1,354	51	(1,225)	(432)	(4,081)
Trading securities, net	(28)	(104)	941	10	(187)	663
Net credit granted to the public	(4,643)	1,468	(15,786)	(629)	1,524	(10,527)
Net credit granted to the Government	264	(329)	(1,117)	266	(357)	(1,099)
Net on securities borrowed or purchased under resale agreements	291	(311)	321	291	(311)	321
Reduction of (additional) investment in investee companies	1	*(9)	*(34)	(22)	*(264)	*(1,530)
Proceeds of the sale of investments in investee companies and dividend	277	*181	*5	233	*78	*574
Acquisition of buildings and equipment	(509)	(626)	(690)	(349)	(385)	(537)
Proceeds from sale of buildings and equipment	7	8	6	7	7	4
Acquisition of an initially consolidated companies (annex A)	-	-	(50)	-	-	-
<b>Net Cash Flows from Asset Transactions</b>	<b>(8,108)</b>	<b>(2,415)</b>	<b>(12,636)</b>	<b>(3,861)</b>	<b>156</b>	<b>(12,850)</b>
<b>Cash Flows From Liability and Capital Transactions:</b>						
Net deposits from the public	(4,001)	2,189	8,790	(1,999)	3,177	9,862
Net deposits from banks	(337)	(831)	(517)	(599)	1,041	(118)
Net deposits from the Government	177	78	81	18	31	91
Net securities loaned or sold under buy-back arrangements	(424)	457	1,299	-	-	-
Issuance of subordinated capital notes	1,237	2,419	2,131	687	350	151
Redemption of subordinated capital notes	(809)	(762)	(800)	(502)	(575)	(705)
Issue of share capital	450	-	-	450	-	-
Dividend paid to shareholders	-	-	(250)	-	-	(250)
תמורה ממכירת פעילות חברה מוחזקת	6	-	-	-	-	-
Dividend paid to the minority shareholders of consolidated subsidiaries	(42)	-	-	-	-	-
<b>Net cash flows from liability and capital transactions</b>	<b>(3,749)</b>	<b>3,550</b>	<b>10,734</b>	<b>(1,945)</b>	<b>4,024</b>	<b>9,031</b>
Increase in cash	(7,410)	4,384	1,755	(3,142)	4,971	(2,185)
Cash balance at beginning of year	23,452	19,068	17,313	17,222	12,251	14,436
<b>Cash balance at end of year</b>	<b>16,042</b>	<b>23,452</b>	<b>19,068</b>	<b>14,080</b>	<b>17,222</b>	<b>12,251</b>

The notes to the condensed financial statements are an integral part thereof.

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31 (CONTINUED)

## ANNEX A - DECREASE IN CASH DUE TO INITIALLY CONSOLIDATED SUBSIDIARIES

## Reported Amounts

	2008
	In NIS millions
Assets and liabilities at acquisition date of consolidated subsidiaries:	
Assets (including excess attributed cost amounting to NIS 78 million, and excluding cash amounting to NIS 83 million)	130
Liabilities	(80)
Goodwill	-
Total decrease in cash due to initially consolidated companies	50

## ANNEX B - NON-CASH ASSET AND LIABILITY ACTIVITY DURING THE REPORTED YEAR

	2010	2009	2008
	In NIS millions		
The Bank:			
Purchase of fixed assets	20	-	28
Lending of securities	703	(498)	216
Consolidated:			
Purchase of fixed assets	28	13	28
Lending of securities	703	(498)	252

The notes to the financial statements are an integral part thereof.

## NOTES TO THE FINANCIAL STATEMENTS

### 1. SIGNIFICANT ACCOUNTING POLICIES

#### A. GENERAL

- 1) The financial statements are prepared in accordance with generally accepted accounting principles applying to banking corporations in Israel and in accordance with directives and guidelines of the Supervisor of Banks regarding the preparation of a bank's annual financial statements.
- 2) The Notes to the financial statements relate to the Bank's financial statements and to the consolidated financial statements of the Bank and its subsidiaries, except where it states that the note relates to the Bank only, or to the consolidated statements only.

#### B. DEFINITIONS

In these financial statements -

"Interested party" - as defined in Section 1 of the Securities Law, 1968.

"Related party" - as defined in Opinion 29 of the Institute of Certified Public Accountants in Israel, excluding interested parties.

"Consolidated subsidiaries" - Companies the financial statements of which are fully consolidated, directly or indirectly, with those of the Bank.

"Affiliated companies" - companies, other than consolidated subsidiaries, the investment in which is included in the financial statements, either directly or indirectly, on the equity basis.

"Investee companies" - consolidated subsidiaries or affiliated companies.

"CPI" - the Consumer Price Index in Israel published by the Central Bureau of Statistics.

"Adjusted amounts" - Amounts in nominal historical terms adjusted to the CPI of December 2003, in accordance with the provisions of Opinions Nos. 23 and 36 of the Institute of Certified Public Accountants in Israel;

"Reported amounts" - Adjusted amounts to date of transition (December 31, 2003), together with nominal amounts which were added subsequent to date of transition, and less amounts which were deducted after that date.

Financial reporting in nominal terms - financial reporting based on reported amounts.

Adjusted financial reporting - Financial reporting in adjusted values based on changes in the general purchasing power of the Israeli currency, in accordance with the provisions of Opinions of the Institute of Certified Public Accountants in Israel.

"Cost" - cost in reported amounts.

"Extensions abroad" - consolidated subsidiaries and branches abroad.

Functional currency - the currency of the principal business environment in which the Bank operates: generally, it is the currency of the environment in which the corporation generates and spends most of the cash.

Presentation currency - the currency in which the financial statements are presented.

#### C. FINANCIAL STATEMENTS IN REPORTED AMOUNTS

- 1) **General.** Standard No. 12 of the Israel Accounting Standard Board, dealing with the discontinuation of the adjustment of financial statements ("Standard 12") came into effect in October 2001. According to Standard 12 and according to Standard No. 17 of December 2002, as from January 1, 2004, the adjustment of financial statements was discontinued and they are presented in reported amounts. Until December 31, 2003, the Bank prepared financial statement on an inflation adjusted basis in accordance with instructions of the Supervisor of Banks, based on the principles determined in Opinion No. 36 of the Institute of Certified Public Accountants in Israel. The adjusted amounts included in the financial statements for December 31, 2003, served as a starting point for the financial reporting in accordance with the Standard, as from January 1, 2004.
- 2) The amounts of non-monetary assets do not necessarily represent their realizable value or updated economic value, but rather the reported amounts of such assets.
- 3) Functional currency and presentation currency - the functional currency of the Bank is the New Israeli Shekel (NIS). The consolidated

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

financial statements are presented in NIS and the amounts are rounded off to the nearest million.

- 4) The data included in these financial statements is presented, in accordance with the Standards and the instructions of the Supervisor of Banks, in "reported amounts" as follows:

(a) Balance sheet

- Monetary items are stated in the balance sheet according to the linkage terms of each balance.
- The stated value of investee companies is determined on the basis of financial statements of these companies presented in reported amounts or translated into NIS.
- Other non-monetary items (mostly - property and equipment and investments presented at cost) are stated in reported amounts.

(b) Statement of income

- Income and expenses relating to non-monetary items (such as: depreciation and amortization, prepaid expenses and deferred income) or to provisions included in the balance sheet are derived from the movement between the reported amount of the opening balance and the reported amount of the closing balance.
- The Bank's share in the results of operations of investee companies and the minority shareholders' interest in the results of consolidated companies, are determined on the basis of the financial statements in reported amounts of these companies.
- The remaining components of the income statement are stated in nominal values.

(c) Statement of Changes in Shareholders' equity

Dividend declared or actually paid in the reported period is stated in nominal values.

### D. FOREIGN CURRENCY AND LINKAGE

- 1) **Assets** (except for investments in investee companies, buildings and equipment) and liabilities are stated in the balance sheet as follows:

- Those in foreign currency or linked thereto, are presented at representative exchange rates published by the Bank of Israel at the balance sheet date, or at a different date, in accordance with the terms of the relevant transactions.
- Those linked to the CPI or to other indices, are presented in the balance sheet according to the latest known index on the balance sheet date.
- Those optionally linked, are stated in accordance with their related terms ruling on the balance sheet date.

- 2) **Transactions in foreign currency**

Transactions in foreign currency are translated into the functional currency according to the exchange rate in effect on dates of transactions, as published by Bank of Israel. Monetary assets and liabilities at the reporting date, denominated in foreign currency, are translated into the functional currency according to the exchange rate in effect on that date. Exchange rate differences in respect of monetary items comprise the difference between the written down cost in the functional currency at the beginning of the period, adjusted by the effective rate of interest and payments made during the period, and the written down value in foreign currency translated according to the exchange rate at the end of the period. Non-monetary assets and liabilities denominated in foreign currency and measured according to fair value are translated into the functional currency according to the exchange rate in effect on the date on which fair value had been determined. Exchange rate differences arising from new translations are recognized in the statement of income, except for differences arising from the new translations of non-monetary capital instruments classified as available for sale, which are directly recognized in shareholders' equity.

- 3) **Foreign operations**

Assets and liabilities of foreign operations, including goodwill and adjustment to fair value created upon acquisition, have been translated into NIS according to exchange rates in effect at balance sheet date. Income and expenses of foreign operations have been translated into NIS according to exchange rates in effect at date of the transactions.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

4) The following are the representative rates of exchange and the CPI and their annual rates of change:

	2010	2009	2008	Annual rate of change		
				2010	2009	2008
				%	%	%
CPI (in points):						
Balance sheet month (December index)	113.5	110.6	106.4	2.6	3.9	3.8
Known at balance sheet month (November index)	113.1	110.6	106.5	2.3	3.8	4.5
Representative exchange rate (in NIS) at the balance sheet date of the:						
U.S. Dollar	3.549	3.775	3.802	(6.0)	(0.7)	(1.1)
Euro	4.7379	5.442	5.297	(12.9)	2.7	(6.4)

### E. CONVERSION OF FINANCIAL STATEMENTS OF EXTENSIONS ABROAD

Up to the year 1994, foreign subsidiaries were considered autonomous units, and the conversion differences with respect to the investment herein were included as a separate item in Shareholders' Equity. The capital reserve from the translation of foreign autonomous units accumulated to this date is to be recognized in the statement of income in the period in which the gain or loss on realization of the investment in the relevant foreign extension is recognized. Following guidelines of the Supervisor of Banks, foreign subsidiaries are considered, as from 1995, "extensions" of the Bank.

Since the year 2008, following the implementation of Standard 13 (amended) regarding "Effect of changes in foreign currency exchange rates", and the guidelines of the Supervisor of Banks, a foreign extension of a banking corporation, which according to earlier rules had been classified by the banking corporation as a "long arm", is classified as a foreign operation the functional currency of which is identical with the functional currency of the banking corporation.

The Supervisor of Banks has clarified that the classification of a new foreign banking extension as an extension the functional currency of which is different from the functional currency of the banking corporation shall be subject to his prior approval.

### F. USE OF ESTIMATES

The preparation of financial statements according to accounting principles accepted in Israel and the directives and guidelines of the Supervisor of Banks, requires the Bank's Management to make use of evaluations and assessments, which affect the implementation of policy and the amounts of assets and liabilities, income and expense and the disclosure given in their respect. It should be clarified that actual results may differ from these assessments.

When forming the accounting assessments used in the preparation of the Bank's financial statements, Management is required to make assumptions as to circumstances and events involving significant uncertainties. When using its judgment in determining the assessments, the Bank's Management takes into consideration past experience, various facts, independent opinions and information and reasonable assumptions according to the circumstances applying to each assessment.

The assessments and assumptions on which they are based are reviewed on an ongoing basis. Changes in accounting assessments are recognized in the period in which the assessments have been changed and in each future period that is affected by the change in assessment.

### G. STATEMENT OF CASH FLOWS

The statement of cash flows is presented classified into cash flows produced by current activities, by activities in assets and by activities in liabilities and capital. Cash flows produced by activities in assets and liabilities and capital are presented on a net basis, except for movements in securities for investment and non-monetary assets. The cash and cash equivalent item includes cash, bank deposits, marketable deposit certificates and deposits with central banks for an initial period of up to three months.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### H. PRINCIPLES OF CONSOLIDATION AND THE IMPLEMENTATION OF THE EQUITY METHOD

- 1) **Principles of consolidation.** Subsidiaries are entities controlled by the Bank. Control exists when the Bank is able to set monetary and operating policy of the entity so as to benefit from its resources and operations. Control exists when the Bank holds, directly or indirectly, shares conferring over 50% of voting rights in the subsidiary and the right to appoint a majority of its Board members, unless circumstances exist which evidently prevent the parent company from exercising actual control.
- 2) The consolidated financial statements include the audited financial statements of the Bank and of subsidiaries controlled by the Bank. The financial statements of subsidiaries are included in the consolidated financial statements from the date on which control commences until the date on which control ceases. Intercompany balances and transactions between the consolidated companies are annulled in the consolidated financial statements. Financial statements of provident funds managed by the Bank or by a consolidated subsidiary have not been consolidated.  
  
The Bank's standalone financial statements include the financial statements of property and service companies wholly owned by the Bank, and which assets are mostly used by the Bank.
- 3) **Investments in investee companies.** Investments in the shares of investee companies (in the consolidated statements - investments in shares of affiliated companies) are presented on the equity basis, based on the financial statements of these investees as of the balance sheet date. Investees are accounted for at equity value method, starting from the date on which material influence commences until the date on which material influence ceases.  
  
The Bank's share in the financial results of such investees is stated net, after amortization of goodwill.
- 4) **Determination of goodwill and its amortization** the excess cost of acquisition of investment in an investee company over the Bank's share in the fair value of its identifiable assets (including intangibles), less the fair value of its identifiable liabilities (net of related taxes) constitutes goodwill. The allocation of the excess of cost to an acquired intangible asset shall be made only where such asset complies with the definition of an intangible asset According to directives of the Supervisor of Banks, positive and negative goodwill is to be amortized over a period of ten years, unless the Supervisor has ordered otherwise. See "R" below, regarding the examination of the need for a provision for impairment.

### I. SECURITIES

- 1) In accordance with directives of the Supervisor of Banks, the Bank's investments in securities are classified into three portfolios, as follows:
  - (a) "Held to maturity bonds" - bonds which the Bank intends and has the ability to hold until maturity, except for debentures which may be called early or otherwise disposed, such that the Bank may not cover substantially all of its recognized investment. Bonds are stated at cost with the addition of accumulated linkage differences or exchange differences and interest, as well as the premium or discount component created upon acquisition and not yet amortized, and net of a provision for impairment which is not of a temporary nature.  
  
The transfer or sale of bonds classified to the held-to-maturity portfolio, is permitted in case of certain changes in circumstances, in which the sale or transfer will not be considered as contradicting the initial classification of the bonds, including evidence of material deterioration in the repayment ability of the bond issuer.
  - (b) "Trading securities" - securities which are held with the intention of selling them in the short term except for shares with no available fair value. The securities are presented at their fair value at the reporting date. Gains or losses due to adjustments to fair value are recorded in the statement of income.
  - (c) "Available for sale securities" - securities not classified under the two previous categories. Securities available for sale are stated at their fair value on the balance sheet date, except for shares the fair value of which is not readily available, which are stated at cost

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

less a provision for impairment in value not of a temporary nature which is recorded in the statement of income. Unrealized gains or losses resulting from the adjustment to fair value, net of the related tax effect, are recorded as a separate line item in Shareholders' Equity, and forwarded to statement of income upon sale or redemption of the securities.

- 2) The cost of realized securities is recognized in the statement of income on a "moving average" basis.
- 3) Dividend income, accrued interest, linkage differentials, amortization of premium or discount (according to the effective interest method) as well as losses on impairment of an other than temporary nature are recognized in the income statement.
- 4) Interest income in respect of acquired beneficiary rights (such as: asset backed financial instruments of the MBS, CDO, CMO types), excluding beneficiary rights of a high credit quality, is recognized according to the prospective interest method, the rate of interest used for recognition of interest income being adjusted to changes in assessment of future cash flows. In this respect, beneficiary rights of a high credit quality comprise beneficiary rights issued with U.S. government guarantee or by U.S. government agencies, as well as asset backed securities the international rating of which is at least "AA".
- 5) The Bank's investment in venture capital funds is treated at cost less losses on impairment of an other than temporary nature. Gains on investments in venture capital are recognized in the income statement upon realization of the investment.
- 6) For the treatment of transactions involving the transfer of financial assets (such as: repurchase agreements, lending of securities, etc.), see O below. In the matter of computing fair value, see K below.
- 7) The Bank and its relevant subsidiaries examine, in accordance with generally accepted accounting principles applying to banking corporations, whether the impairment of securities is of an other than temporary nature.

The review is based on the following considerations:

- The ratio of loss to cost/depreciated cost (while examining developments subsequent to balance sheet date);
- The period in which the fair value of the security is lower than its cost;
- The rate of yield to redemption in the case of bonds;
- The credit rating of the security, including changes in its rating;
- In the case of shares - events of reduction due to the distribution of dividends or its cancellation;
- In the case of bonds - Events of default in the payment of periodic interest in accordance with the terms of the bond, forecast of changes in the expected cash flow from the bond.
- Relating the impairment in value to the deterioration in the financial position of the issuer, or to the change in general market condition;
- The intent and ability of the Bank and its relevant subsidiary to continue holding the securities until such time that the expected recovery of the fair value of the securities occurs.

The Bank recognizes impairment of a nature other than temporary, at least in each of the following cases:

- Relevant information regarding the financial condition of the issuer and changes therein, analysis of specific events that might affect the activities of the issuer and his profitability and an analysis of the economic sector and of the country in which the issuer operates. or until redemption thereof.
- A security that had been sold prior to the date of publication of the financial report for that period;
- A security, which near the date of publication of the financial report for that period, is intended to be sold within a short period;
- A bond, the rating of which at date of publication of the financial report for that period has been significantly reduced compared to its rating on date of purchase by the bank;
- A bond which following its purchase has been classified by the bank as problematic;
- A bond in respect of which there has been a payment default subsequent to its purchase;
- A security, the fair value of which at the end of the reporting period and also proximate to the date of publication of the financial report

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

for that period, was significantly lower than its cost (or written-down cost in case of bonds). This, unless the bank has objective and solid evidence as well as a careful analysis of all relevant factors, which proves at a high level of assurance that the impairment is of a temporary nature.

Where impairment of an other than temporary nature occurs, the cost of the security is written down to its fair value, which serves as a new cost basis. The cumulative loss in respect of a security classified as available-for-sale, which in the past had been reflected as a separate item in shareholders' equity within the framework of other comprehensive profit, is reflected in the statement of income when the impairment in respect of which is of an other than temporary nature. Increase in value during consecutive reporting periods, are recognized as a separate item in shareholders' equity within the framework of other comprehensive profit, and are not reflected in the income statement (the new cost base).

### J. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE TRANSACTIONS

The Bank recognizes all derivatives as assets or liabilities on the balance sheet and measures them at fair value.

The fair value of derivatives as abovementioned is stated, net, in the items "Other assets" or "Other liabilities".

Changes in the fair value of a derivative instrument shall be reflected in the statement of income, or shall be included in shareholders equity as an "other comprehensive income" component, in accordance with the designation of the derivative instrument.

The change in the fair value of derivatives hedging exposure to the change in the fair value of an asset, a liability or a firm commitment, shall be recognized in the statement of income on a current basis, as well as the change in value of the hedged item, which may be related to the hedged risk.

The accounting treatment of changes in the fair value of derivatives that hedge exposure to changes in the cash flow generated by an asset, a liability or an anticipated transaction, depends on the effectiveness of the hedging relationships.

- The effective part of the change in the fair value of a derivative designated to hedge a cash flow risk, is initially reported in shareholders equity (outside the statement of income) as a component of "other comprehensive income", following which, when the anticipated transaction affects the income statement, it is reclassified to the statement of income.
- The non-effective part of the change in the fair value of a derivative designated as above is recognized immediately in the statement of income. Gain or loss on a derivative instrument not designated as a hedging instrument is recognized in the income statement as incurred.

In accordance with the decision to cancel the purpose of derivatives as hedging instruments in effect as from January 1, 2010, there were no hedging derivatives in 2010.

For further details see Note 20 hereunder.

### K. FAIR VALUE MEASUREMENT OF FINANCIAL INSTRUMENTS

A. Fair value is the amount at which an asset may be bought or sold (a liability may be assumed or repaid) in a regular transaction between willing parties, i.e. in a transaction other than forced sale or sale in the course of liquidation. The Bank determines fair value as follows:

- (1) Securities - the fair value of trading securities and available-for-sale securities is determined based on quoted market prices in active markets. If a quoted market price is unavailable, the estimated fair value relies on the best available information. The estimated fair value considers prices of similar assets or liabilities and the outcome of various valuation methods, as set forth in section (4) below.
- (2) Financial derivatives instruments - financial derivatives instruments which have an active market have been valued at market value, and when multiple active markets exist on which the instrument is traded, the valuation was based on the most active market. Financial derivatives instruments not traded on an active market were valued using models which serve the Bank in its regular operations, which account for the risk inherent in the financial derivative instruments (market risk, credit risk etc.), as set forth in section (4) below.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

- (3) Other, non-derivative financial instruments - most financial instruments in this category (such as: deposits from the public and deposits with banks, credit to the public and to the Government, bonds, subordinated capital and non-negotiable loans) have no quoted "market price", since they are not traded on any active market. Therefore, fair value is estimated using generally acceptable pricing models, such as present value of future cash flows, discounted using a discount rate which reflects the risk level associated with the financial instrument.
- (4) Determination of fair value in inactive markets - the Bank applies clarification FSP FAS 157-3 (ASC 820) with regard to "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active". Accordingly, when determining the fair value of securities and other financial instruments traded on an inactive market, significant use of judgment is sometimes made, including review as to whether transactions were conducted under stress and duress. In cases where no price quote is available on an active market, fair value is determined using generally accepted pricing models, based on an independent, validated system at the Bank, or based on valuations obtained from experts in valuating financial instruments. Valuation methods involve the use of various parameters, such as interest rate curves, currency exchange rates and standard deviations, and account for assumptions with regard to various factors.
- (5) For further information about major methods and assumptions used in estimating fair value of financial instruments, see Note 21.
- B. Effective January 1, 2008, the subsidiary IDB New York (Hereinafter: "IDBNY") adopted the U.S. financial accounting standard FAS 159 "The Fair Value Option for Financial Assets and Financial Liabilities". (Hereinafter: "FAS 159").

### L. PROVISION FOR DOUBTFUL DEBTS

- The provision for doubtful debts includes a specific provision, a general provision and a supplemental provision. The provision for doubtful debts of the Bank and the consolidated subsidiaries in Israel was made according to the directives of the Supervisor of Banks. The provisions for doubtful debts in the consolidated banking subsidiaries abroad, are determined according to generally accepted principles in those countries.
- The specific provision for doubtful debts has been recorded on the basis of the Bank's estimate of expected losses in credit portfolios, including off-balance sheet debt items, by examining and monitoring the financial condition of the debtors and their business activities, an assessment of collateral held, and an evaluation of the risks related to their financial condition, performed on a quarterly basis.
- Interest income in respect of debt (or a part thereof) classified as non-performing, is not recognized as from the beginning of the quarter in which such debt have been declared as non-performing. Upon collection of the interest, such income is stated as "Other financing income".
- The specific provisions regarding housing loans granted by banking subsidiaries in Israel, have been calculated according to the directives of the Supervisor of Banks, on an increasing scale in accordance with the extent of the arrears.
- The supplemental provision for doubtful debts is calculated based on the quality of the portfolio of debts according to the characteristics of risk as stated in the directives of the Supervisor of Banks.
- The ratios of the general provision and the supplemental provision (including the provision for off-balance sheet items), to credit granted to the public for the Bank and its consolidated subsidiaries in Israel are:

	Consolidated		The Bank	
	December 31			
	2010	2009	2010	2009
General provision	0.17%	0.20%	0.19%	0.16%
Supplemental provision	0.20%	0.19%	0.17%	0.13%

The directives of the Supervisor of Banks stipulate that the balance of the general provision for doubtful debts, at adjusted values, accumulated under the previous directives, at a rate of 1% of total indebtedness as of December 31, 1991, should be maintained.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The adjustment of the general provision was discontinued on January 1, 2005, according to directives of the Supervisor of Banks.

- 7) The supplemental provision and the general provision are not deductible for tax purposes, and in accordance with the directives of the Supervisor of Banks, a deferred tax asset has not been recorded.
- 8) A foreign subsidiary creates a general provision for doubtful debts based on past experience and management's estimate of business and economic conditions, the concentration of the credit portfolio, quality of the borrowers and trend of arrears in repayments.
- 9) Bad debts are written off when the Bank reaches the conclusion that the debt is uncollectible, either after taking legal proceedings, or as a result of agreements and arrangements made, most of which were in cases where legal proceedings were not taken, and the debts are not collectable, or for other reasons rendering them unrecoverable.

For details regarding the instruction in the matter of "Measurement and disclosure of delinquent debts, credit risk and provisions for credit losses" to be implemented in financial statements of banking corporations and credit card companies as from the statements for January 1, 2011 onwards, see section AA (3) below.

### M. THE BASIS OF RECOGNITION OF INCOME AND EXPENSES

Income and expenses are recognized on an accrual basis. Financing income on non-performing loans and interest in arrears on housing loans of a mortgage bank, are recognized when collected.

In respect of hybrid capital instruments, which include a structured step-up redemption, the interest rates used to compute the interest cost are the interest rates in effect prior to the step-up, based on Management's evaluation that the instruments would be redeemed at date of increase in the interest rate.

Income from commission on early loan repayments, net of a proportionate part attributed to the financial capital, is included in the statement of income in equal annual installments over the remaining period of the loan or over three years from the date of early repayment, the shorter of the two periods.

With respect to securities - see I above; with respect to the provision for doubtful debts - see L above; with respect to derivative financial instruments - see J above.

Sale and leaseback transactions are presented in the financial statements in accordance with International Accounting Standard (IAS) 17.

### N. SET-OFF OF FINANCIAL INSTRUMENTS

Assets and liabilities are set-off against one another where an enforceable legal right of set-off and the intention to set-off the transactions at maturity date exist. In addition, designated deposits, the repayment of which to the depositor is conditional upon the extent of collection of the loans granted out of such deposits, and where the Bank has no risk of loss from such loans, are stated in the balance sheet net of the loans granted therefrom. The margin earned on this activity is included in the item "Operating commissions".

### O. TRANSFERS AND SERVICES RELATING TO FINANCIAL ASSETS AND SETTLEMENT OF LIABILITIES.

The Bank applies the measurement and disclosure rules determined in the U.S. Financial Accounting Standard FAS 140 (ASC 860-10) "Transfers and servicing of financial assets and extinguishments of liabilities" as amended by FAS 166 "Transfers of financial assets" (ASC 860-10) (see subsection Z(2) below), for the accounting treatment of financial asset transfers and extinguishments of liabilities.

According to the said rules, the transfer of a financial asset shall be treated as a sale accounting wise, if and only if all the following conditions exist: (1) the transferred financial asset had been isolated from the transferor, also in the case of bankruptcy or other type of receivership; (2) any transferee of the asset (or if the transferee is an entity, the only purpose of which is to engage in securitization or in asset backed financial activity, and which is prevented from pledging or exchanging the transferred financial asset - any third party holding beneficiary rights) may pledge or exchange the transferred asset (or the beneficiary rights), and no conditions exist which also restrict the transferee (or a third party who holds the beneficiary rights) from using his right to pledge or exchange the asset and which grants the transferor a larger than just a trivial benefit; (3) the transferor, or subsidiary companies included in its financial statements, or its agents, do not retain

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

effective control over the financial assets or over the beneficiary rights relating to such transferred assets.

In addition, in order for the transfer of a part of a financial asset to be considered a sale, the transferred part must fall within the definition of participating rights. Participating rights have to meet the following criteria: the right has to represent proportionate rights in relation to the total financial asset; all cash flows receivable from the asset are distributed among the participating rights proportionally to their interest in the asset; the rights are not subordinated to other rights in the asset; no right of return of the asset to the transferor or to other participating right holders exists (except in cases of misrepresentation or violation of commitments, ongoing contractual obligations for the service of the financial asset as a whole and the management of the transfer agreement, and contractual obligations to share in the setoff of any benefits received by any holder of participating rights); the transferor and also the holder of participating rights have no right to pledge or exchange the financial asset in entirety, except where all the holders of the participating rights agree to pledge or exchange the financial asset in its entirety.

In the event that the transaction meets the terms for treatment thereof as a sale transaction, the transferred financial assets are removed from the balance sheet of the Bank. Where sale conditions do not exist, the transfer is treated as a collateralized debt. A sale of a part of a financial asset, which is not considered a participating right, is treated as a collateralized debt, namely, the transferred asset continue to be stated in the balance sheet of the Bank and the proceeds of sale are recognized as a liability of the Bank.

In view of the above, securities sold under repurchase terms or purchased under resale terms, securities loaned or borrowed, as well as other financial instruments transferred or received by the Bank, in which the Bank retained control over the transferred asset or did not acquire control over the asset received, are treated as a collateralized debt.

Furthermore, according to guidelines of the Supervisor of Banks, certain securities sold to the Bank of Israel under repurchase terms, are treated as a collateralized debt. Financial instruments transferred under such transactions are measured according to the same measurement rules applying prior to their transfer. Namely, such securities are not removed from the balance sheet, against which a deposit is recognized secured by a pledge on the said securities, which are stated in the item "Securities loaned or sold under repurchase agreements". Securities received under such transactions, are stated according to the cash amount paid by the Bank in the item "Securities borrowed or purchased under resale agreements". The Bank monitors the fair value of securities borrowed or loaned and of securities transferred under repurchase and resale agreements, and where necessary additional collateral is sought. Interest paid or received in respect of securities as above, is reported as financing income or expenses, respectively.

The Bank removes a liability if and only if it had been extinguished, namely, if one of the following terms exists: (a) the Bank had paid the lender and was released from its obligations regarding this liability; or (b) the Bank, under a legal process, had been legally released from liability or, with the consent of the lender, had been released from being the principal debtor in respect of this liability.

### P. BUILDINGS AND EQUIPMENT

1) Buildings and equipment are presented at cost, with the addition of direct acquisition costs after the deduction of accumulated depreciation and impairment in value if such was made. Adjusted depreciation is calculated by the straight-line method based on the estimated useful life of the assets. The cost of buildings includes interest capitalized during the construction period. Buildings and realty designated for sale have been presented at their market price in those cases where it is lower than their adjusted cost.

2) Software purchased by the Bank is measured at cost less accumulated amortization and loss on impairment.

Costs in respect of the development of software or its modification for own use are capitalized if, and only if: it is possible to reliably measure the development costs; the software is feasible from the technical and commercial aspects; future economic benefits are expected; and the Bank has sufficient resources and intent to complete the development and make use of the software. Costs recognized as an intangible asset include the direct cost of materials, services and direct payroll to employees. Such costs are measured at cost less accumulated depreciation and loss on impairment. Overhead costs that cannot be directly attributed to the development of

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

the software are recognized as expenses as incurred. Costs of preliminary research and development as well as costs relating to the post application development stage (end of acceptance tests) were recorded in the income statement as incurred. These expenses are amortized as from the date of completion of the development, over the useful economic lives of these assets.

Subsequent costs in respect of software are recognized as an asset only if they increase the future economic benefits embodied in the asset in respect of which costs had been incurred. All other costs are reflected in the statement of income as incurred.

Amortization is recognized by the "straight line" method over the anticipated useful life of the software, beginning with the period in which the software is ready for use.

The core systems ("Ofek Project") development costs are being amortized over a period of seven years.

### Q. INTANGIBLE ASSETS

Goodwill created upon the acquisition of subsidiaries (including the acquisition of the minority interest) is included in the item "other assets". For details regarding the initial recognition of goodwill, see Section H(4) above.

Goodwill is measured according to cost less accumulated amortization and loss of impairment. Goodwill regarding investments treated by the equity method of accounting is included in the stated value of the investment. Loss on impairment in respect of such investments is not attributed to any particular asset, including goodwill, which forms part of the stated value of the investment.

### R. IMPAIRMENT IN THE VALUE OF ASSETS

The Bank implements Accounting Standard No. 15 (Amended), which deals with the impairment in the value of assets. The Standard sets out procedures which a corporation has to adopt in order to secure that assets in the consolidated balance sheet are not stated in amounts which exceed their recoverable amount, being the higher of the net selling price or the present value of the estimated amount of anticipated future cash flows to be generated by the use of the asset and its realization.

The Standard applies to all assets included in the consolidated balance sheet, excluding tax assets and monetary assets (except for monetary assets comprising investments in investee companies that are not subsidiaries). The Standard also determines the principles of presentation and disclosure in respect of assets, the value of which has been impaired.

### S. EMPLOYEE BENEFITS

Liabilities in respect of employee rights are covered by appropriate provisions. For further details see Note 16 hereunder.

The subsidiary IDB New York adopted EITF Issue No. 06-04, "Accounting for Deferred Compensation and Postretirement Benefits Aspects of Endorsement Split-Dollar Life Insurance Arrangements", as of January 1, 2008. The Task Force reached a consensus that for an endorsement split-dollar life insurance arrangement within the scope of this Issue, an employer should recognize a liability for future benefits in accordance with FAS 106 (if, in substance, a postretirement benefit plan exists) or Opinion 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee.

### T. SHARE BASED COMPENSATION

Share based compensation transactions include transactions with employees or other parties involving payment in capital instruments, cash or other assets.

In share based payment transactions settled by capital instruments, the benefit created upon the granting of option warrants to officers, is recognized as a payroll expense alongside an increase in equity, based on the fair value of the options at grant date, using the Black & Scholes model. The benefit created is spread over the vesting period based on the evaluation of the Bank as to the number of options that would become vested.

The fair value of the amount due to officers in respect of rights regarding the increase in value of fully paid in cash shares (phantom options), is recorded as an expense against a parallel increase in liabilities over the period in which the right to the payment is attained. The liability is re-measured at each reporting date, as well as at the settlement date. Any change in the fair value of the liability is recognized as a

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

payroll expense in the income statement.

(For details regarding an option plan to officers of the Bank, see Note 13 E below. For details as to phantom options to officers of the Bank, see Note 13 E (1), E (4) below).

### U. CONTINGENT LIABILITIES

The accounting treatment of outstanding legal actions is in accordance with the provisions of the U.S. Accounting Standard SFAS-5 "Accounting for Contingencies" and its related guidelines, and in accordance with the guidelines and clarifications of the Supervisor of Banks, including public reporting directives in the matter of the "Accounting for Contingencies".

In assessing the outstanding legal actions, Managements of the Bank and of its subsidiaries base themselves on opinions of their legal Counsels, which determine the probability of the exposure to the risk involved in these claims materializing.

Claims have been classified according to the probability range for a risk exposure materializing, as follows:

- 1) Probable - probability of over 70%.
- 2) Reasonably possible - probability of over 20% and up to and including 70%.
- 3) Remote - probability of 20% or less.

The financial statements include appropriate provisions regarding claims the realization of the exposure in respect thereof was considered probable.

According to the guidelines, only in rare cases may a banking corporation state in its financial statements that it is not possible to assess the prospects of a risk exposure materializing in respect of an ordinary legal action and an action approved as a class action, this in four financial statements (including one annual financial statements) to be published subsequently to the filing of an action together with a petition to have it approved as a class action suit, such period is not to include a period in which the Court has decided to stay the proceedings. Note 19 states separately the outstanding claims, in respect of which a reasonable assessment of the exposure to risk is not possible.

The Bank has described material legal proceedings being conducted against the Bank and Group companies. In this respect, the Bank has determined that as a general rule, a legal proceeding shall be disclosed where the amount claimed exceeds 0.5% of the equity capital of the Bank and it is not possible to assess the prospects of the risk exposure materializing and exceeds 1% of the equity capital where there are reasonably possible prospects of the risk exposure materializing or where the prospects of the risk exposure materializing are remote.

It should further be noted, that in cases where the Bank is one of the defendants in the action, and the claimants have not allocated the amount claimed to each of the defendants, the amount estimated as relevant to the Bank is computed to the best of ability, considering the fact that taking the full amount into account might be misleading and is not correct under the circumstances, and that the estimate made does not necessarily represent the allocation which at the end of the day would be decided by the Court.

The financial statements include appropriate provisions in accordance with generally accepted accounting principles and the estimates of the Managements of the Bank and of its subsidiaries, based on opinions of their legal Counsels.

The Bank is exposed to unasserted claims or suits due, inter alia, to doubts with regard to interpretation of agreements and/or statutory provisions and/or their application. The Bank is made aware of such exposure in several ways, including: appeals or complaints by third parties to Bank entities. In assessing the risk associated with unasserted claims/lawsuits, the Bank relies on internal assessment by the handling entities and by Management, which weigh the estimated probability of a claim being made, the chances of such claim, if made, to prevail and any settlement payments. Such assessment is based on past experience with regard to the claims filed, and on an analysis of the actual allegations. By nature, in view of the preliminary stage of inquiring of the legal allegation, the actual outcome may differ from assessment conducted prior to filing of the claim.

### V. TAXES ON INCOME

(1) The Bank and its consolidated subsidiaries use the tax allocation method with respect to timing differences in the recognition for tax

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

purposes of certain income and expenses.

Deferred taxes have been calculated according to the "liability" method, at tax rates expected to be applicable during the period in which the deferred taxes are realized, based on laws in force at the balance sheet date. The realization of deferred taxes receivable is contingent upon the future existence of taxable income. Management believes that such deferred tax assets will be realizable in the future.

- (2) A provision for deferred taxes is included in the financial statements for that part of the adjustment of depreciable non-monetary assets (excluding buildings - see Note 29 M) which will not be deductible for tax purposes.
- (3) Retained earnings of certain investee companies may be subject to additional taxes if and when distributed as cash dividends. With respect to consolidated subsidiaries - when a dividend distribution is not expected in the foreseeable future - no provision for taxes has been recorded. With respect to affiliated companies - a provision for taxes on income was recorded if an additional tax liability is likely to arise due to the distribution of dividend.
- (4) Profits from the future sale of investments in shares of investee companies may attract additional taxes. The provision for deferred taxes does not include taxes relating to the sale of investments in investee companies as long as the supposition of the ongoing holding of the investment exists.
- (5) The provision for taxes on income of the Bank and its consolidated subsidiaries which are financial institutions, for the purposes of Value Added Tax, includes profit tax levied on income as stipulated in the Value Added Tax Law. Value Added Tax levied on payroll of financial institutions is included in the statement of income under the item "Salaries and related expenses".
- (6) A deferred tax asset in respect of brought forwards tax losses and in respect of a brought forward right to a tax setoff is recognized in the books in cases where the said tax utilization in the foreseeable future is not uncertain. A deferred tax asset in respect of temporary differences is recognized where it is probable that a tax savings will arise upon their reversal. The creation of net deferred taxes shall not exceed the current tax in the period, unless in special cases where the tax realization in the foreseeable future is not uncertain.

### W. SEGMENT REPORTING

Segment reporting is a component of a banking corporation engaged in operations from which it may generate income and incur expenses. Division into segments and the related reporting outline have been set in provisions and directives of the Supervisor of Banks. For further information, see Note 31 below.

### X. AMORTIZATION OF DEFERRED EXPENSES

Bond and subordinated capital notes issue costs are amortized proportionally to the outstanding principal amount of the bonds.

### Y. EARNINGS PER SHARE

The Bank presents basic and fully diluted earnings per share with respect to its ordinary share capital. The basic earnings per share is computed by dividing the earnings or loss attributed to the holders of ordinary shares of the Bank by the weighted average number of ordinary shares outstanding during the period. The fully diluted earnings per share is determined by adjusting the earnings or loss attributed to the holders of the ordinary shares and by adjusting the weighted average number of ordinary shares outstanding in respect of the effect of all potentially diluting ordinary shares, which include share option warrants granted to employees.

### Z. INITIAL APPLICATION OF ACCOUNTING PRINCIPLES, UPDATES OF ACCOUNTING STANDARDS AND DIRECTIVES OF THE SUPERVISOR OF BANKS

#### (1) Adoption of a new hierarchy in the implementation of U.S. accounting standards

On July 1, 2009, the U.S. Financial Accounting Standards Board (FASB) implemented a change in the organization of accounting standards, this within the framework of U.S. Accounting Standard 168 regarding the "Codification of accounting standards of the FASB and hierarchy of accepted accounting principles" (at present - ASC 105, accepted accounting principles) published by the FASB. The standard determined the FASB Accounting Standards Codification (ASC) as the sole source for accepted accounting principles in

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

the U.S. which shall apply to reporting entities, which are not Government agencies (Nongovernmental U.S. GAAP), except for the guidelines of the U.S. SEC. Accordingly, all accounting principles not adopted as above, as well as the principles that are not based upon SEC guidelines, are not included in the codification and have become non-binding principles. Following the codification, the U.S. FASB shall no longer publish standards (SFAS) and position papers (FASB Staff Positions) or clarifications and guidelines on specific issues (EITF Abstracts), but shall publish Accounting Standards Updates (ASU), which shall update the codification.

According to the update of the definitions item in the public reporting instructions, determined in the circular published by the Supervisor of Banks in the matter of "Measurement of fair value, fair value alternative, adoption of certain international financial reporting standards (IFRS)", dated December 31, 2009, the Bank adopted as from January 1, 2010, the said new hierarchy. It should be noted that in accordance with the decision of the Supervisor of Banks, despite the hierarchy determined in U.S. standard 168, any position made public by the banking regulatory authority in the U.S. or by the staff of the bank supervisory authorities in the U.S., regarding the manner in which U.S. accepted accounting principles are to be implemented, is to be considered "accounting principle accepted by U.S. banks" (within the meaning of this term in the public reporting instructions) and it shall be binding regarding banking corporations and credit card companies, in matters of implementation of U.S. accounting principles adopted or which will be adopted in the future within the framework of the public reporting instructions of the Supervisor of Banks. The implementation of the codification has had no effect on the accounting principles applying to banks, but only on the manner in which banks will refer to accepted accounting principles by U.S. banks.

### (2) Initial application of accounting principles

In June 2009, the FASB published U.S. financial accounting standard 166 (hereinafter: "FAS 166"), regarding "Transfers and servicing of financial assets" (Amendment of FAS 140 (ASC 860)). FAS 166 cancels the principle of qualified special purpose entity (QSPE), determines stricter terms for the accounting treatment as a sale of the transfer of a part of financial assets, including clarification regarding the terms for removal of financial assets, amends measurement principles in the initial recognition of retained interests, and also cancels the principles for the reclassification of guaranteed mortgage securitization.

Concurrently, the FASB published the U.S. financial accounting standard 167 (hereinafter: "FAS 167"), regarding "Amendments to interpretation 46 as amended (FIN 46(R) - consolidation of entities having variable interests (ASC 810))", which amends principles determined in FIN 46(R) (ASC 810) regarding the consolidation of entities having variable interests. FAS 167 requires the examination at date of initial implementation of the standard, on January 1, 2010, of the obligation to consolidate all entities previously defined as qualified special purpose entities (QSPE) as well as entities having variable rights (VIES), updates the criteria for the identification of variable interests entities (VIEs), changes the approach to determining the identity of the primary beneficiary (from the approach based on quantitative tests to a qualitative test for the identification of control of financial interests). It also requires the reporting corporations to perform a re-examination of the consolidation obligation of VIEs at more frequent intervals.

According to a circular of the Supervisor of Banks dated September 6, 2009, a banking corporation and a credit card company (hereinafter: "a banking corporation") are required to apply the rules determined by FAS 166 and FAS 167, including the disclosure requirements stated therein as from January 1, 2010 onwards, in accordance with the transitional instructions determined in such standards. As a general rule, the transitional instructions require the following:

- The application of the recognition and measuring requirements specified in the standard with respect to the transfer of financial assets made on January 1, 2010 and thereafter;
- The examination on January 1, 2010 and thereafter of whether it is required to consolidate in accordance with FAS 167 entities defined according to the old rules as qualified special purpose entities (QSPE).

Furthermore, the banking corporation may not provide the comparative data for 2009, with respect to disclosure requirements added for the first time in accordance with the said circular.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The effect of the initial application of FAS 166 and FAS 167 is not material.

### AA. DISCLOSURE OF THE EFFECT OF NEW ACCOUNTING STANDARDS ON THE PERIOD PRIOR TO THEIR APPLICATION.

Details regarding the effect of new accounting standards and of new directives of the Supervisor of Banks are stated hereunder.

(1) **Accounting Standard No. 29.** The Israel Accounting Standards Board published in July 2006 Accounting Standard No. 29 "Adoption of International Financial Reporting Standards (IFRS)" (hereinafter: "the Standard").

In accordance with the provisions of the Standard, corporations to which the Securities Law, 1968 applies and which are obligated to report in accordance with the rules enacted under this Law, will prepare their financial statements in accordance with the international financial reporting standards, starting with the financial statements for the period beginning January 1, 2008 and thereafter.

The above is not applicable to corporations, whose financial statements are prepared according to the directives and guidelines of the Supervisor of Banks, in accordance with the Securities Regulations.

In June 2009, the Supervisor of Banks issued a circular in the matter of "Reporting by banking corporations and credit card companies in accordance with International Financial Reporting Standards (IFRS)", which determines the expected manner according to which the IFRS will be adopted by banking corporations and credit card companies in Israel.

According to the circular, the targeted date for the reporting by banks and credit card companies in accordance with the IFRS rules, are:

- As regards issues which are not part of the core banking business - as from January 1, 2011. As from this date onwards, banking corporations would be required to update the accounting treatment of these issues on a current basis, in accordance with the transitional provisions prescribed by new international standards to be issued regarding these issues, and in accordance with clarifications to be given by the Supervisor of Banks;
- As regards issues which form part of the core banking business - as from January 1, 2013. It is the intention of the Supervisor of Banks to make a final decision on this matter during of 2011. The final decision will take into consideration the time table that will be provided in the United States and the progress to be made in the convergence process of the international and the US accounting standards boards.

The circular clarifies that following the modification of the rules to international standards, the Supervisor of Banks will maintain his authority to issue binding clarifications as to the manner of implementation of the requirements specified by international standards, as well as prescribe further directives in cases where these are required in view of the requirements of regulatory authorities of developed countries, or regarding issues for which no reference exists in the international standards. In addition, the Supervisor of Banks will maintain his authority to issue disclosure and reporting requirements, instructions regarding internal control over financial reporting and instructions relating to the work of the independent auditors.

Accordingly, until the target dates for the implementation of the IFRS rules, financial statements of banking corporations or of credit card companies shall continue to be prepared according to the directives and guidelines of the Supervisor of Banks.

**Adoption of certain international financial reporting standards (IFRS).** On December 31, 2009, the Supervisor of Banks issued a circular according to which certain international financial reporting standards (IFRS), dealing with the treatment of subjects that are not part of the core banking business, are to be adopted. In addition, a combined version of the public reporting directives was published in July 2010, within the framework of which the directives regarding the adoption of certain international financial reporting standards (IFRS), adopted in accordance with the circular dated December 31, 2009, have been updated, as well as the adoption of an additional group of international financial reporting standards. It should be noted that there are additional international financial reporting standards, addressing issues outside the core banking business, which have not yet been adopted in the public reporting directives. In accordance with the combined version of the directive, international financial reporting standards regarding the following matters have been adopted:

1. IFRS 2, regarding "Share based payment";

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

2. IFRS 3 (2008), regarding "Business combinations";
3. IFRS 5, regarding "Non-current assets held for sale and discontinued operations".
4. IAS 8, regarding "Accounting policies, changes in accounting estimates and errors";
5. IAS 10, regarding "Events subsequent to the reporting period";
6. IAS 16, regarding "Property, plant and equipment";
7. IAS 17, regarding "Leases";
8. IAS 20, regarding "Accounting treatment of government grants and disclosure regarding government assistance";
9. IAS 21, regarding "The effects of changes in foreign exchange rates";
10. IAS 27 (2008), regarding "Consolidated and separate financial statements";
11. IAS 28, regarding "Investment in associates";
12. IAS 29, regarding "Financial reporting in hyperinflationary economies";
13. IAS 31, regarding "Interest in joint transactions";
14. IAS 33, regarding "Earnings per share";
15. IAS 34, regarding "Interim financial reporting";
16. IAS 36, regarding "Impairment of assets";
17. IAS 38, regarding "Intangible assets";
18. IAS 40, regarding "Investment property".

The international financial reporting standards stated above and interpretations of the International Financial Reporting Interpretations Committee (IFRIC) relating thereto, shall be adopted according to the following principles:

In cases where no specific reference exists in the Standards or in interpretations of material issues or where several alternatives exist for treating a material issue, a banking corporation shall act according to specific implementation guidelines determined by the Supervisor of Banks. This approach is intended to provide a higher certainty level in the financial reporting of banking corporations and of credit card companies, while maintaining a high level of consistency in the reports of banking corporations;

In cases where a material issue is not addressed in the international standards or in the implementation directives of the Supervisor, a banking corporation shall treat the matter in accordance with generally accepted accounting principles in U.S. banks that specifically apply to such issues;

In cases where reference exists in an international standard to another international standard that has been adopted by the public reporting instructions, the banking corporation shall act in accordance with the provisions of that other standard and the related guidelines of the Supervisor of Banks;

In cases where reference exists in an international standard to another international standard that has not been adopted by the public reporting instructions, the banking corporation shall act in accordance with the public reporting instructions and in accordance with generally accepted accounting principles in Israel;

In cases where an international standard includes reference to a definition of a term that is defined in the public reporting instructions, then the reference to the definition in the instructions shall replace the original reference.

The principles for the adoption of the international financial reporting standards, as stated in the circular, clarify that any material issue related to financial reporting, and in particular in any place where clarification is required regarding references and standpoints included in the public reporting instructions with respect to the international standards, the matter should be referred to the Supervisor of Banks. Furthermore, in places where the international standard is not materially different from accounting principles previously applied, it is to be considered whether a decision, according to which it is proper to change the accounting treatment due only to the implementation

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

of the international standard, would be justified.

Banking corporations shall implement the international financial reporting standards stated above, as well as the interpretations of IFRIC related to the implementation of these standards, as from January 1, 2011 onwards. Upon the initial implementation of an international financial reporting standard according to the circular, a banking corporation shall act in accordance with the transitional instructions determined in the international financial reporting standard. The above stated includes a retroactive restatement of prior period figures, if this is required by the international financial reporting standard. As from January 1, 2011 onwards, a banking corporation shall currently update the accounting treatment of issues mentioned in the circular in accordance with the effective date and the transitional instructions determined in new international financial reporting standards to be issued with respect to these matters, in accordance with the adoption principles detailed in the circular and in accordance with clarifications of the Supervisor of Banks.

The transitional instructions for adoption of the international financial reporting standards included in the circular, state that upon the implementation of an international financial reporting standard relating to a certain subject, to the extent that according to the transitional instructions of the standard it is required to apply it also with respect to existing transactions, a banking corporation shall consider what is the suitable accounting treatment according to the standard to be applied to all existing transactions that are treated according to this standard. In cases where the banking corporation has reached a conclusion according to which it is appropriate to materially change the accounting treatment applied by it in the past with respect to a certain issue, it should consider thoroughly whether the conditions justifying such a change in accounting treatment do exist, or whether it should treat the change as a correction of an error. In case of doubt or in any event where the treatment decided in the matter is a correction of error, a bank should apply to the Supervisor of Banks for preliminary guidance.

**Reliefs in application.** Due to the fact that the adoption of international financial reporting standards is made in a two-stage process, banking corporations in Israel are not able to adopt international financial reporting standard No.1 (hereinafter - "Standard No.1") on the subject of "The initial adoption of international financial reporting standards", with its attaching reliefs.

The Supervisor of Banks issued clarifications regarding the manner of the initial implementation of a number of standards, as follows: International financial reporting standard No.3 (hereinafter: Standard No.3") with respect to business combinations:

1. Initial implementation of the Standard in the financial statements as of January 1, 2011 - a banking corporation is allowed not to implement retroactively the Standard regarding business combinations and investments in affiliated companies made prior to December 31, 2010. A banking corporation choosing to act as above shall implement the guidelines stated in this respect in Standard No.1.
  2. The treatment of impairment of goodwill, intangible assets and investments in affiliated companies in the financial statements as of December 31, 2010 and in later financial reports - a banking corporation acting in accordance with the relief mentioned in section (1) above, is required, with respect to the financial statements as of December 31, 2010, to perform a documented examination of the impairment as at December 31, 2010, complying with the provisions determined in international accounting standard No. 36 "Impairment of assets" and in international accounting standard No. 28 "Investments in affiliated companies", as the case may be, with respect to the following assets: any goodwill, any intangible asset created as a result of a business combination, if at all, any investment in an affiliated company. The said examination is required even if no indications exist at December 31, 2010, for impairment of the said assets. A loss on impairment found by the said examination will be recognized in the statement of income for the year 2010.
- B. International Financial Reporting Standard No. 28 (hereinafter: "IFRS 28") regarding "Investments in affiliated companies":
- Despite that stated in IFRS 28, a banking corporation, because of practical reasons, is permitted to refrain from making adjustments to the accounting policy in respect of matters relating to the core banking business, applied by a non-financial affiliate, which prepares its financial statements in accordance with international financial reporting standards. Such adjustments being required so that

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

the accounting policy of the affiliated company regarding these matters would be compatible with that of the banking corporation.

A banking corporation acting in accordance with this Section shall disclose this fact. The Supervisor of Banks will reconsider his position on this matter when the financial reporting standards will be adopted in full in the public reporting directives.

- C. International Financial Reporting Standard No. 21 (hereinafter: "IFRS 21") regarding "The effect of changes in foreign currency exchange rates":

The Supervisor of Banks has clarified that a banking corporation may decide to accumulate translation differences in respect of a foreign operation as from date of transition and thereafter.

**Certain aspects in the implementation by the Bank.** The Bank has elected to adopt Standard No.3, using the reliefs determined by the Supervisor of Banks, as stated above, and performed the necessary examinations, as stated in (b) above.

It should be noted that in accordance with the Standard, goodwill acquired in a business combination is to be measured at its cost, less impairment losses. Accordingly, the Bank will discontinue amortizing goodwill acquired prior to the transition date.

**Following is an explanation regarding the effects of adoption of certain IFRS standards, to take effect on January 1, 2011:**

- A. IFRS 3 (2008) "Business combinations" - as stated, the Bank had elected to implement the Standard from now onwards, starting with the financial statements for the period beginning on January 1, 2011. In view of this, no effects are expected as a result of the initial implementation of IFRS 3 (2008). It should be noted that in accordance with the Standard, goodwill acquired in a business combination is to be measured at its cost, less impairment losses. Accordingly, the Bank will discontinue amortizing goodwill acquired prior to the transition date.
- B. IFRS 5, "Non-current assets held for sale and discontinued operations" - Israeli GAAP, as adopted by Directives of the Supervisor of Banks, do not include specific guidelines for the measurement of assets held for sale. According to international standards as adopted by the public reporting directives, non-current assets and realization groups meeting the criteria determined in the Standard, excluding foreclosed assets as defined in the public reporting directives, are to be measured according to the lower of their stated value or their fair value net of selling expenses. In addition, according to the IFRS, no depreciation is included in respect of such assets as from date on which they were classified as held for sale. Implementation of the Standard is from now onwards, starting with the financial statements for period beginning January 1, 2011.
- C. IAS 21, "Effect of changes in foreign currency exchange rates" the negative capital reserve created by translation differences in the amount of NIS 231 million, accumulated until 1994 in respect of the overseas banking extensions, which in the past had been classified as autonomous units, will be recognized on the transition date as part of the retained earnings balance. Starting with that date, foreign currency exchange rate differences in respect of extensions the functional currency of which is other than the Shekel, shall be recognized in the translation differences capital reserve.
- D. Change in the classification of the minority interest - according to the public reporting directives, the minority interest is at present classified under a separate item, between the items "long-term liabilities" and "shareholders' equity". According to the IFRS the minority interest in consolidated subsidiaries is to be classified as a separate component of equity of the Bank. As a result of the said reclassification, shareholders equity of the Bank will increase by the amount of the minority interest. Notwithstanding, it should be clarified that the capital base of the Bank will remain unchanged, as the minority interest is already included therein.

The Bank has completed its preparations for the adoption of the international financial reporting standards adopted in the public reporting directives. The initial implementation of the said standards will be reflected in the interim financial statements as of March 31, 2011.

The Bank believes that the implementation of the standards will have no material effect.

- (2) **Accounting Standard No. 23.** In December 2006, the Israel Accounting Standards Board published Accounting Standard No. 23 - "The accounting treatment of transactions between an entity and the controlling shareholder therein". The Standard replaces the Securities

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(Presentation in the financial statements of transactions between an entity and the controlling shareholder therein) Regulations 1996, which were adopted in the public reporting instructions of the Supervisor of Banks. The Standard states that assets and liabilities being the subject of a transaction between the entity and its controlling shareholders shall be measured at date of the transaction according to their fair value, and the difference between the fair value amount and the consideration determined for the transaction shall be recorded as part of shareholders' equity. Where the difference is a negative amount, it forms a dividend in substance, and therefore reduces the balance of retained earnings. A credit difference forms in substance an investment by the owners and is to be presented as a separate item in shareholders' equity to be designated as "Capital reserve on a transaction between the entity and its controlling shareholders". The Standard discusses three issues relating to transactions between an entity and its controlling shareholders, as follows: (1) the transfer of an asset from the controlling shareholder to the entity or vice versa, transfer of an asset from the entity to the controlling shareholder; (2) assumption of debt of the entity to a third party, in part or in full, by the controlling shareholder, indemnification of the entity by the controlling shareholder in respect of an expense, a waiver of a debt, in part or in full, due by the entity to the controlling shareholder; and (3) loans granted by the entity to the controlling shareholder or granted by the controlling shareholder to the entity. Furthermore, the Standard determines the disclosure that should be included in the financial statements with respect to transactions between the entity and its controlling shareholders during the period.

The Standard applies to transactions between an entity and the controlling shareholder therein subsequent to January 1, 2007, and is also applicable as from the said date to a loan extended to the controlling shareholder or received from the controlling shareholder prior to the said date.

In May 2008, the Supervisor of Banks issued a letter stating that rules applying to banking corporations and credit card companies with respect to the treatment of transactions between an entity and its controlling shareholders are being re-examined. According to this letter, the Supervisor intends to determine that the following rules will apply to transactions between a banking corporation and a credit card company and the controlling shareholders thereof and to transactions between a banking corporation and a corporation under its control: (1) the international financial reporting standards; (2) in the absence of specific reference in the international financial reporting standards, U.S. generally accepted accounting principles applying to banking corporations in the U.S. shall apply, provided that they do not contradict the international financial reporting standards; (3) in the absence of reference in the U.S. generally accepted accounting principles, then the relating part of Standard 23 shall apply, provided that it does not contradict the international financial reporting standards and the U.S. generally accepted accounting principles, as stated above.

As of date of issue of the financial statements, the final directive of the Supervisor of Banks with respect to the adoption of specific principles on this matter and to the manner of their initial implementation has not yet been published.

- (3) **Directive in the matter of "measurement and disclosure of delinquent debts, credit risk and provision for credit losses".** On December 31, 2007, the Supervisor of Banks issued a Directive in the matter of "Measurement and disclosure of impaired debts, credit risk and the provision for credit losses" (hereinafter: "the Original Directive"). The Directive aligns the reporting principles applying to banking corporations in Israel in this matter with those applying to banks in the United states, and among other things, it is based on U.S. accounting principles and on the directives of the bank regulatory authorities in the U.S. as well as on the SEC. The principles on which the directive is based constitute a material change in the present directives - regarding classification of problematic debts and measurement of provisions for credit losses in respect of these debts.

In continuation of the original Directive, the Supervisor of Bank issued on February 18, 2010, an update of the original Directive.

On February 21, 2010, the Supervisor of Banks issued a letter regarding the "reporting of the effect of the Directive for the measurement and disclosure of delinquent debts, credit risk and provision for credit losses". The letter requires that banking corporations and credit card companies report to the Supervisor of Banks certain balance sheet data, on the assumption that the Directive would have been

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

applied at the reporting dates, this within the framework of quarterly reporting as of December 31, 2009, March 31, 2010, June 30, 2010 and September 30, 2010.

On February 18, 2010, amendments to Proper Banking Management Directives were published, following the change in public reporting directives regarding delinquent debts. The principal amendments are:

- The sections in Proper Banking Management Directive No. 325 regarding "Management of credit facilities in current accounts", which relate to the accounting aspects of classifying certain accounts as problematic, and to the recognition of interest income will be cancelled. These matters are to be treated within the framework of the general directive as to the measurement of provisions for credit losses and disclosure regarding problematic debts.
- Reference to risk characteristics of "problematic debts" included in Proper Banking Management Directive No. 315 regarding "Supplemental provision for doubtful debts" has been amended, in line with the definitions and terms included in the instruction for "Measurement and disclosure of delinquent debts, credit risk and provision for credit losses". The risk characteristic has been changed to "credit risk with negative classification and credit risk under special supervision", and under it three types of credit risk have been defined (compared to four prior to the amendment): "credit risk under special supervision", "inferior credit risk" and "delinquent credit risk". Furthermore, the rates of the supplemental provision applying to the various classes of problematic debts have been updated as follows:

Credit risk under special supervision	- 1%
"Inferior" credit risk	- 2%
"Delinquent" credit risk	- 4%

- Proper Banking Management Directive No. 311 regarding "Minimal capital ratio", clarified the mode of computing balance sheet and off-balance sheet risk assets so that they would be stated after deducting accounting write-offs, specific and group provisions and with the addition of a general provision for doubtful debts, included in the tier II capital.

The Bank implements the Directive as from January 1, 2011, in accordance with the transitional instructions and guidelines of the Supervisor of Banks. See below, in Note 1A., in which pro-forma data are brought regarding the effect of the new Directive on principal balance sheet items in the financial statements as of December 31, 2010, had the Directive been implemented at that date. Also detailed in Note 1A., is the accounting policy applied in the preparation of the pro-forma Note.

For details regarding the effect of implementing the Directive (pro-forma), had it been implemented on December 31, 2010, see Note 1A below.

- (4) On December 27, 2010, the Supervisor of Banks published a Directive, according to which the provision for doubtful debts in respect of housing loans payable in monthly or quarterly installments, shall be computed only on the basis of the period in arrears. The provision for doubtful debts in respect of loans which are repayable in monthly or quarterly installments, shall not be computed on the basis of the period in arrears but by alternative means. The Directive will be implemented as from January 1, 2011. Adjustments resulting from the initial implementation of the provisions of the Directive shall be reflected directly in the surplus item of shareholders' equity. The effect of the initial implementation (pro forma) on Discount Mortgage Bank as of December 31, 2010, amounted to NIS 12.3 million.

(5) **Measurement of fair value and fair value alternative**

On December 31, 2009, the Supervisor of Banks published a circular regarding "Measurement of fair value, fair value alternative, and adoption of certain international financial reporting standards (IFRS)" (hereinafter: "the circular"). Among other things, the circular adopts as follows:

- (a) U.S. financial accounting standard 157, regarding "Measurement of fair value" (hereinafter: "FAS 157");
- (b) U.S. financial accounting standard 159, regarding "Fair value alternative for financial assets and liabilities" (hereinafter: "FAS 159");

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### (a) FAS 157 - measurement of fair value

FAS 157 defines fair value and determines a consistent framework for the measurement of fair value by defining techniques for the evaluation of fair value in respect of assets and liabilities, and the determination of a fair value scale and detailed implementation guidelines. Observable inputs reflect information available on the market, received from independent sources, while unobservable inputs reflect the assumptions of the banking corporation. These classes of inputs create a fair value grading as detailed below:

Observable inputs reflect information available on the market, received from independent sources, while unobservable inputs reflect the assumptions of the banking corporation. These classes of inputs create a fair value grading as detailed below:

- Level 1 inputs: quoted prices (non-adjusted) on active markets for identical assets or liabilities;
- Level 2 inputs: quoted prices on active markets for similar assets or liabilities; quoted prices on inactive markets for identical assets or liabilities; prices derived from evaluation models, where all significant inputs are observable in the market or are supported by observable market inputs;
- Level 3 inputs: unobservable inputs for assets or liabilities derived from evaluation models, one or more of their significant inputs are unobservable.

Furthermore, FAS 157 extends the disclosure requirements regarding fair value measurement. Implementation of the provisions of FAS 157 will require termination of the use of a blockage factor in computing fair value as well as replacement of the guidelines of EITF 02-3 "Issues of accounting treatment of derivative contracts held for trading and energy trading contracts and risk management activities", which prohibit the recognition of day one profits and require to determine the fair value of derivative instruments that are not traded on an active market on the basis of the transaction cost. Furthermore, FAS 157 requires the banking corporation to reflect the nonperformance risk in measuring fair value of the debt, including derivatives, which had been issued by it and measured according to fair value. The nonperformance risk shall include the credit risk of the banking corporation, but shall not be limited to that risk only.

FAS 157 shall apply as from January 1, 2011 onwards, and shall be initially adopted in a limited format of retroactive application. In view of this, FAS 157 shall be applied from now onwards, excluding financial instruments that had been measured before the initial application of FAS 157, in the following manner:

- Positions in financial instruments traded on an active market, measurement of the fair value of which has been made using the blockage factor:
- Financial instruments, the fair value of which was measured at date of the initial recognition according to Part 1A to the public reporting directives, using the transaction price, in accordance with the guidelines mentioned in footnote 3 of EITF 02-3;
- Hybrid financial instruments the fair value of which is measured at date of initial recognition in accordance with Part 1A to the public reporting directives.

The Bank believes that the implementation of the standard will not have a material effect.

The new disclosure requirements, including the disclosure required only in annual financial reports, shall be applied as from the first quarter of 2011, with no obligation to apply these disclosure requirements to financial statements for periods presented prior to the initial application of FAS 157.

In order to determine the adjusting amount to be recorded as cumulative effect on the opening balance of retained earnings as of January 1, 2011, and in order to secure compatibility of the evaluation methods of the banking corporation with principles determined in FAS 157, the banking corporation will be required to re-examine the evaluation methods applied by it for the measurement of fair value taking into consideration the relevant circumstances of the different transactions, including prices of the most recent transactions in the market, indicative prices of evaluation agencies and the results of back-testing of similar types of transactions.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The Bank is studying the implications of adoption of the Standard on the financial statements, though at this stage it is unable to assess the expected effect of the initial application of FAS 157.

### **(b) U.S. financial accounting standard 159 - fair value alternative for financial assets and liabilities**

The purpose of FAS 159 is to allow a reduction in volatility of reported earnings resulting from the measurement of hedged assets and liabilities and of hedging derivative instruments, according to different measurement bases.

FAS 159 will allow a banking corporation to choose, at defined selection dates, to measure at fair value financial instruments and other specific items (the eligible items), which in accordance with the public reporting directives, are not required to be measured at fair value. Unrealized gains and losses in respect of changes in fair value of items, in respect of which the fair value alternative has been elected, shall be reported in the income statement at every consecutive reporting date. Furthermore, costs and commission paid in advance, related to items in respect of which the fair value alternative has been chosen, shall be recognized in the income statement as incurred and shall not be deferred. Selection of the application of the fair value alternative, as stated, shall be made instrument-by-instrument and may not be revoked. Furthermore, FAS 159 determines presentation and disclosure requirements intended to facilitate comparison between banking corporations choosing different measurement bases for similar types of assets and liabilities.

Notwithstanding the above, the circular clarifies that a banking corporation shall not select the fair value alternative unless the banking corporation has developed in advance knowledge, systems, procedures and controls at a high level, which would allow it to measure the item at a high level of reliability. Accordingly, a banking corporation shall not select the fair value alternative in respect of any asset that meets the classification of level 2 or level 3 of the fair value scale, or in respect of any liability whatever, unless it had received the prior approval of the Supervisor of Banks.

FAS 159 shall apply as from January 1, 2011 onwards. Retroactive or early adoption of the Standard is not permitted.

The transitional instructions of the Supervisor of Banks relate to the application in respect of eligible items existing at the effective date, as well as to available-for-sale securities and securities held to maturity, as follows:

- Application in respect of eligible items existing at the effective date - a banking corporation is permitted to choose the fair value alternative for eligible items existing at the effective date. In such cases, the stated balances of such eligible items shall be adjusted to fair value, and the effect of the first renewed measurement of fair value shall be recorded as an adjustment in respect of the cumulative effect on the opening balance of retained earnings. Furthermore, a banking corporation choosing the fair value alternative in respect of items existing at the effective date shall include extensive disclosure in the annual financial report and in its first interim financial report for 2011, as required in the circular.
- Available-for-sale securities and securities held to maturity - available-for-sale securities and securities held to maturity, existing at the effective date, are eligible for the fair value alternative at that date. Where the fair value alternative is selected in respect of any security of the said securities held at the effective date, unrealized accumulated gains or losses at that date, shall be included in the adjustment in respect of the cumulative effect, and the said security will be reported as from that date as a trading security. Furthermore, a separate disclosure shall be given regarding the unrealized gains or losses that had been reclassified from other cumulative comprehensive earnings, and regarding the amount of unrealized gains or losses not recognized earlier. Upon the initial application, the selection of the fair value alternative for an existing security held to maturity shall not indicate doubt as to the intention of the banking corporation to hold to maturity other bonds in the future.

The Bank has elected not to apply the Standard at this stage.

## **1. A. EFFECT OF THE DIRECTIVE REGARDING "MEASUREMENT AND DISCLOSURE OF IMPAIRED DEBTS, CREDIT RISK AND PROVISION FOR CREDIT LOSSES" ON CERTAIN BALANCE SHEET ITEMS AS OF DECEMBER 31, 2010 (PRO-FORMA)**

### **A. General**

On February 18, 2010, the Supervisor of Banks published an update of the original Directive dated December 31, 2007, in the matter of "Measurement and disclosure of impaired debts, credit risk and provision for credit losses" and on December 27, 2010, the Supervisor of Banks published an amendment to Proper banking Management Directive No. 314 in the matter of "Treatment of problematic debts" (hereinafter together: "the Directive"), which is to be implemented in financial statements of banking corporations starting on January 1, 2011 and thereafter. On January 18, 2011, the Supervisor of Banks issued a transitional instruction, according to which the banking corporations are required to include in the financial statements for the year 2010 a pro-forma Note with the following information:

- a) The pro-forma effect of the initial adoption of the Directive on January 1, 2011, on principal balance sheet items in the financial statements as of December 31, 2010, had the Directive been initially implemented on December 31, 2010 - see Section C hereunder.
- b) The accounting policy according to which the pro-forma note had been prepared - see Section B hereunder.

Development of the principal parts of the designated information system was completed only in December 2010. The first production of data was made in December 2010 with respect to data as of September 2010, within the framework of the preparation of an initial assessment of the impact of the implementation of the Directive on the Bank for the purpose of reporting to the Supervisor of Banks. Integration of the system was completed in January 2011. Various corrections and improvements in the system were made in February 2011, and it is possible that further improvements will have to be made also in the coming months.

It should be noted in this respect, that the Income Tax Authorities have not yet formed guidelines both as to the type of provisions that would be recognized for tax purposes and as to the date on which these expenses could be claimed tax wise.

Accordingly, the data presented in the pro-forma Note are based also on assessments and discretion regarding certain issues, which in Management's opinion were required for the preparation of this Note, on the basis of information at hand at the time.

Management believes that the data included in the pro-forma Note reflect fairly the information that should be presented in this Note. Notwithstanding, in view of the above, the data that will be actually developed upon the initial implementation of the Directive as of January 1, 2011, and included in the interim financial statements of the Bank as of March 31, 2011, to be published towards the end of May 2011, may be different from that presented in the pro-forma Note below.

It should also be noted that the principles forming the basis of the new Directive constitute a far reaching change in relation to the existing instructions in the matter of classification of problematic debts and measurement of provisions for credit losses in respect of these debts, requiring the Bank's Management, among other things, to form a methodology regarding certain issues, while using assumptions, assessments and discretion. In future, following the study and analysis of the information produced over a period of time, concurrently with the completion of the integration and software modification processes, certain changes may have to be made to the said methodology, assumptions and assessments.

### **B. Principle pro-forma accounting policy**

Following are details regarding the principal accounting policies in respect of certain matters included in the Directive, to be implemented by the Bank in financial statements for the period beginning January 1, 2011 and thereafter, and which were used, as the case may be, in the preparation of the pro-forma Note.

The provision required to cover anticipated credit losses is to be computed based on one of the following: "provision on a group basis " or " provision on a specific basis ".

#### **(1) Debts, the provision for credit losses in respect of which is examined on a group basis**

The provision for credit losses in respect of small and homogeneous debts is assessed on a group basis. The population of these debts includes all housing loans, the provision for credit losses in respect of whom is computed on the basis of the period in arrears, as well

## **1. A. EFFECT OF THE DIRECTIVE REGARDING "MEASUREMENT AND DISCLOSURE OF IMPAIRED DEBTS, CREDIT RISK AND PROVISION FOR CREDIT LOSSES" ON CERTAIN BALANCE SHEET ITEMS AS OF DECEMBER 31, 2010 (PRO-FORMA) (CONTINUED)**

as other debts whose contractual debt balance is lower than NIS 1 million (in a consolidated subsidiary - lower than NIS 50 thousand). Furthermore, provision on a group basis will also be computed with regards to debts the provision for credit losses in respect of which was examined on a specific basis (see below) and which have not been classified as "impaired".

### **(2) Debts, the provision for credit losses in respect of which is examined on a specific basis**

These include debts the contractual outstanding balance thereof exceeds NIS 1 million (in a consolidated subsidiary - exceeding NIS 50 thousand; in a consolidated credit card company, in respect of credit card debts of over NIS 500 thousand and credit granted to trading houses of any amount), excluding housing loans the provision for credit losses in respect of which is computed on the basis of the period in arrears, and including restructured troubled debts.

### **(3) Impaired debts**

#### **- Classification**

Debts classified as "impaired" include the following classes of problematic debts:

- All restructured troubled debts.
- Debts examined on a specific basis: debts the period in arrears in their respect exceeds ninety days (excluding "well secured" debts that are "in the process of collection" - as defined in the Directive), debts where no credit entries in an amount that is not below their average outstanding debt balance, have been recorded in their related current account within a certain period of 240 days, debts constantly exceeding their approved credit facility during a period exceeding ninety days, as well as debts under legal proceedings (including stay of proceedings, receivership and bankruptcy).
- Any other debt, examined on a specific basis, and where the Bank believes that it may not be possible to collect all amounts due in accordance with its contractual terms.

#### **- Interest accrual**

The principles applied by the Bank in the matter of interest accrual in respect of "impaired" debts, include:

- Discontinuation of interest income accrual in respect of "impaired" debts, starting with the date of their classification as "impaired";
- The outstanding balance of accrued interest on an "impaired" debt until the beginning of the period in which it has been classified as "impaired" not collected by the date of its being classified as such is written off accounting wise;
- Notwithstanding the above, the Bank will continue to accrue interest in respect of restructured troubled debts, where the debt is being repaid according to the terms of the arrangement and expectations for the repayment of the loan are supported by a well based credit evaluation;
- In a consolidated credit card company - the discontinuation of accrual of interest as from arrears of ninety days and over, in respect of all types of credit.

### **(4) Writing-off of debts that had been examined on a specific basis and classified as impaired**

In accordance with guidelines included in the Directive, the Bank distinguishes between two types of accounting write offs, as follows:

#### **- Writing off of debts classified as impaired**

Debts examined on a specific basis and classified as impaired and which are considered uncollectible or having a very low value, leaving them as an asset would be unjustified, or would require long-term efforts, are to be written off accounting wise. Principles for the writing off of impaired debts have been determined in this respect, according to the following characteristics:

- Impaired debt the collection of which is "collateral dependent" - the part of the debt exceeding the optimistic assessment of the fair value of the collateral is to be written off accounting wise.

## **1. A. EFFECT OF THE DIRECTIVE REGARDING "MEASUREMENT AND DISCLOSURE OF IMPAIRED DEBTS, CREDIT RISK AND PROVISION FOR CREDIT LOSSES" ON CERTAIN BALANCE SHEET ITEMS AS OF DECEMBER 31, 2010 (PRO-FORMA) (CONTINUED)**

- A restructured troubled debt - the amount of the "conditional waiver" included in the debt arrangement is to be written off.
- Other impaired debts - the balance of the debt exceeding the amount expected to be received from the debtor shall be written off accounting wise, unless the Bank has evidence of additional collections expected from the borrower and on condition that certainty exists as to the loss to be sustained by the Bank. As a general rule, an accounting write off in respect of uncertainty as to the amount of loss to be sustained by the Bank, shall not be deferred for over two years since the date on which the debt had been classified as impaired.
- **Writing off of debts, the provision for credit losses in respect of which is examined on a group basis**  
The writing off of such debts is made on the basis of the following principles and debt characteristics:
  - Debts which are not collateralized by house mortgage - the amount exceeding financial collateral shall be written off after 150 days since the beginning of the default.
  - Debt collateralized by a house mortgage - the amount of the debt exceeding the fair value of the housing property shall be written off after 180 days since the beginning of the default.
  - Debts of individuals or corporations in bankruptcy or receivership - the part of the debt in excess of the value of the collateral received by the Bank is to be written off after sixty days since the date of the receivership order or of the liquidation order, as the case may be, on condition that collection of the collateral amount is expected.
  - Debts fraudulently created - the part of the debt in excess of the value of the collateral obtained by the Bank is to be written off accounting wise at the end of ninety days since the beginning of the default, on condition that foreclosure of the collateral had begun and is assured, no later than the end of ninety days since the beginning of the arrears period.

### **(5) Provisions for credit losses**

The provision for credit losses reflects the assessment of the Bank regarding credit losses inherent in its asset portfolio. In accordance with guidelines determined by the Directive, the principles for measurement of the provisions and of credit losses are divided into two groups, as follows:

- **Debts, the provision for credit losses in respect of which are assessed on a specific basis**

Provisions for credit losses in respect of these debts computed on the basis of appropriate documentation, by one of the following methods:

- In respect of collateral dependent impaired debts - the provision for credit losses comprises the difference between the recorded amount of the impaired debt and the fair value of the collateral, net, after realization expenses.
- In respect of other impaired debts - the balance of provision for credit losses comprises the difference between the recorded amount of the impaired debt and the expected payments by the borrower, discounted on the basis of the original effective interest rate of the impaired debt, over and above amounts written off accounting wise, as stated above.
- **Debts, the provision for credit losses in respect of which are assessed on a group basis**

The provision for credit losses on a group basis is computed according to the following principles:

- Debts to which the provisional directive of the Bank of Israel, published on February 18, 2010, applies:  
The provisional directive applies to all credit instruments at the Bank, excluding debts examined on a specific basis and classified as impaired and housing loans, the provisions for loan losses in respect of which are computed by the period in arrears method. According to the provisional directive, the group provision is computed in respect of such debts by multiplying the recorded amount of credit to which the directive applies (segmentized according to economic sectors), by the "coefficient for credit loss provisions", for each of the said economic sectors, differentiating between "commercial criticized credit" (including commercial

## **1. A. EFFECT OF THE DIRECTIVE REGARDING "MEASUREMENT AND DISCLOSURE OF IMPAIRED DEBTS, CREDIT RISK AND PROVISION FOR CREDIT LOSSES" ON CERTAIN BALANCE SHEET ITEMS AS OF DECEMBER 31, 2010 (PRO-FORMA) (CONTINUED)**

criticized exposure examined on a specific basis), "credit to private individuals which is impaired or in default for over ninety days", and other credit granted to the public, including credit examined on a specific basis and found in order.

In accordance with the provisional directive, the Bank has fixed a "coefficient for credit loss provisions" for each of the economic sectors and for each of the sub-groups, as stated above, based on the "provisions range" (computed on the basis of balances and provisions in each economic sector, as actually reported by the Bank in the years 2008-2010). The Bank believes that the "coefficients for credit loss provision" determined for the purpose of evaluating the provision for credit losses on a group basis, as stated, comprise the best available assessment (within the "provision range"), with respect to the rate of unidentified losses inherent in the credit portfolio, for each of the groups mentioned above.

- Housing loans, the provision in respect of which is computed by the period in arrears method:

The provisions for credit losses in respect of these loans are computed on the basis of the rates determined in Proper Banking Management Directive No. 314, derived from the period in arrears of each of the loans.

- Off-balance sheet credit instruments (not classified as impaired):

The provisions for credit losses in respect of such credit risk are computed by multiplying the recorded amount of the off-balance sheet credit risk in each economic sector, by the "coefficient for credit loss provision", in accordance with the methodology described above in relation to the balance sheet credit risk, after conversion of the off-balance sheet credit risk into "credit equivalent", in accordance with the CCF coefficients, determined on the basis of past experience and in the absence of past data - according to the rules determined in Proper Banking Management Directive No. 203.

- Other debt instruments - the provisions for credit losses in respect of other debt instruments are computed by multiplying the recorded amount of the debt instrument, by the "provision coefficient", based on the credit rating of the debt instrument.

In accordance with the provisional directive, the total group provision shall not fall below the outstanding amount of the general, supplemental and special provisions, as computed according to Proper Banking Management Directive No. 315, gross before tax ("grossed-up" amount).

### **(6) Comprehensive reasonableness examination**

According to the Directive an examination is required of the overall appropriateness of the provision for credit losses.

### **(7) The accounting treatment at date of initial implementation**

The Directive will be initially applied for periods beginning January 1, 2011 and thereafter. The Directive will not be applied retroactively in the financial statements for prior periods.

At date of the initial application, the Bank shall, among other things:

- Write off accounting wise any debt which at that date is eligible for accounting write-off;
- Classify under special mention, substandard or impaired any debt that matches the conditions for such classification. In this respect, it is clarified that despite the definition stating that a restructured troubled debt is an impaired debt, the Bank will not classify as impaired a debt that had been restructured prior to January 1, 2007, so long as the debt is not impaired under the terms of the restructuring agreement;
- Reverse all accumulated interest income that has not been collected in respect of any debt which at this date matches the related terms;
- Adjust the balance of the provision for credit losses in respect of credit granted to the public and in respect of off-balance sheet credit instruments as of January 1, 2011, to the requirements of the Directive. The said adjustments will be recognized directly in the retained earnings item of shareholders equity, net after tax effect;
- Examine the need for adjustment of the current taxes balance and of deferred tax assets and liabilities as of January 1, 2011;

## 1. A. EFFECT OF THE DIRECTIVE REGARDING "MEASUREMENT AND DISCLOSURE OF IMPAIRED DEBTS, CREDIT RISK AND PROVISION FOR CREDIT LOSSES" ON CERTAIN BALANCE SHEET ITEMS AS OF DECEMBER 31, 2010 (PRO-FORMA) (CONTINUED)

### C. Pro-forma data as of December 31, 2010

The following pro-forma data detail the effect of the initial implementation of the Directive on certain balance sheet items and on the outstanding balance of problematic debts as of December 31, 2010, had the Directive been implemented on that date.

It should be mentioned, that a U.S. consolidated subsidiary is implementing the rules of FAS 114 for quite some time, and therefore no adjustment in its respect was required upon the initial implementation of the Directive.

## 2. CASH AND DEPOSITS WITH BANKS

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
	in NIS millions			
Cash and deposits with central banks	13,787	18,964	12,018	15,123
Deposits with commercial banks	4,185	*5,338	3,126	*3,565
Deposits with specialized banking institutions	215	*281	14,473	*12,846
<b>Total cash and deposits with banks</b>	<b>18,187</b>	<b>24,583</b>	<b>29,617</b>	<b>31,534</b>
Includes cash, deposits with banks and deposits with central banks for an initial period of up to three months	16,042	23,452	14,080	17,222

\* Reclassified.

### 3. SECURITIES<sup>(1)</sup> - CONSOLIDATED

#### A. COMPOSITION OF THIS ITEM

December 31, 2010					
	Book value	Amortized cost	Unrecognized gains from adjustment to fair value	Unrecognized losses from adjustment to fair value	Fair value <sup>(2)</sup>
In NIS millions					
<b>(1) Held-to-maturity bonds:</b>					
Bonds and bills:					
Government	4,785	4,785	76	16	4,845
Government Sponsored Enterprises (GSE) Agencies	1,654	1,654	8	45	1,617
Others	313	313	10	-	323
<b>Total held-to-maturity bonds and bills</b>	<b>6,752</b>	<b>6,752</b>	<b>94</b>	<b>61</b>	<b>6,785</b>
<b>(2) Available for sale securities:</b>					
Bonds and bills:					
Government	17,430	17,265	206	41	17,430
Government Sponsored Enterprises (GSE) Agencies	6,751	6,623	140	12	6,751
Others	3,369	3,552	55	238	3,369
Total bonds and bills	27,550	27,440	401	291	<sup>(3)</sup> 27,550
Shares:					
Fund of Hedge Funds	7	<sup>(7)</sup> 7	-	-	7
Others	674	658	16	-	674
Total shares	681	665	16	-	<sup>(5)</sup> 681
<b>Total available-for-sale securities</b>	<b>28,231</b>	<b>28,105</b>	<b><sup>(4)</sup>417</b>	<b><sup>(4)</sup>291</b>	<b>28,231</b>

For footnotes see next page.

**3. SECURITIES<sup>(1)</sup> - CONSOLIDATED (CONTINUED)****A. COMPOSITION OF THIS ITEM (CONTINUED)**

December 31, 2010					
	Book value	Amortized cost (for shares - cost)	Unrealized gains from adjustment to fair value	Unrealized losses from adjustment to fair value	Fair value <sup>(2)</sup>
In NIS millions					
<b>(3) Trading Securities:</b>					
Bonds and bills:					
Government	2,063	2,064	3	4	2,063
Government Sponsored Enterprises (GSE) Agencies	18	18	-	-	18
Others	100	105	1	6	100
<b>Total bonds and bills</b>	<b>2,181</b>	<b>2,187</b>	<b>4</b>	<b>10</b>	<b>2,181</b>
Shares:					
Others	12	12	5	5	12
<b>Total trading securities</b>	<b>2,193</b>	<b>2,199</b>	<b>(6)9</b>	<b>(6)15</b>	<b>2,193</b>
<b>Total securities</b>	<b>37,176</b>	<b>37,056</b>	<b>520</b>	<b>367</b>	<b>37,209</b>

General footnotes: See Note 23 E for details of results from bond investment activity. For results of investment activity in shares, see Note 25. Footnotes:

(1) See Note 15 for pledges.

(2) Fair value data are generally based on market quotations, which do not necessarily reflect the price which may be received when securities are sold in large quantities.

(3) Including securities sold under repurchase terms by a foreign consolidated subsidiary amounting to NIS 7,227 million (US \$2,036 million).

(4) Included in shareholders' equity in the item "Adjustments for presentation of available-for-sale securities at fair value".

(5) Including shares, the fair value of which is not readily available, stated at cost of NIS 626 million.

(6) Recorded in the statement of income.

(7) The balance of the investment at December 31, 2010 is net of impairment considered not to be temporary in nature in the amount of NIS 61 million, and net of redemption of part of the fund's units. Subsequent to balance sheet date, the fund redeemed further units in the total amount of NIS 6 million.

December 31, 2009					
	Book value	Amortized cost	Unrecognized gains from adjustment to fair value	Unrecognized losses from adjustment to fair value	Fair value <sup>(2)</sup>
In NIS millions					
<b>(1) Held-to-maturity bonds:</b>					
Bonds and bills:					
Government	1,561	1,561	49	1	1,609
Government Sponsored Enterprises (GSE) Agencies	20	20	1	-	21
Others	408	408	2	26	384
<b>Total held-to-maturity bonds and bills</b>	<b>1,989</b>	<b>1,989</b>	<b>52</b>	<b>27</b>	<b>2,014</b>

For footnotes see next page.

### 3. SECURITIES<sup>(1)</sup> - CONSOLIDATED (CONTINUED)

#### A. COMPOSITION OF THIS ITEM (CONTINUED)

	Book value	Amortized cost (for shares - cost)	Cumulative other comprehensive income		Fair value <sup>(2)</sup>
			Profits	Losses	
<b>(2) Available for sale securities:</b>					
Bonds and bills:					
Government	18,937	18,768	213	44	18,937
Government Sponsored Enterprises (GSE) Agencies	9,204	8,985	238	19	9,204
Others	3,350	3,698	33	381	3,350
<b>Total bonds and bills</b>	<b>31,491</b>	<b>31,451</b>	<b>484</b>	<b>444</b>	<b><sup>(3)</sup>31,491</b>
Shares:					
Fund of Hedge Funds	44	<sup>(7)</sup> 44	-	-	44
Others	659	656	3	-	659
<b>Total shares</b>	<b>703</b>	<b>700</b>	<b>3</b>	<b>-</b>	<b><sup>(5)</sup>703</b>
<b>Total available-for-sale securities</b>	<b>32,194</b>	<b>32,151</b>	<b><sup>(4)</sup>487</b>	<b><sup>(4)</sup>444</b>	<b>32,194</b>

December 31, 2009

	Book value	Amortized cost (for shares - cost)	Unrealized gains from adjustment to fair value	Unrealized losses from adjustment to fair value	Fair value <sup>(2)</sup>
In NIS millions					

#### (3) Trading Securities:

Bonds and bills:					
Government	2,033	1,994	41	2	2,033
Government Sponsored Enterprises (GSE) Agencies	5	5	-	-	5
Others	107	111	2	6	107
<b>Total bonds and bills</b>	<b>2,145</b>	<b>2,110</b>	<b>43</b>	<b>8</b>	<b>2,145</b>
Shares:					
Others	10	16	1	7	10
<b>Total trading securities</b>	<b>2,155</b>	<b>2,126</b>	<b><sup>(6)</sup>44</b>	<b><sup>(6)</sup>15</b>	<b>2,155</b>
<b>Total securities</b>	<b>36,338</b>	<b>36,266</b>	<b>583</b>	<b>486</b>	<b>36,363</b>

General footnotes: See Note 23 E for details of results from bond investment activity. For results of investment activity in shares, see Note 25. Footnotes:

- (1) See Note 15 for pledges.
- (2) Fair value data are generally based on market quotations, which do not necessarily reflect the price which may be received when securities are sold in large quantities.
- (3) Including securities sold under repurchase terms by a foreign consolidated subsidiary amounting to NIS 7,651 million (US \$2,027 million).
- (4) Included in shareholders' equity in the item "Adjustments for presentation of available-for-sale securities at fair value".
- (5) Including shares and bonds, the fair value of which is not readily available, stated at cost of NIS 650 million.
- (6) Recorded in the statement of income.
- (7) The balance of the investment at December 31, 2009 is net of impairment considered not to be temporary in the amount of NIS 47 million, and net of redemption of part of the fund's units.

**3. SECURITIES<sup>(1)</sup> - THE BANK (CONTINUED)****B. COMPOSITION OF THIS ITEM**

December 31, 2010					
	Book value	Net adjusted cost	Unrealized gains from adjustment to fair value	Unrealized losses from adjustment to fair value	Fair value <sup>(2)</sup>
In NIS millions					
<b>(1) Held-to-maturity bonds:</b>					
Bonds and bills:					
Government	2,265	2,265	39	-	2,304
<b>Total held-to-maturity bonds</b>	<b>2,265</b>	<b>2,265</b>	<b>39</b>	<b>-</b>	<b>2,304</b>
<b>(2) Available for sale securities:</b>					
Bonds and bills:					
Government	10,358	10,238	147	27	10,358
Others	723	723	17	17	723
Total	11,081	10,961	164	44	11,081
Shares:					
Fund of Hedge Funds	7	<sup>(6)</sup> 7	-	-	7
Others	9	6	3	-	9
Total shares	16	13	3	-	<sup>(4)</sup> 16
<b>Total available-for-sale securities</b>	<b>11,097</b>	<b>10,974</b>	<sup>(3)</sup> <b>167</b>	<sup>(3)</sup> <b>44</b>	<b>11,097</b>

For footnotes see next page.

### 3. SECURITIES<sup>(1)</sup> - THE BANK (CONTINUED)

#### B. COMPOSITION OF THIS ITEM (CONTINUED)

December 31, 2010					
	Book value	Net adjusted cost (for shares - cost)	Non-realized gains from adjustment to fair value	Non-realized losses from adjustment to fair value	Fair value <sup>(2)</sup>
In NIS millions					
<b>(3) Trading Securities:</b>					
Bonds and bills:					
Government	1,973	1,974	3	4	1,973
Others	3	5	-	2	3
<b>Total</b>	<b>1,976</b>	<b>1,979</b>	<b>3</b>	<b>6</b>	<b>1,976</b>
Shares:					
Others	7	4	5	2	7
<b>Total trading securities</b>	<b>1,983</b>	<b>1,983</b>	<b>(5)8</b>	<b>(5)8</b>	<b>1,983</b>
<b>Total securities</b>	<b>15,345</b>	<b>15,222</b>	<b>214</b>	<b>52</b>	<b>15,384</b>

General footnote: See Note 23 E for details of results of bond investment activity. For results of investments in shares, see Note 25.

Footnotes:

(1) See Note 15 for pledges.

(2) Fair value data are generally based on market quotations, which do not necessarily reflect the price which may be received when securities are sold in large quantities.

(3) Included in shareholders' equity in the item "Adjustments for presentation of available-for-sale securities at fair value".

(4) Including shares and bonds, the fair value of which is not readily available, stated at cost of NIS 8 million.

(5) Recorded in the statement of income.

(6) The balance of the investment at December 31, 2010 is net of impairment considered not to be temporary in nature in the amount of NIS 61 million, and net of redemption of part of the fund's units. Subsequent to balance sheet date, the fund redeemed further units in the total amount of NIS 6 million.

**3. SECURITIES<sup>(1)</sup> - THE BANK (CONTINUED)****B. COMPOSITION OF THIS ITEM (CONTINUED)**

December 31, 2009					
	Book value	Net adjusted cost (for shares - cost)	Cumulative other comprehensive income		Fair value <sup>(2)</sup>
			Profits	Losses	
In NIS millions					
<b>(1) Available for sale securities:</b>					
Bonds and bills:					
Government	9,841	9,693	156	8	9,841
Others	1,573	1,609	13	49	1,573
<b>Total</b>	<b>11,414</b>	<b>11,302</b>	<b>169</b>	<b>57</b>	<b>11,414</b>
Shares:					
Fund of Hedge Funds	44	<sup>(6)</sup> 44	-	-	44
Others	12	12	-	-	12
<b>Total shares</b>	<b>56</b>	<b>56</b>	<b>-</b>	<b>-</b>	<b><sup>(4)</sup>56</b>
<b>Total available-for-sale securities</b>	<b>11,470</b>	<b>11,358</b>	<b><sup>(3)</sup>169</b>	<b><sup>(3)</sup>57</b>	<b>11,470</b>

	Book value	Net adjusted cost (for shares - cost)	Non-realized gains from adjustment to fair value	Non-realized losses from adjustment to fair value	Fair value <sup>(2)</sup>
<b>(2) Trading Securities:</b>					
Bonds and bills:					
Government	1,974	1,935	41	2	1,974
Others	5	8	-	3	5
<b>Total</b>	<b>1,979</b>	<b>1,943</b>	<b>41</b>	<b>5</b>	<b>1,979</b>
Shares:					
Others	2	4	-	2	2
<b>Total trading securities</b>	<b>1,981</b>	<b>1,947</b>	<b><sup>(5)</sup>41</b>	<b><sup>(5)</sup>7</b>	<b>1,981</b>
<b>Total securities</b>	<b>13,451</b>	<b>13,305</b>	<b>210</b>	<b>64</b>	<b>13,451</b>

General footnote: See Note 23 E for details of results of bond investment activity. For results of investments in shares, see Note 25.

Footnotes:

- (1) See Note 15 for pledges.
- (2) Fair value data are generally based on market quotations, which do not necessarily reflect the price which may be received when securities are sold in large quantities.
- (3) Included in shareholders' equity in the item "Adjustments for presentation of available-for-sale securities at fair value".
- (4) Including shares and bonds, the fair value of which is not readily available, stated at cost of NIS 52 million.
- (5) Recorded in the statement of income.
- (6) The balance of the investment at December 31, 2009 is net of impairment considered to be other than temporary in nature in the amount of NIS 47 million, and net of redemption of apart of the units of the fund.

**C. Transfer of bonds from the available-for-sale portfolio to the held-to-maturity portfolio.** Due to the significant change in the treatment of available-for-sale bonds when computing the ratio of capital to risk assets (in Basel II terms), the Supervisor of Banks informed that he would allow banking corporations the one off transfer on March 31, 2010, of bonds from the available-for-sale portfolio to the held-to-

### 3. SECURITIES<sup>(1)</sup> - THE BANK (CONTINUED)

maturity portfolio, subject to the terms determined by him. In accordance with that stated above, the Bank and IDB New York transferred on March 31, 2010, bonds from the available-for-sale portfolio to the held to maturity portfolio, as follows:

- The Bank transferred government bonds of a par value of NIS 1 billion, the stated value and fair value of which at transfer date amounted to NIS 1.473 billion;
- IDB New York transferred mortgage backed securities and securities of federal agencies and trading mortgage backed securities, the fair value and the stated value of which amounted on date of transfer to US\$568 million and US\$566 million, respectively (approx. NIS 2.1 billion).

The capital reserve in respect of adjustments of stating available-for-sale securities at fair value, relating to the securities transferred as above, amounted to NIS 30 million at December 31, 2010, and will remain part of equity as other comprehensive profit and will be amortized over the life of the bonds.

**D.** In the first quarter of 2011, IDB New York, sold, out of the "held to maturity" portfolio, securities the amount of which at December 31, 2010 was US\$42 million (NIS 149 million). The said securities were of the non-U.S. Government agencies RMBS type, which upon purchase thereof had been classified to the "held to maturity" portfolio, the quality of credit in respect of which has significantly declined. The loss on the sale was recognized in the financial statements for 2010.

#### **E. Further details regarding mortgage and asset backed securities, on a consolidated basis**

The Bank's securities portfolio as of December 31, 2010, includes investments in asset backed securities, primarily investment in mortgage backed securities (MBS) which are held for the most part by IDB New York.

**Mortgage-backed Securities - MBS.** A type of asset-backed security (ABS) that is secured by a mortgage or a pool of mortgages, in respect of which periodic payments of principal and interest are paid.

These securities are also referred to as mortgage related or mortgage pass-through securities.

In accordance with the IDB NY Treasury Management and Asset-Liability Policy, investments in MBSs, excluding GNMA's, are limited to 75% of the total investment portfolio. The market risk of these securities is evaluated prior to purchase to determine their suitability for inclusion in the portfolio. Moreover, certain high risk tranches, are not allowable.

**Mortgage Pass - Through.** A security issued by a financial institution which constitutes holdings of a proportionate share of the mortgage loan portfolio of private borrowers. Where the issue is executed by Ginnie Mae, a US Government guarantee is in effect. When the issue is performed by Fannie Mae or Freddie Mac, Government Sponsored Enterprises (hereinafter: "GSE"), the issuer provides guarantee for any loss on the loan portfolio backing the bond. Where the issue is performed by other financial institutions, the security is backed by the mortgages alone. The large issuers of securitized assets are the GSE's who have a high credit rating. The GSE's are sponsored by the U.S. Government and are supervised by it. There is, however, no explicit guarantee on the part of the U.S. Government to the GSE's.

Mortgage loans, grant the private borrower the right of early repayment at any given time.

As a result, the investor's have interest exposure (early repayment), as well as exposure to the condition in the real estate market and the economy in general.

**Collateralized Mortgage Obligation - CMO.** A type of structured bond, backed by a portfolio of mortgage loans of private borrowers in the United States. The CMO is divided into tranches. Each tranche represents a bond security entitled to receive interest and repayment of principal before or after other bonds in the CMO, so that each bond reflects a different maturity period and interest risk.

Where the CMO is issued by the internal control layout over financial reporting at ICC as of December 31, 2010, has been audited by the independent auditors and found to be effective, the issuer provides guarantee for any loss on the loan portfolio backing the bond. Where the CMO is issued by other financial institutions, the bond is backed by the mortgages alone and preference is given to bonds high rated in respect of payments of principal and interest over the other tranches given a lower rating.

**3. SECURITIES - CONSOLIDATED (CONTINUED)****F. ADDITIONAL DETAILS (CONSOLIDATED) REGARDING MORTGAGE AND ASSET BACKED SECURITIES**

	December 31, 2010			
	Other cumulative income <sup>(1)</sup>			
	Amortized cost	Unrecognized gain from adjustment to fair value	Unrecognized losses from adjustment to fair value	Fair value
	In NIS millions			
<b>1. Mortgage-backed securities (MBS):</b>				
Available-for-sale trading securities:				
A. Mortgage pass-through securities:				
Securities guaranteed by GNMA	100	5	-	105
Securities issued by FHLMC and FNMA	2,623	93	3	2,713
<b>Total mortgage-backed pass-through securities</b>	<b>2,723</b>	<b>98</b>	<b>3</b>	<b>2,818</b>
B. Other mortgage-backed securities (including CMO, REMIC and STRIPPED MBS):				
Securities issued or guaranteed by FHLMC, FNMA and GNMA	6,092	76	14	6,154
Other mortgage-backed securities	2	-	-	2
<b>Total mortgage-backed other MBS securities</b>	<b>6,094</b>	<b>76</b>	<b>14</b>	<b>6,156</b>
<b>Total available-for-sale MBS securities</b>	<b>8,817</b>	<b>174</b>	<b>17</b>	<b>8,974</b>
Held-to-maturity securities:				
A. Mortgage pass-through securities:				
Securities guaranteed by GNMA	110	2	-	112
Securities issued by FHLMC and FNMA	128	3	-	131
<b>Total mortgage-backed pass-through securities</b>	<b>238</b>	<b>5</b>	<b>-</b>	<b>243</b>
B. Other mortgage-backed securities (including CMO, REMIC and STRIPPED MBS):				
Securities issued or guaranteed by FHLMC, FNMA and GNMA	1,425	16	1	1,440
Other mortgage-backed securities	218	8	-	226
<b>Total mortgage-backed other MBS securities</b>	<b>1,643</b>	<b>24</b>	<b>1</b>	<b>1,666</b>
<b>Total held-to-maturity MBS securities</b>	<b>1,881</b>	<b>29</b>	<b>1</b>	<b>1,909</b>
Securities for sale:				
A. Mortgage pass-through securities:				
Securities issued by FHLMC and FNMA	4	-	-	4
B. Other mortgage-backed securities (including CMO, REMIC and STRIPPED MBS):				
Securities issued by FHLMC and FNMA	39	-	-	39
<b>Total securities for sale MBS securities</b>	<b>43</b>	<b>-</b>	<b>-</b>	<b>43</b>
<b>Total mortgage-backed securities (MBS)</b>	<b>10,741</b>	<b>203</b>	<b>18</b>	<b>10,926</b>
<b>2. Asset-backed available-for-sale securities (ABS):</b>				
Credit financing the purchase of motor vehicles	2	-	-	2
Securitized Loan Portfolio (CDO)	12	-	-	12
<b>Total asset-backed available-for-sale securities (ABS)</b>	<b>14</b>	<b>-</b>	<b>-</b>	<b>14</b>
<b>Total mortgage and asset-backed securities</b>	<b>10,755</b>	<b>203</b>	<b>18</b>	<b>10,940</b>

Footnote:

(1) Total other cumulative income - for available for sale securities.

### 3. SECURITIES - CONSOLIDATED (CONTINUED)

#### F. ADDITIONAL DETAILS (CONSOLIDATED) REGARDING MORTGAGE AND ASSET BACKED SECURITIES (CONTINUED)

	December 31, 2009			
	Other cumulative income <sup>(1)</sup>			
	Amortized cost	Unrecognized gain from adjustment to fair value	Unrecognized losses from adjustment to fair value	Fair value
In NIS millions				
<b>1. Mortgage-backed securities (MBS):</b>				
Available-for-sale trading securities:				
A. Mortgage pass-through securities:				
Securities guaranteed by GNMA	282	6	1	287
Securities issued by FHLMC and FNMA	4,684	158	2	4,840
<b>Total mortgage-backed pass-through securities</b>	<b>4,966</b>	<b>164</b>	<b>3</b>	<b>5,127</b>
B. Other mortgage-backed securities (including CMO, REMIC and STRIPPED MBS):				
Securities issued or guaranteed by FNMA and FHLMC or GNMA	8,217	95	35	8,277
Other mortgage-backed securities	84	-	10	74
<b>Total available-for-sale other MBS securities</b>	<b>8,301</b>	<b>95</b>	<b>45</b>	<b>8,351</b>
<b>Total available-for-sale MBS securities</b>	<b>13,267</b>	<b>259</b>	<b>48</b>	<b>13,478</b>
Held-to-maturity securities:				
A. Mortgage pass-through securities:				
Securities issued by FHLMC and FNMA	10	1	-	11
B. Other mortgage-backed securities (including CMO, REMIC and STRIPPED MBS):				
Other mortgage backed securities	251	-	26	225
<b>Total held-to-maturity MBS securities</b>	<b>261</b>	<b>1</b>	<b>26</b>	<b>236</b>
Securities for sale:				
Mortgage pass-through securities:				
Securities issued by FHLMC and FNMA	5	-	-	5
<b>Total securities for sale MBS securities</b>	<b>5</b>	<b>-</b>	<b>-</b>	<b>5</b>
<b>Total mortgage-backed securities (MBS)</b>	<b>13,533</b>	<b>260</b>	<b>74</b>	<b>13,719</b>
<b>2. Asset backed available-for-sale securities (ABS):</b>				
Credit financing the purchase of motor vehicles	4	-	-	4
Credit to other than private individuals	1	-	-	1
Securitized Loan Portfolio (CDO)	*19	-	*1	*18
<b>Total asset-backed available-for-sale securities (ABS)</b>	<b>24</b>	<b>-</b>	<b>1</b>	<b>23</b>
<b>Total mortgage and asset-backed securities</b>	<b>13,557</b>	<b>260</b>	<b>75</b>	<b>13,742</b>

\* Reclassified.

Footnote:

(1) Total other cumulative income - for available for sale securities.

**3. SECURITIES - CONSOLIDATED (CONTINUED)****G. ADDITIONAL DETAILS (CONSOLIDATED) REGARDING MORTGAGE AND ASSET-BACKED SECURITIES**

Additional details regarding mortgage and asset-backed securities in unrealized loss position:

	December 31, 2010			
	Less than 12 months		12 months and over	
	Fair value	Unrealized losses	Fair value	Unrealized losses
	In NIS millions			
Mortgage-backed securities (MBS):				
Available-for-sale trading securities:				
A. Mortgage pass-through securities:				
Securities issued by FHLMC and FNMA	251	3	-	-
Total mortgage-backed pass-through securities	251	3	-	-
B. Other mortgage-backed securities (including CMO, REMIC and STRIPPED MBS):				
Securities issued or guaranteed by FHLMC, FNMA and GNMA	1,672	14	32	*-
Total other mortgage-backed securities	1,672	14	32	-
<b>Total available-for-sale MBS securities</b>	<b>1,923</b>	<b>17</b>	<b>32</b>	<b>-</b>
Held-to-maturity securities				
Other mortgage-backed securities (including CMO, REMIC and STRIPPED MBS):				
Securities issued or guaranteed by FHLMC, FNMA and GNMA	180	1	-	-
Other MBS securities	18	-	-	-
Total other mortgage-backed securities	198	1	-	-
<b>Total held-to-maturity MBS securities</b>	<b>198</b>	<b>1</b>	<b>-</b>	<b>-</b>
Securities for sale				
Other mortgage-backed securities (including CMO, REMIC and STRIPPED MBS):				
Securities issued or guaranteed by FHLMC, FNMA and GNMA	18	*	-	-
<b>Total bonds for sale MBS securities</b>	<b>18</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Total mortgage-backed securities (MBS)</b>	<b>2,139</b>	<b>18</b>	<b>32</b>	<b>-</b>

\* An amount lower than NIS 1 million.

### 3. SECURITIES - CONSOLIDATED (CONTINUED)

#### G. ADDITIONAL DETAILS (CONSOLIDATED) REGARDING MORTGAGE AND ASSET-BACKED SECURITIES (CONTINUED)

Additional details regarding mortgage and asset-backed securities in unrealized loss position (continued):

	December 31, 2009			
	Less than 12 months		12 months and over	
	Fair value	Unrealized losses	Fair value	Unrealized losses
	In NIS millions			
<b>Mortgage-Backed Securities(MBS):</b>				
A. Mortgage pass-through securities:				
Securities guaranteed by GNMA	64	1	-	-
Securities issued by FHLMC and FNMA	417	2	-	-
<b>Total mortgage-backed pass through securities</b>	<b>481</b>	<b>3</b>	<b>-</b>	<b>-</b>
B. Other Mortgage-Backed Securities (including CMO, REMIC and STRIPPED MBS):				
Securities issued or guaranteed by FHLMC, FNMA and GNMA	2,270	34	67	1
Other MBS securities	-	-	74	10
<b>Total other mortgage-backed securities</b>	<b>2,270</b>	<b>34</b>	<b>141</b>	<b>11</b>
<b>Total available-for-sale MBS securities</b>	<b>2,751</b>	<b>37</b>	<b>141</b>	<b>11</b>
Held-to-maturity securities				
Other Mortgage-Backed Securities (including CMO, REMIC and STRIPPED MBS):				
Other MBS securities	26	3	199	23
<b>Total held-to-maturity MBS securities</b>	<b>26</b>	<b>3</b>	<b>199</b>	<b>23</b>
<b>Total mortgage-backed securities (MBS)</b>	<b>2,777</b>	<b>40</b>	<b>340</b>	<b>34</b>
Asset-backed available-for-sale Securities (ABS):				
Securitized Loan Portfolio (CDO)	-	-	*18	*1
<b>Total asset-backed available-for-sale securities (ABS)</b>	<b>-</b>	<b>-</b>	<b>18</b>	<b>1</b>
<b>Total mortgage and asset-backed securities</b>	<b>2,777</b>	<b>40</b>	<b>358</b>	<b>35</b>

\* Reclassified.

### 3. SECURITIES - CONSOLIDATED (CONTINUED)

H. The available-for-sale securities portfolio includes corporate bonds, including bonds of banks, in a total amount of NIS 3,369 million (December 31, 2009: NIS 3,350 million). The balance of the said bonds included as of December 31, 2010, unrealized losses in the amount of NIS 238 million (December 31, 2009: NIS 381 million).

I. Most of the unrealized losses as at December 31, 2010 relate to securities rated as "investment grade" and they are attributed to certain factors, including changes in market interest rate subsequent to date of acquisition, an increase in margins occurring in the credit market concerning similar types of securities, the impact of inactive markets and changes in the rating of securities. For debt securities, there are no securities past due or securities for which the Bank and/or its relevant consolidated companies estimates that it is not probable that they will be able to collect all the amounts owed to them pursuant to the investment contracts.

In 2010, IDB New York recorded other than temporary in nature write downs on several securities, in the amount of US\$13 million (NIS 47 million) [2009: US\$27 million (NIS 102 million)].

Since the Bank and the relevant consolidated subsidiaries have the ability and intent to hold on to securities with unrealized losses until a market price recovery (which for bonds, may not be until maturity), the Bank and the relevant consolidated subsidiaries do not consider the impairment in value of these investments to be other than temporarily impaired at December 31, 2010 except for certain securities, in respect of which a provision for impairment in value has been included.

J. **Investment in bonds of foreign financial institutions.** The Bank and IDB New York recorded a provision for impairment in value in 2008, in respect of the foreign financial institution bonds, which include the Lehman Group, WAMU and Landsbanki in the amount of NIS 283 million.

K. The securities portfolio of the Discount Group as at December 31, 2010, includes a direct investment in bonds of the Federal Home Loan Bank (FHLB), Fannie Mae and Freddie Mac (hereinafter: "the Federal Agencies"), that are being held by IDB New York, in an amount of US\$420 million, (NIS 1,490 million), compared to US\$161 million on December 31, 2009 (NIS 608 million).

### 4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS)

#### A. CREDIT GRANTED TO THE PUBLIC

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
	in NIS millions			
Credit	119,047	114,672	68,296	67,590
Customers' liabilities for acceptances	287	343	214	276
Total credit	119,334	115,015	68,510	67,866
General provision and supplemental provision for doubtful debts	(668)	(589)	(340)	(325)
<b>Total credit granted to the public</b>	<b>118,666</b>	<b>114,426</b>	<b>68,170</b>	<b>67,541</b>

Footnote:

The specific provision for doubtful debts has been deducted from the relevant items (see Note 4 C).

#### 4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

##### B. CREDIT GRANTED TO THE PUBLIC INCLUDES

###### Credit to problem borrowers

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
	in NIS millions			
<b>a) Non-Income Bearing Loans to Problem Borrowers</b>				
Balance at balance sheet date:				
In Israeli currency, non-linked	1,340	1,574	1,005	1,182
In Israeli currency, linked to CPI	119	151	43	62
In foreign currency (including linked to foreign currency)	681	*705	490	*415
<b>b) Restructured Credit to Borrowers</b>				
1) Credit restructured in prior years, with waiver of income:				
Balance at balance sheet date:				
In Israeli currency, non-linked	3	1	2	-
In Israeli currency linked to CPI	74	78	65	70
2) Credit restructured during the current year - without waiver of income:				
Balance at balance sheet date:				
In Israeli currency, non-linked	368	636	327	585
In Israeli currency, linked to CPI	26	101	16	95
In foreign currency (including linked to foreign currency)	1,356	*681	1,347	*625
<b>c) Restructured Credit Not Yet Executed</b>				
Balance at balance sheet date	91	266	85	266
<b>d) Credit in Temporary Arrears</b>				
Balance at balance sheet date <sup>(1)</sup>	391	*537	270	*388
Interest in respect of such credit included in the statement of income	11	*23	6	*20
<b>e) Credit Under Special Supervision</b>				
Balance at balance sheet date <sup>(1)</sup>	3,300	*3,547	2,474	*2,278

\* Reclassified.

Note:

(1) Including local authorities.

**4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED):****C. PROVISION FOR DOUBTFUL DEBTS**

	2010			
	Specific provision <sup>(1)</sup>		Supplemental provision <sup>(2)</sup>	Total
	According to period of arrears	Other		
In NIS millions				
<b>Consolidated</b>				
Balance of provision at beginning of year	169	5,820	652	6,641
Provision for current year	44	1,035	117	1,196
Reduction of provision	(45)	(269)	(37)	(351)
Collection of debts written-off in previous years	-	(24)	-	(24)
Provision charged to statement of Income	(1)	742	80	821
Net write-offs*	(1)	(1,062)	-	(1,063)
Exchange rate differentials	-	(15)	-	(15)
<b>Balance of provision at end of year</b>	<b>167</b>	<b>5,485</b>	<b>732</b>	<b>6,384</b>
Includes - Balance of provision that was not deducted from "credit granted to the public"	-	84	64	148
<b>The Bank</b>				
Balance of provision at beginning of year	-	4,433	369	4,802
Provision for current year	-	694	46	740
Reduction of provision	-	(181)	(31)	(212)
written-off in previous years	-	(4)	-	(4)
Provision charged to statement of Income	-	509	15	524
Net write-offs*	-	(535)	-	(535)
Exchange rate differentials	-	(11)	-	(11)
<b>Balance of provision at end of year</b>	<b>-</b>	<b>4,396</b>	<b>384</b>	<b>4,780</b>
Includes - Balance of provision that was not deducted from "credit granted to the public"	-	81	44	125

\* Net of debts collected during the year.

Footnotes:

(1) For loans for which a provision was made according to the extent of the delinquency - does not include a provision for interest on such debt in arrears.

For other loans - does not include provision for interest on doubtful debts after such debts were deemed doubtful.

(2) Includes balance of a general provision for doubtful debts: Consolidated: -NIS 424 million; 2009 - NIS 348 million; 2008 - NIS 404 million. The bank - NIS 197 million; 2009 - NIS 197 million; 2008 - NIS 197 million (see Note 1 L).

2009				2008			
Specific provision <sup>(1)</sup>			Total	Specific provision <sup>(1)</sup>			Total
According to period of arrears	Other	Supplemental provision <sup>(2)</sup>		According to period of arrears	Other	Supplemental provision <sup>(2)</sup>	
In NIS millions							
167	5,451	685	6,303	166	5,133	676	5,975
50	1,214	66	1,330	55	939	95	1,089
(47)	(173)	(99)	(319)	(50)	(156)	(86)	(292)
-	(13)	-	(13)	-	(17)	-	(17)
3	1,028	(33)	998	5	766	9	780
(1)	(657)	-	(658)	(4)	(447)	-	(451)
-	(2)	-	(2)	-	(1)	-	(1)
169	5,820	652	6,641	167	5,451	685	6,303
-	184	63	247	-	186	62	248
-	4,212	362	4,574	-	4,031	349	4,380
-	725	42	767	-	629	53	682
-	(78)	(35)	(113)	-	(94)	(40)	(134)
-	-	-	-	-	(1)	-	(1)
-	647	7	654	-	534	13	547
-	(426)	-	(426)	-	(351)	-	(351)
-	-	-	-	-	(2)	-	(2)
-	4,433	369	4,802	-	4,212	362	4,574
-	173	44	217	-	179	44	223

**4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)****D. COMPOSITION OF CREDIT TO THE PUBLIC<sup>(1)</sup> AND OFF-BALANCE-SHEET CREDIT RISK<sup>(2)</sup>, BY SIZE OF CREDIT TO INDIVIDUAL BORROWERS**

Consolidated

		December 31							
		2010			2009				
		Number of borrowers <sup>(2)</sup>	Credit <sup>(1)</sup>	Credit risk <sup>(3)</sup>	Number of borrowers* <sup>(2)</sup>	Credit* <sup>(1)</sup>	Credit risk* <sup>(3)</sup>		
		in NIS millions							
Credit limit (in NIS thousand):									
	Up to	10	895,783	1,780	1,692	1,038,244	2,734	1,865	
Over	10	Up to	20	330,477	2,170	2,762	241,108	1,998	2,678
Over	20	Up to	40	244,782	3,445	3,627	172,791	3,217	3,568
Over	40	Up to	80	148,691	4,878	3,317	107,919	4,228	3,428
Over	80	Up to	150	61,372	4,618	1,935	53,626	4,226	2,228
Over	150	Up to	300	32,913	5,635	1,161	31,589	5,374	1,241
Over	300	Up to	600	22,858	8,494	1,071	22,457	8,090	1,163
Over	600	Up to	1,200	13,505	8,879	1,515	12,395	7,677	1,790
Over	1,200	Up to	2,000	3,502	4,133	913	3,198	3,658	959
Over	2,000	Up to	<sup>(4)</sup> 4000	2,356	5,027	1,281	2,282	4,788	1,475
Over	4,000	Up to	<sup>(4)</sup> 8000	1,192	4,976	1,628	1,193	4,944	1,800
Over	8,000	Up to	<sup>(4)</sup> 20,000	1,015	8,769	3,516	1,109	9,993	3,789
Over	20,000	Up to	<sup>(4)</sup> 40,000	531	9,847	3,987	576	10,759	4,800
Over	40,000	Up to	<sup>(4)</sup> 200,000	648	30,361	15,620	598	27,934	16,258
Over	200,000	Up to	<sup>(4)</sup> 400,000	47	8,963	4,036	38	7,536	3,327
Over	400,000	Up to	<sup>(4)</sup> 800,000	19	7,020	3,154	16	5,431	3,156
Over	800,000	Up to	<sup>(4)</sup> 1,200,000	6	3,487	2,527	9	5,113	3,723
Over	1,200,000	Up to	<sup>(4)</sup> 1,600,000	-	-	-	1	74	1,143
Over	1,600,000	Up to	<sup>(4)</sup> 2000000	1	11	1,820	-	-	-
<b>Total</b>			1,759,698	122,493	55,562	1,689,149	117,774	58,391	

\* Reclassified (See Note 1Z).

Footnotes:

- (1) Including investments in bonds of the public and assets related to derivative financial instruments created with the public, net of a specific provision for doubtful debts.
- (2) Number of borrowers based on total credit and credit risk.
- (3) Credit risk of off-balance sheet financial instruments, as computed for the purpose of limitations on a borrower (not including credit facilities under banks guarantees as of December 31, 2010 – NIS 4,214 million, as of December 31, 2009 – NIS 3,172 million).
- (4) Consolidated - by combining specific balances.

#### 4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

##### D. COMPOSITION OF CREDIT TO THE PUBLIC<sup>(1)</sup> AND OFF-BALANCE-SHEET CREDIT RISK<sup>(2)</sup>, BY SIZE OF CREDIT TO INDIVIDUAL BORROWERS

###### The Bank

		December 31									
		2010				2009					
		Number of borrowers <sup>(2)</sup>		Credit		Credit risk		Number of borrowers <sup>(2)</sup>		Credit risk	
		in NIS millions									
Credit limit (in NIS thousand):											
		Up to	10	180,217	360	504	181,626	367	515		
Over	10	Up to	20	114,733	697	1,036	108,943	678	989		
Over	20	Up to	40	123,161	1,653	1,882	119,180	1,594	1,871		
Over	40	Up to	80	91,780	2,974	2,217	86,019	2,686	2,308		
Over	80	Up to	150	44,749	3,079	1,680	43,764	2,802	1,892		
Over	150	Up to	300	16,903	2,402	958	15,922	2,210	1,004		
Over	300	Up to	600	5,594	1,543	786	5,493	1,508	814		
Over	600	Up to	1,200	3,100	1,671	922	3,185	1,702	995		
Over	1,200	Up to	2,000	1,317	1,436	583	1,367	1,465	660		
Over	2,000	Up to	4,000	1,216	2,449	1,006	1,211	2,383	1,103		
Over	4,000	Up to	8,000	831	3,145	1,480	819	3,057	1,508		
Over	8,000	Up to	20,000	630	5,343	2,564	640	5,464	2,710		
Over	20,000	Up to	40,000	306	5,802	2,775	318	5,994	3,088		
Over	40,000	Up to	200,000	334	18,932	7,672	332	18,823	8,239		
Over	200,000	Up to	400,000	41	7,605	3,937	39	7,291	3,448		
Over	400,000	Up to	800,000	19	7,002	3,360	16	5,482	3,224		
Over	800,000	Up to	1,200,000	5	2,851	2,264	9	4,967	3,665		
Over	1,200,000	Up to	1,600,000	-	-	-	1	74	1,143		
Over	1,600,000	Up to	2,000,000	1	11	1,820	-	-	-		
<b>Total</b>				584,937	68,955	37,446	568,884	68,547	39,176		

Footnotes:

- (1) Including investments in bonds of the public and assets related to derivative financial instruments created with the public, net of a specific provision for doubtful debts.
- (2) Number of borrowers based on total credit and credit risk.
- (3) Credit risk of off-balance sheet financial instruments, as computed for the purpose of limitations on a borrower.

**4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)****E. DETAILS AS TO THE MANNER OF COMPUTING THE SPECIFIC PROVISION FOR HOUSING LOANS**

December 31, 2010						
	Balance of credit	Balance of debt <sup>(4)</sup>	Balance in arrears	Specific provision		Total
				According to extent of delinquency <sup>(5)</sup>	Other	
in NIS millions						
Housing loans <sup>(1)(6)</sup>	13,262	230	114	152	-	152
"Large loans" <sup>(2)</sup>	4,023	99	38	6	26	32
Other loans <sup>(3)</sup>	942	39	15	9	14	23
<b>Total</b>	<b>18,227</b>	<b>368</b>	<b>167</b>	<b>167</b>	<b>40</b>	<b>207</b>
Of which: in respect of housing loans granted to certain acquisition groups that are in the midst of construction processes	256	1	1	-	-	-
December 31, 2009						
Housing loans <sup>(1)(6)</sup>	11,146	245	108	152	-	152
"Large loans" <sup>(2)</sup>	4,058	109	39	5	26	31
Other loans <sup>(3)</sup>	861	43	17	12	14	26
<b>Total</b>	<b>16,065</b>	<b>397</b>	<b>164</b>	<b>169</b>	<b>40</b>	<b>209</b>
Of which: in respect of housing loans granted to certain acquisition groups that are in the midst of construction processes	296	2	-	1	-	1

## Footnotes:

- (1) Loans, which according to the Directive of The Bank of Israel, the provision in respect thereof is to be computed based on the extent of delinquency.
- (2) Housing loans, the outstanding balance of each exceeds NIS 893 thousand (2009: NIS 873 thousand).
- (3) Loans secured by a mortgage of a residential unit - prepared according to a circular published by the Bank of Israel on January 1, 2006, stating that housing loans for purposes of financial statements presentation are to include multi purpose loans secured by a mortgage on a residential unit.
- (4) Balance of problematic loans (over 3 months in arrears) and net of the balance of provisions.
- (5) Includes interest on arrears without deduction of the balance of provisions in the amount of NIS 24.9 million (2009: NIS 22.5 million).
- (6) Including balance of credit at the Bank in the amount of NIS 69 million (2009: NIS 120 million).

#### 4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

##### F. HOUSING LOANS AND THE PROVISION FOR DOUBTFUL DEBTS IN RESPECT THEREOF BASED ON THE PERIOD OF ARREARS

Consolidated

	December 31, 2010					December 31, 2009				
	Duration of arrears									
	Over 3 and up to 6 months	Over 6 and up to 15 months	Over 15 and up to 33 months	Over 33 months	Total	Over 3 and up to 6 months	Over 6 and up to 15 months	Over 15 and up to 33 months	Over 33 months	Total
	In NIS millions									
Amount in arrears	7	10	15	99	131	6	12	18	91	127
Of which: Interest on the amount in arrears	1	1	1	30	33	1	-	1	26	28
Balance of provision for doubtful debts based on period of arrears <sup>(1)</sup>	3	16	34	113	166	1	17	40	111	169
Balance of loans net of provision for doubtful debts	94	86	27	20	227	107	94	35	27	263

Footnote:

(1) Not including a provision for interest in respect of the amount in arrears.

**5. CREDIT GRANTED TO GOVERNMENTS**

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
	in NIS millions			
Deposit of the Accountant General - tender for teaching employees	1,551	1,517	1,551	1,517
Other credit <sup>(1)</sup>	5	303	-	301
<b>Total credit granted to Governments</b>	<b>1,556</b>	<b>1,820</b>	<b>1,551</b>	<b>1,818</b>

Footnote:

(1) Including credit to foreign governments: Consolidated - NIS 4 million (2009: NIS 2 million), the Bank - no balance.

## 6. INVESTMENTS IN INVESTEE COMPANIES

### A. CONSOLIDATED

	December 31, 2010		December 31, 2009			
	Affiliated companies	Consolidated subsidiaries	Total	Affiliated companies	Consolidated subsidiaries	Total
In NIS millions						
<b>Investments</b>						
Shares stated on equity basis (including goodwill) <sup>(1)</sup>	1,563	-	1,563	1,674	-	1,674
<b>Other investments:</b>						
Capital notes	49	-	49	52	-	52
Shareholders' loans	72	-	72	69	-	69
<b>Total other investments</b>	121	-	121	121	-	121
<b>Total investments</b>	1,684	-	1,684	1,795	-	1,795
<b>Includes:</b>						
Earnings accumulated since January 1, 1992	972	-	972	1,053	-	1,053
Items accumulated in shareholders' equity since January 1, 1992:						
Adjustments in respect of presentation of securities available for sale at fair value, net	3	-	3	19	-	19
Adjustment for translation of foreign currency financial statements	(2)	-	(2)	(2)	-	(2)
<b>Details Regarding Goodwill:</b>						
Period of amortization	10 years		10 years			
Original amount	4	293	297	7	293	300
Unamortized balance	-	149	149	3	174	177
<b>Book and Market Values of Marketable Investments:</b>						
Book value	1,532	-	1,532	1,632	-	1,632
Market value	1,425	-	1,425	1,683	-	1,683

Footnote:

(1) Includes earnings and translation adjustments in units having a functional currency that differs from the reporting currency accumulated from the acquisition date up to December 31, 1991.

**6. INVESTMENTS IN INVESTEE COMPANIES (CONTINUED)****B. THE BANK**

	December 31, 2010			December 31, 2009		
	Affiliated companies	Consolidated subsidiaries	Total	Affiliated companies	Consolidated subsidiaries	Total
in NIS millions						
<b>Investments:</b>						
Shares stated on equity basis (including goodwill) <sup>(1)</sup>	1,568	7,092	8,660	1,667	6,833	8,500
<b>Other investments:</b>						
Subordinated debt notes and Capital notes	-	1,550	1,550	3	1,546	1,549
Shareholders' loans	2	-	2	2	-	2
<b>Total other investments</b>	2	1,550	1,552	5	1,546	1,551
<b>Total investments</b>	1,570	8,642	10,212	1,672	8,379	10,051
<b>Includes:</b>						
Retained earnings since January 1, 1992	1,011	3,610	4,621	1,087	3,405	4,492
Items accumulated in shareholders' equity since January 1, 1992:						
Adjustments in respect of presentation of securities available for sale at fair value, net						
	1	22	23	17	(31)	(14)
Adjustment for translation of foreign currency financial statements						
	-	31	31	-	30	30
The State's bonus to the employees (privatization)						
	-	32	32	-	32	32
<b>Details Regarding Goodwill:</b>						
Period of amortization						
	10 years			10 years		
Original amount	4	292	296	7	292	299
Unamortized balance	-	148	148	3	173	176
<b>Book and Market Values of Marketable Investments:</b>						
Book value	1,532	-	1,532	1,632	-	1,632
Market value	1,425	-	1,425	1,683	-	1,683

Footnote:

(1) Includes earnings and translation adjustments in units accumulated from the acquisition date up to December 31, 1991.

## 6. INVESTMENTS IN INVESTEE COMPANIES (CONTINUED)

### THE BANK'S SHARE OF INCOME OR LOSS OF INVESTEE COMPANIES

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
In NIS millions						
The Bank's share of operating income of investee companies (consolidated - affiliated companies)	136	149	18	429	664	272
Provision for impairment in value of investee companies	(3)	(1)	(88)	(3)	(1)	-
	133	148	(70)	426	663	272
Provision for taxes:						
Current taxes	-	-	-	37	26	26
Deferred taxes	<sup>(2)</sup> (53)	(10)	-	<sup>(2)</sup> (53)	(10)	<sup>(1)</sup> (23)
Total provision for taxes (tax saving)	(53)	(10)	-	(16)	16	3
<b>Bank's share in operating income (loss) net of tax effect of investee companies (consolidated - affiliated companies)</b>	<b>186</b>	<b>158</b>	<b>(70)</b>	<b>442</b>	<b>647</b>	<b>269</b>

Footnotes:

- (1) Including the reversal of the provision for taxes in respect of the Bank's share in the earnings of ICC (see Note 29 K hereunder).  
(2) Reduction in the provision for taxes in respect of the Bank's share in earnings of the First International Bank, see Note 29 L.

**6. INVESTMENTS IN INVESTEE COMPANIES (CONTINUED)****C. INFORMATION ON PRINCIPAL INVESTEE COMPANIES**

Name of Company	Details of company	Share in capital		Share in		Value of investment in			
		rights to profits		voting rights		shares on equity			
		2010	2009	2010	2009	Equity basis <sup>(1)</sup>		Market value	
		As a percentage	As a percentage			2010	2009	2010	2009
						In NIS millions			
<b>1. Consolidated Subsidiaries:</b>									
Discount Bancorp, Inc. <sup>(2)</sup>	Holding company, U.S.A.	100.00	100.00	100.00	100.00	21	23	-	-
Israel Discount Bank of New York <sup>(3)</sup>	Commercial bank, U.S.A.	100.00	100.00	100.00	100.00	2,714	2,672	-	-
Mercantile Discount Bank Ltd.	Commercial bank	100.00	100.00	100.00	100.00	1,855	1,695	-	-
Discount Mortgage Bank Ltd.	Mortgage bank	100.00	100.00	100.00	100.00	1,127	1,097	-	-
Israel Credit Cards Ltd. <sup>(4)</sup>	Credit card service	71.83	71.83	79.00	79.00	689	742	-	-
Discount Leasing Ltd.	Equipment leasing	100.00	100.00	100.00	100.00	108	106	-	-
Discount Israel Capital Markets and Investments Ltd.	Underwriting and investments	100.00	100.00	100.00	100.00	(34)	(23)	-	-
Discount Manpikim Ltd.	Securities issue	100.00	100.00	100.00	100.00	59	58	-	-
IDB (Swiss) Bank Ltd.	Commercial bank, Switzerland	100.00	100.00	100.00	100.00	197	183	-	-
<b>Companies held by Israel Discount Bank of New York:</b>									
Discount Bank (Latin America) <sup>(5)</sup>	Commercial bank, Uruguay	100.00	100.00	100.00	100.00	238	209	-	-
IDBNY Realty (Delaware), Inc. <sup>(5)</sup>	Holding company, USA	100.00	100.00	100.00	100.00	1,669	1,738	-	-
IDB Realty LLC. <sup>(6)</sup>	Investment company, USA	100.00	100.00	100.00	100.00	6,194	6,419	-	-
<b>Company held by Discount Israel Capital Markets and Investments Ltd.:</b>									
Freenet A.K. Communications Ltd.	Holding company	100.00	100.00	100.00	100.00	(6)	(29)	-	-
<b>Companies held by Israel Credit Cards Ltd.:</b>									
Diners (Club) Israel Ltd.	Credit card service	51.00	51.00	51.00	51.00	115	92	-	-
Cal Mimun Ltd.	חנות מימון	100.00	100.00	100.00	100.00	149	90	-	-
<b>2. Affiliated Companies:</b>									
First International Bank of Israel Ltd. <sup>(7)</sup>	Commercial bank	26.45	26.45	26.45	26.45	1,532	1,632	1,425	1,683

**Footnotes:**

(1) Including allocated excess of cost over book value and goodwill.

(2) A holding company, wholly-owned by the Bank, which fully owns and controls Israel Discount Bank of New York.

(3) The company is owned by Discount Bancorp, Inc.

(4) For details regarding a guarantee unlimited in amount in favor of VISA Europe, securing all of ICC's liabilities, see Note 19 C 9 below.

(5) Included in the financial statements of Israel Discount Bank of New York.

(6) Included in the financial statements of IDBNY Realty (Delaware), Inc.

(7)

(8) Including adjustments from translation of financial statements of units having a functional currency that differs from the reporting currency and adjustments concerning the presentation of certain securities of investee companies at fair value.

(9) Goodwill.

(10) Including a reduction in the provision for taxes in respect of the Bank's share in earnings of the First International Bank, see Note 29 L.

(11) Included in other assets.

Of which: excess of cost balance		Other investments		Contribution to net operating income		Of which: loss on impairment		Dividend		Other items recorded in shareholders' equity <sup>(9)</sup>		Guarantees issued for consolidated subsidiaries in favor of entities outside the group	
2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009
In NIS millions													
-	-	-	-	(2)	-	-	-	-	-	3	3	-	-
-	-	267	287	(22)	119	-	-	-	-	(256)	(286)	-	-
-	-	-	-	113	181	-	-	-	-	61	47	-	-
<sup>(9)</sup> 6	<sup>(9)</sup> 7	500	497	29	30	-	-	-	-	-	-	-	7
<sup>(9)</sup> 142	<sup>(9)</sup> 166	28	20	39	109	-	-	108	-	7	-	103	111
-	-	-	-	1	3	-	-	-	-	-	-	-	-
-	-	190	233	(11)	(19)	-	-	-	-	1	(1)	-	-
-	-	-	-	2	1	-	-	-	-	-	-	-	-
<sup>(11)</sup> 20	<sup>(11)</sup> 44	-	-	(13)	(9)	(14)	(7)	-	-	-	-	-	-
-	-	-	-	18	13	-	-	-	-	11	-	-	-
-	-	-	-	(72)	39	-	-	-	-	(2)	2	-	-
-	-	-	-	(288)	11	-	-	-	-	(48)	(91)	-	-
-	-	531	488	20	12	-	-	-	-	(5)	(5)	-	-
-	-	-	-	32	22	-	-	-	-	-	-	-	-
-	-	27	15	59	22	-	-	-	-	-	-	-	-
-	-	-	-	<sup>(10)</sup> 180	161	-	-	212	-	2	18	-	-

**[INSERTS: Ebe 6.2 ]****6. INVESTMENTS IN INVESTEE COMPANIES (CONTINUED)****D. THE INVESTMENT IN THE FIRST INTERNATIONAL BANK ("FIBI")**

**Signing an agreement with FIBI holdings.** In the second half of March 2010, the Bank reached an understanding with FIBI Holdings Ltd. (hereinafter: "FIBI Holdings") regarding the Bank's holdings in FIBI.

On March 28, 2010, following approval by the Boards of Directors of FIBI Holdings and of the Bank, an agreement was signed between the Bank and FIBI Holdings, on the basis of agreements reached.

Following are the principal terms of the agreement:

- The agreement contains conditions precedent to its validity (hereinafter: "the conditions precedent"), which are: obtaining the approval of the Supervisor of Banks and the approval of the Antitrust Commissioner to the agreement ("the regulatory approvals"), this until the end of 150 days from the date of signing of the agreement; as well as the distribution of a cash dividend of NIS 800 million by FIBI to its shareholders, out of its retained earnings as of December 31, 2005, as per its financial statements (hereinafter: "the distribution");
- It has been agreed that FIBI Holdings will act to the best of its ability towards the unification of the share capital of FIBI, following which, all shares making up the share capital of FIBI shall be of one class and shall confer equal voting rights;
- Israel Discount Bank shall vote in favor of completing the process of unification of the share capital in the general meetings of shareholders of FIBI, subject to obtaining the regulatory approvals to the agreement as well as to the realization of the terms specified in the agreements, inter-alia, completion of actual distribution or obtaining confirmation according to which all required proceedings for the distribution have been realized and all approvals for the distribution have been obtained;
- Soon after completion of the unification of capital, if and when completed, Israel Discount Bank shall deposit with a trustee a number of shares of FIBI, the voting rights attached therein (out of the total voting rights in FIBI) exceeding the existing rate of voting rights held by Israel Discount Bank (hereinafter: "the deposited shares"), this in accordance with a trusteeship agreement to be approved by the Supervisor of Banks. Israel Discount Bank or the trustee shall refrain from acting upon the voting rights attached to the deposited shares. The trustee shall pass on to Israel Discount Bank any dividend or any other benefit of any kind that will be received by him by virtue of the deposited shares, immediately upon their receipt (excluding bonus shares or shares stemming from the unification of the capital, or a split of the deposited shares, or shares deriving from securities convertible into shares, which FIBI may issue in respect of the deposited shares. These shares shall remain in the hands of the trustee and shall become an integral part of the deposited shares for all intents and purposes). The trustee shall release the deposited shares in the event that the ratio of voting rights held by Israel Discount Bank in FIBI shall fall below the ratio existing at present (11.09%) in order to restore the ratio of voting rights to the existing ratio, or for the purpose of transferring the deposited shares, or part thereof, to a third party;
- Until the end of six months from the date of completion of the unification of capital, and subject to the fulfillment of the conditions precedent and subject to the completion of the unification of the capital, Israel Discount Bank shall act towards the sale of 6% of its holdings in the equity and voting rights in FIBI to third parties, provided that market conditions allow this sale at a price that is not lower than the stated value of the investment in such shares in the financial statements of Israel Discount Bank;
- It has been agreed that until the determining date, as signified below, Israel Discount Bank shall be entitled to purchase additional securities within the framework of any rights offer by FIBI to its shareholders, on condition that the additional shares purchased by Israel Discount Bank, if at all, shall be deposited with the trustee and all the provisions applying to the deposited shares shall also apply to them;
- Starting with the date on which all conditions precedent to the agreement are fulfilled, the arrangement existing between Israel Discount Bank and FIBI Holdings regarding the right of first refusal for the purchase of shares in FIBI, as well as any transfer or sale of shares in FIBI by FIBI Holdings or by Israel Discount Bank, shall not be subject to the said right;

## 6. INVESTMENTS IN INVESTEE COMPANIES (CONTINUED)

- Starting with the date on which all conditions precedent to the agreement are fulfilled and until December 31, 2013 (hereinafter: "the determining date"), Israel Discount Bank shall be entitled to have FIBI Holdings continue to cause the appointment of one quarter of the Directors of FIBI from among candidates recommended by Israel Discount Bank (subject to directives regarding the prevention of conflict of interests), regardless of the number of shares held by Israel Discount Bank. Subsequent to the determining date, the arrangement existing between Israel Discount Bank and FIBI Holdings, including the arrangement regarding appointment of directors recommended by Israel Discount Bank, shall become null and void. The determining date may be postponed under certain conditions determined in the agreement. Among other things, if the completion of the unification of capital of FIBI is not achieved within one year from date of signing the agreement, the determining date shall be postponed to December 31, 2014.

For details regarding the approvals of the Supervisor of Banks and the Antitrust Commissioner, see hereunder.

**General meetings of shareholders of FIBI for approval of a distribution of dividend and the unification of the share capital.** A special general meeting of shareholders of FIBI held on June 24, 2010, resolved to approve the following resolutions, in accordance with that stated in an immediate report published by FIBI calling the meeting, under the Securities Regulations (Transaction between a corporation and a controlling shareholder), 2001 (hereinafter: "the Regulations"), and in accordance with the Companies Law, 1999 (hereinafter - "the Companies law"):

- Resolution regarding the distribution of a cash dividend to shareholders of FIBI in a total amount of NIS 800 million (hereinafter: "the distribution"). The dividend shall be distributed out of retained earnings accumulated, per the financial statements of FIBI, in the period from March 31, 2003 and until December 31, 2005. The distribution is subject to the fulfillment of conditions precedent to the validity of the agreement signed between FIBI Holdings and Israel Discount Bank. Such conditions precedent include approvals of the agreement by the Supervisor of Banks and the Antitrust Commissioner and its execution.
- Resolutions regarding the unification of the share capital of FIBI, according to which every five ordinary shares of NIS 0.01 par value of FIBI shall be converted into one ordinary share of NIS 0.05 par value of FIBI (hereinafter: "the unification of capital"). The unification of capital shall be effected without any indemnification what so ever. The unification of capital is subject to the fulfillment of the conditions precedent to the validity of the agreement, including approvals of the agreement by the Supervisor of Banks and the Antitrust Commissioner, and approval of the distribution by the meeting of shareholders of FIBI.

Resolutions regarding the merger of the share capital were also approved by class meetings of the various shareholders of FIBI, called for that purpose.

The resolutions regarding dividend distribution and regarding the merger of the share capital came into effect upon receipt of the approvals for the agreement.

**Distribution of Dividend.** On September 6, 2010, the Bank received a cash dividend of NIS 212 million.

**Unifications of share capital.** The determining date for the unification of FIBI's share capital was on September 19, 2010, and as from September 20, 2010 only shares of a par value of NIS 0.05 of FIBI are being traded on the Tel Aviv Stock Exchange. Upon completion of the process for the unification of the share capital of FIBI, the rate of the Bank's holdings in FIBI increased to 26.4% in the voting rights. In accordance with the provisions of the agreement, the Bank deposited with a Trustee shares which grant it voting rights in excess of 11.09%.

It should be mentioned that at this stage the Bank has not yet sold 6% of the shares in the First International Bank, due to the fact that conditions enabling a sale at a price which is not below the stated value of the shares in the Bank's books have not yet arisen.

**Approvals of the Supervisor of Banks and the Antitrust Commissioner.** Following the signing of the agreement, the Bank applied to the Supervisor of Banks and to the Antitrust Commissioner for their approval of the agreement. The approval of the Supervisor of Banks for the agreement and the approval of the Antitrust Commissioner (hereinafter: "the Commissioner) for "merger of companies" under the Restrictive Trade Practices Law, 1988, were received on August 17, 2010, with respect to the process of unification of the share capital

## 6. INVESTMENTS IN INVESTEE COMPANIES (CONTINUED)

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to be executed by FIBI.

The parties to the agreement confirmed that the conditions precedent determined in the agreement for this purpose have been fulfilled with the receipt of the above mentioned two approvals.

The agreement, approved by the Supervisor of Banks, specified that the Supervisor of Banks would consider the Bank's request in the event that FIBI would offer rights to all its shareholders and the Bank would seek to participate in such offer.

Among other things, the approval by the Commissioner specified that the Bank must reduce its holdings in FIBI to a rate below 10% of the issued share capital of FIBI by December 31, 2015, or until the end of five years from date of the unification of the share capital of FIBI, the earlier of the two, and in addition reduce its holdings in FIBI to a rate below 5% of the issued share capital of FIBI by December 31, 2017, or until the end of seven years from date of completion of the unification of the share capital of FIBI, the earlier of the two. Alternatively, the Bank must reduce its holdings in FIBI to a rate below 5% of the issued share capital of FIBI by December 31, 2016, or until the end of six years from date of completion of the unification of the share capital of FIBI, the earlier of the two. In addition, the Commissioner's approval specifies that in the event that the Bank does not reduce its holdings until the end of the above mentioned periods, as the case may be, then the excess number of shares in FIBI held by the Bank subsequent to the dates detailed above, shall be sold by a Trustee appointed for this purpose, this in accordance with the arrangements determined in this matter in the Commissioner's approval. Furthermore, it has been determined that the Bank shall not acquire shares in FIBI or any right in FIBI any other way, unless with the prior permission in writing by the Commissioner.

On September 6, 2010, following completion of the distribution and the actual payment in cash of the dividend, in accordance with the agreement, and upon obtaining the regulatory approvals with respect to the agreement, the conditions precedent have been fulfilled and the agreement came into effect.

It should be noted, that following the formation of the agreements with FIBI Holdings, the Bank has already included in its financial statements as of December 31, 2009, a provision for taxes in the amount of NIS 120 million, in respect of its holdings in FIBI, this in view of the uncertainty regarding the continued holding by the Bank of the shares in FIBI and based on the assumption that over a period of time, the Bank will sell all of its holdings in FIBI.

## 7. BUILDINGS AND EQUIPMENT

### A. COMPOSITION

	Consolidated			The Bank		
	Buildings and land**	Equipment, furniture and vehicles	Total	Buildings and land**	Equipment, furniture and vehicles	Total
in NIS millions						
<b>Cost</b>						
Balance at beginning of the year	*2,376	*4,134	6,510	1,668	2,973	4,641
Additions	48	489	537	11	358	369
Disposals	(22)	(268)	(290)	(21)	(246)	(267)
Balance as at December 31, 2010	2,402	4,355	6,757	1,658	3,085	4,743
<b>Depreciation</b>						
Balance at beginning of the year	*951	*2,381	3,332	691	1,568	2,259
Depreciation for the year	75	483	558	52	367	419
Recognized impairment losses	4	-	4	4	-	4
Reversed impairment losses	-	-	-	-	-	-
Accumulated depreciation on disposals	(13)	(262)	(275)	(13)	(241)	(254)
Balance as at December 31, 2010	1,017	2,602	3,619	734	1,694	2,428
<b>Depreciated balance as at December 31, 2010</b>	<b>1,385</b>	<b>1,753</b>	<b>3,138</b>	<b>924</b>	<b>1,391</b>	<b>2,315</b>
<b>Depreciated balance as at December 31, 2009</b>	<b>1,425</b>	<b>1,753</b>	<b>3,178</b>	<b>977</b>	<b>1,405</b>	<b>2,382</b>
The average depreciation rate in 2010	4.9%	15.2%	11.9%	4.9%	16.0%	12.4%
The average depreciation rate in 2009	3.3%	14.9%	10.8%	2.6%	16.0%	11.1%

\* Reclassified.

\*\* Includes:

- Installations and leasehold improvements, the depreciated balance of which amounted to NIS 130 million - consolidated and to NIS 63 million in the Bank (2009: NIS 133 million - consolidated; and NIS 67 million - in the Bank).
- Interest capitalized in prior years net of amortization, in the amount of NIS 2 millions (2009: NIS 2 millions).
- Including a provision for decline in value in the amount of NIS 46 million - consolidated and NIS 44 million - in the Bank (2009: NIS 46 million - consolidated and NIS 44 million - in the Bank).

- B. The Bank and a consolidated subsidiary own leasehold rights for various periods ending in the years 2012 to 2056. The Bank and a consolidated subsidiary are the owners of non-capitalized leasehold rights: Consolidated - NIS 29 million (2009: NIS 34 million). The Bank, stand alone: NIS 25 million (2009: NIS 30 million). The Bank and a consolidated subsidiary are the owners of capitalized leasehold rights: Consolidated - NIS 81 million (2009: NIS 82 million). The Bank, stand alone - NIS 52 million (2009: NIS 55 million).
- C. The depreciated cost of buildings not yet registered in the names of the Bank or of its subsidiaries at the Land Registry Office, amounts to NIS 259 million (2009: NIS 596 million) on a consolidated basis, and NIS 82 million (2009: NIS 435 million) for the Bank.
- D. The depreciated cost of buildings not in use by the Bank, and which are mostly let to outside parties, amounts to NIS 16 million (2009: NIS 13 million) on a consolidated basis, and NIS 9 million (2009: NIS 9 million) for the Bank. No losses were recognized in 2010 in respect of impairment.
- E. The outstanding balance of building and equipment designated for sale amounted on December 31, 2010 to NIS 0.4 million (2009: NIS 6 million). Losses on impairment of buildings and equipment in the amount of NIS 0.4 million were recognized in 2009.

**7. BUILDINGS AND EQUIPMENT (CONTINUED)****F. THE COST OF IN-HOUSE DEVELOPMENT OF COMPUTER SOFTWARE :**

	Consolidated		The Bank	
	2010	2009	2010	2009
	in NIS millions			
The cost of software put into operation	1,613	1,531	1,520	1,438
Accumulated depreciation	(865)	(662)	(794)	(602)
Undepreciated balance	748	869	726	836
Accumulated costs in respect of software under development	191	73	160	65
<b>Total cost of in-house development of computer software</b>	<b>939</b>	<b>942</b>	<b>886</b>	<b>901</b>

**8. OTHER ASSETS**

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
	In NIS millions			
Net deferred tax assets (see Note 29 N)	480	402	176	116
Excess advance tax payments over current provisions	57	317	-	65
Excess deposits for severance pay and pensions, over provision (see Note 16 E,I)	397	410	384	392
Goodwill	149	174	-	-
Issue costs and discount expenses of subordinated capital notes	32	28	39	36
Income receivable	183	176	94	84
Debit balances of derivative financial instruments (except for derivative instruments)	2,039	1,836	1,957	1,724
Surrender value of life assurance policies owned by a consolidated subsidiary	581	611	-	-
Assets in respect of the "Maof" market operations	386	*472	386	*472
Gold deposit	581	*366	581	*366
Other debtors and debit balances	477	*549	181	*308
<b>Total other assets</b>	<b>5,362</b>	<b>5,341</b>	<b>3,798</b>	<b>3,563</b>

\* Reclassified.

## 9. DEPOSITS FROM THE PUBLIC

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
	In NIS millions			
Demand deposits	33,766	32,470	18,000	17,648
Time and other deposits	99,293	103,770	81,629	83,320
Savings plan deposits	4,952	5,585	4,480	4,954
<b>Total deposits from the public</b>	<b>138,011</b>	<b>141,825</b>	<b>104,109</b>	<b>105,922</b>

## 10. DEPOSITS FROM BANKS

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
	In NIS millions			
Commercial banks:				
Demand deposits	957	950	266	513
Time deposits	1,175	1,344	2,400	2,659
Acceptances	282	330	209	264
Central banks:				
Schedule deposits	707	982	-	-
Specialized banking institutions:				
Deposits on demand	14	60	67	279
Schedule deposits	252	58	423	249
<b>Total deposits from banks</b>	<b>3,387</b>	<b>3,724</b>	<b>3,365</b>	<b>3,964</b>

**11. SUBORDINATED CAPITAL NOTES**

	Average maturity years <sup>(1)</sup>	Internal rate of return <sup>(1)</sup> %	Consolidated		The Bank	
			December 31		December 31	
			2010	2009	2010	2009
in NIS millions						
<b>Subordinated capital notes not convertible into shares:</b>						
In non-inked Israeli currency	5.79	6.23	2,971	2,422	278	69
In Israeli currency, linked to CPI	7.17	5.45	7,626	7,447	2,038	1,909
<b>Subordinated capital notes convertible into shares:</b>						
In Israeli currency, linked to CPI <sup>(2)</sup>	10.91	5.05	1,697	1,660	1,697	1,660
<b>Total subordinated capital notes</b>			<b>12,294</b>	<b>11,529</b>	<b>4,013</b>	<b>3,638</b>

Footnotes:

- (1) Internal rate of return is the rate which discounts the projected payment flow of amounts presented in the balance sheet. Period to maturity is the average of the repayments periods weighted by the cash flows discounted at the internal rate of return. Data regarding the internal rate of return and the period to maturity relates to the consolidated statements as of December 31, 2010.
- (2) Subordinated capital notes regarded as "hybrid tier I capital" (see Note 14 5 below).

**12. OTHER LIABILITIES**

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
in NIS millions				
Net provision for deferred taxes (see Note 29 N)	14	14	14	14
Excess current tax provisions over advance payments	125	30	102	-
Excess of the provision for severance and retirement benefits over amounts deposited (See Note 16 E, I)	52	42	-	-
Provisions for vacation pay, seniority bonus and retirement benefits	1,134	*1,074	940	*913
Deferred income	183	168	68	58
Credit balances of derivative financial instruments (except for derivative instruments)	3,215	2,489	2,972	2,292
Payables for credit card activity	5,456	5,257	2,595	2,182
Provision for doubtful debts in respect of guarantees	149	154	125	124
Accrued expenses	780	747	274	370
Commitments in respect of "Maof" market operations	386	*472	386	*472
Amounts received from realization of other creditors and credit balances	1,371	*2,065	672	*574
<b>Total other liabilities</b>	<b>12,865</b>	<b>12,512</b>	<b>8,148</b>	<b>6,999</b>

\* Reclassified.

### 13. SHAREHOLDERS' EQUITY PREFERRED SHARES, SHARE BASED PAYMENT TRANSACTIONS AND DIVIDENDS

#### A. THE AUTHORIZED, ISSUED AND PAID-UP NOMINAL SHARE CAPITAL (IN NEW ISRAEL SHEKELS):

	December 31, 2010		December 31, 2009	
	Issued and		Issued and	
	Authorized	Fully Paid-Up	Authorized	Fully Paid-Up
Ordinary "A" Shares of NIS 0.1 par value each	196,100,000	105,386,930	196,100,000	98,063,921
6% Cumulative Preferred Shares, of NIS 0.00504 par value each (equivalent to 10 pounds sterling each)	202	202	202	202
<b>Total shareholders equity</b>	<b>196,100,202</b>	<b>105,387,132</b>	<b>196,100,202</b>	<b>98,064,123</b>

Ordinary "A" Shares are registered and are listed for trade on the Tel Aviv Stock Exchange.

#### B. 6% CUMULATIVE PREFERRED REGISTERED SHARES:

The dividend and the rights of these shareholders are linked to the representative rate of exchange of the New Israel shekel to the pound sterling at the date of each payment. At the balance sheet date, every holder of a preference share, the par value of which is equivalent to 10 pounds sterling, is entitled to an annual dividend in an amount of NIS 3.30, and at the time of liquidation to a distribution in an amount of NIS 54.93. According to an Opinion issued by the Institute of Certified Public Accountants in Israel, non-participating preference shares are not to be included as part of shareholders' equity, and accordingly they are presented under the item "other liabilities".

#### C. (1) Increase of the authorized share capital in the years 2006-2008 -creation of a pool of shares for the purpose of "forced conversion events" of subordinate capital notes Series "A" and "B"

The special meetings of shareholders convened on December 26, 2006 and September 22, 2008, resolved to increase the Bank's authorized share capital by a total amount of 820 million ordinary A shares of NIS 0.1 par value each. The shares derived from the said increases are intended to be issued to investors in subordinate capital notes (series "A") in a total amount of NIS 2 billion, in the event of a compulsory conversion of the principal amount and/or interest, in certain circumstances that have been determined by the Supervisor of Banks (hereinafter: "compulsory conversion events"; for further details see Note 14 below).

In December 2006 and September 2008, the Bank issued subordinate capital notes (Series "A") in an approximate par value of NIS 1,147 million (see Note 14(7)a hereunder). In respect of the said capital notes the Bank maintained in its share capital a pool of approximately NIS 470 million ordinary "A" shares (the said quantity is subject to adjustment to the benefit component included in the rights issue of December 2010).

In March 2009, the Bank issued approximately 350 million par value of subordinate capital notes Series "B" (see Note 14(7)b hereunder). In respect of the said capital notes, the Bank maintained in its authorized share capital a pool of approximately 267 million shares to be used, if required, in a forced conversion event (the said quantity is subject to adjustment to the benefit component included in the rights issue of December 2010).

#### (2) Increase of the authorized share capital in 2009 - increase for the purpose of raising tier I capital

The special meeting of shareholders convened on December 15, 2009 resolved to increase the Bank's authorized share capital by 111 million ordinary A shares of NIS 0.1 par value each. The shares created by the said increase were intended to promote a move for the raising of tier I capital.

The Bank is committed towards the State of Israel, which at that date owned a 20% of the Bank's shares, that the shares constituting part of the Bank's authorized share capital, which were created as a result of the said increase in capital, will be utilized for the above purpose and will not be used for any other purposes.

### **13. SHAREHOLDERS' EQUITY PREFERRED SHARES, SHARE BASED PAYMENT TRANSACTIONS AND DIVIDENDS (CONTINUED)**

#### **D. Share issuance in 2010**

In December 2010 the bank completed a share offer to the public as well as a rights issue, as follows:

- On December 6, 2010, the Bank completed a share offer to the public issuing 34,000,000 ordinary "A" shares, according to a shelf offer report dated December 6, 2010, for total gross consideration of NIS 263.8 million.
- On December 16, the Bank completed a rights offer issuing 38,881,192 ordinary "A" shares, for which exercise notices had been received, according to a shelf offer report dated November 28, 2010 (as updated on November 29, 2010), for total gross consideration of NIS 198.3 million. The Bank's controlling shareholders have exercised in full the rights offered to them.

The net proceeds of the above mentioned offers amounted to NIS 450 million.

#### **E. EQUITY BASED COMPENSATION TRANSACTIONS - AN OPTION PLAN FOR OFFICERS OF THE BANK**

##### **(1) Phantom plan for the acting Chairman of the Board and for the acting President & CEO**

Within the framework of an approved remuneration plan in respect of the Chairman of the Board and the President & CEO (see Note 22), it had been determined that the Chairman of the Board and the President & CEO will be entitled to a phantom type remuneration, dependent on the performance of the Bank's shares. The Bank granted to the chairman of the Board a quantity of 6,511,628 phantom rights and to the President & CEO a quantity of 4,878,049 phantom rights (hereinafter: "the phantom rights")

The phantom rights do not entitle any rights to the Bank's shares and/or to any rights whatever stemming from the holding of the Bank's shares, excluding certain adjustments.

The phantom rights shall vest in five equal annual lots, each lot numbering one fifth of the total quantity of phantom rights, so that one annual lot shall vest in each year. The first annual lot pertaining to the Chairman of the Board vested on January 1, 2011, and his last lot shall vest on January 1, 2015. The first annual lot pertaining to the President & CEO shall vest on January 1, 2012 and his last lot shall vest on January 1, 2016.

Each annual lot of phantom rights is exercisable, in whole or in part, during a period of two years from date of vesting, thereafter it shall expire and will no longer entitle to any rights (hereinafter: "the exercise period")

In each of the following cases, the vesting date of each annual lot of phantom rights shall be deferred or an annual lot shall expire:

- (1) In the event that the Bank's most recent quarterly financial statements issued prior to the vesting date of the relevant annual lot, will present a net loss from ordinary operations on a cumulative basis over the four quarters preceding the said vesting date, then the vesting date of the said annual lot will be deferred and will apply immediately after the date of issue of the Bank's quarterly financial statements showing a net profit from ordinary operations on a cumulative basis over the most recent four quarters preceding the said financial statements (and the exercise period will also be deferred, respectively). In determining the net profit or loss from ordinary operations for the purpose of this item, expenses stemming from an early retirement plan in respect of a part the Bank's employees, the budget for which will be approved by the Board of Directors, if at all performed, shall be eliminated;
- (2) In the event that the most recent financial statements of the Bank issued prior to the vesting date of the relevant annual lot, will show a material deviation from the required total capital adequacy ratio, then the vesting date of the said annual lot will be deferred and will apply immediately after the date of issue of the Bank's quarterly financial statements showing a total capital adequacy ratio that does not materially deviate from the required total capital adequacy ratio. In this respect, a deviation at a rate exceeding 20% of the required total capital adequacy ratio will be considered a material deviation;
- (3) In the event that the Bank will be obliged to convert into the Bank's ordinary shares the outstanding balance of principal and interest of subordinate capital notes (of whatever Series) issued by the Bank (this in accordance with the terms of issue of the said subordinate capital notes), then the right to receive the annual lot of phantom rights, the vesting thereof takes effect during the four quarters following the conversion event, as above, shall expire.

### 13. SHAREHOLDERS' EQUITY PREFERRED SHARES, SHARE BASED PAYMENT TRANSACTIONS AND DIVIDENDS (CONTINUED)

The plan includes provisions regarding shortening of the exercise period and granting phantom rights in the case of termination of engagement as well as provisions regarding the modification of the plan under certain circumstances.

In respect of each exercise notice, the Bank shall pay an amount equal to the difference between the closing market price for each ordinary "A" share of the Bank and the base price, multiplied by the number of phantom rights being exercised.

For this purpose, the "base price" is the last closing market price of each ordinary "A" share of the Bank on the trading date preceding the date of the approval of the Board of Directors granted to the Phantom plan, with the addition of CPI linkage increments according to the rise of the CPI between the known Index at date of approval by the Board and the known Index at date of exercise of the rights.

The overall fair value of the rights (for five years), calculated by the Black & Scholes model, is NIS 14 million in respect of phantom rights granted to the Chairman of the Board, and NIS 12 million in respect of phantom rights granted to the President & CEO. The above economic value was computed on the basis of the assumption that all the phantom rights would be exercised on the last day of the exercise period determined in respect thereof, on the basis of the market closing price of an ordinary "A" share of the Bank on December 19, 2010 (NIS 8.092), a standard deviation of 32.9% for computation purposes and a risk-free interest rate of between 0% and 1.5% (according to the period).

It should be noted that the above calculation serves as an indication only to the cost of the phantom award, and that the actual cost may change, as it is affected by changes in the market price of the shares during the period of the plan.

The expense in respect of the different lots will be recognized over the period up to their vesting dates. Until the final date of exercise of the phantom rights, at each reporting date the fair value of the plan shall be calculated in accordance with market conditions at those dates, the differences being recognized in the statement of income.

In the financial statements as of December 31, 2010, an expense of NIS 7.4 million was recognized, in respect of the proportionate share of all the tranches granted to the Chairman of the Board (excluding payroll tax).

In respect of the above plan, an expense will be recognized in the financial statements for 2011, of NIS 4.3 million in respect of the Chairman of the Board and NIS 6.5 million in respect of the President & CEO, in fair value terms as of December 31, 2010 (excluding payroll tax).

#### (2) An option plan for the Bank's officers (excluding the former Chairman of the Board and the former President & CEO)

**General.** In its resolutions of the dates March 26, 2006, July 1, 2006 and July 25, 2006, the Board of Directors approved a stock option plan and the allotment to a Trustee of 9,806,391 option warrants in respect of the Bank's nine officers, including the former Internal Auditor and excluding the Bank's former Chairman of the Board and former President & CEO (hereinafter in this Note - "Officers").

The option warrants are non-marketable and are convertible into ordinary "A" shares of NIS 0.1 each, on terms and dates as determined in the option plan.

**The terms of the option warrants.** The exercise price of each of the option warrants offered according to the plan to seven of the other officers, was NIS 6.379 (subject to adjustments in terms of the plan). The said exercise price had been determined on the basis of the closing market price of the Bank's shares on February 1, 2005. The exercise price of the option warrants granted to two Officers, who began their employment with the Bank on March 1, 2006 and on April 2, 2006, is the market closing price of the Bank's shares on the last trading day prior to the beginning of work at the Bank of the respective officer.

The above exercise prices are linked to the CPI and are subject to adjustments stemming from the distribution of cash dividends and/or bonus shares as well as a rights issue by the Bank.

The exercise price of each of the said option warrants as of December 31, 2010, were NIS 7.067 in respect of four officers (remaining in the Bank out of the seven officers mentioned above), NIS 9.796 in respect of the officer who joined the Bank on March 1, 2006, and NIS 9.663 in respect of an officer who joined the Bank on April 2, 2006.

### 13. SHAREHOLDERS' EQUITY PREFERRED SHARES, SHARE BASED PAYMENT TRANSACTIONS AND DIVIDENDS (CONTINUED)

The exercise period of two thirds of the warrants allotted under the plan began on January 5, 2009 and ended on January 4, 2011, and the exercise period of the remaining one third began on January 1, 2011 and will end on December 31, 2012, all subject to the provisions specified in the plan as regards the termination of employment of the offerees with the Bank.

In accordance with section 102 of the Income tax ordinance, all the option warrants under the plan were allotted in the name of a Trustee for and on behalf of the offerees, in accordance with the terms of the capital gains alternative by means of the Trustee.

Procedure for the exercise of the options - At each exercise date, the amount of the benefit to the offeree will be computed and the Bank would issue to the Trustee for the offeree a number of ordinary shares, the total market value of which, based on the closing market price of the Bank's shares on the trading date preceding the exercise date, equals the amount of the monetary benefit.

The Bank will convert into share capital, that part of its earnings, within the meaning of section 302(b) of the Companies Law, 1999, ("the Companies law"), from premium on shares or from any other source included in its shareholders' equity, as stated in Section 304(a) of the Companies Law, equal to the par value amount of the exercised shares to be allotted as stated.

Each option warrant not exercised in accordance with the terms of the plan until the end of the period determined for its exercise, shall become null and void and would not entitle to any rights whatever.

The theoretical value of the benefit in respect of the option warrants, allotted as above, in accordance with the provisions of Accounting Standard No. 24, is estimated at NIS 39 million. The value of the benefit in respect of the option warrants, allotted as above, which includes payroll tax, considering the change that has taken place in the payroll tax rates and the actual profit component (in contrast to that estimated at the time), is assessed at NIS 40 million.

The value of the benefit on behalf of the said nine officers will be allocated in the Bank's books as from the date of grant of the options (March 26, 2006), and until the beginning of the exercise period of each portion (two thirds over a period of 2.8 years and the additional one third over a period of 4.8 years). One of the officers retired from the Bank at the end of 2006, and the options that had been allotted to him expired (1,176,767). Following the retirement of an officer in the course of 2007, the options issued to her (1,176,767) expired. Following the retirement of one of the officers at the end of January 2009, the option warrants allotted to him expired in 2009 (1,176,767). In 2010, 2,876,540 option warrants were exercised by officers. The balance of the unexpired option warrants on December 31, 2010, in respect of six officers amounted to 3,399,550 option warrants. The said balance includes 326,880 option warrants in respect an officer who retired from office on December 31, 2010 (termination of employer/employee relations on March 31, 2011).

, and who, according to the terms of the plan, may exercise the balance of the option warrants allotted to them and not expired on January 4, 2011, until September 30, 2011. The outstanding balance includes also 392,256 option warrants in respect of an officer who retired from the Bank in the course of the year and was appointed President & CEO of one of the Bank's subsidiaries in Israel, and which under these circumstances, in accordance with the terms of the plan, will be considered for the purpose of the plan as if he continued in office at the Bank and as if his engagement by the Bank had not been terminated.

1,307,518 option warrants expired on January 4, 2011. In the year ended on December 31, 2010, an amount of NIS 1.8 million was charged in respect of six officers, as salary expenses as against a capital reserve. (2009: an amount of NIS 1 million in respect of seven Officers; 2008: an amount of NIS 8.5 million in respect of seven Officers) at date of expiry or exercise of the option warrants, which have been vested, the Bank allocates to the balance of premium the related part of the capital reserve.

#### (3) Option plan for the former Chairman of the Board and former President & CEO

The Bank's special shareholders meeting held on August 26, 2007, approved the terms of office of the Bank's former Chairman of the Board as well as the issue of option warrants to the former Chairman of the Board within the framework of the stock option plan for the former Chairman of the Board and for the former President & CEO.

Within the framework of the option plan, 8,090,275 option warrants were allotted to a trustee on behalf of the former President &

### 13. SHAREHOLDERS' EQUITY PREFERRED SHARES, SHARE BASED PAYMENT TRANSACTIONS AND DIVIDENDS (CONTINUED)

CEO, and an equal number of options to a trustee on behalf of the former Chairman of the Board of Directors; each option exercisable into one ordinary share. The exercise price of the options is NIS 8.455. The price was determined according to the closing rate of the Bank's shares on the stock exchange on the day prior to the date of approval by the general meeting, linked to the CPI, subject to adjustments.

The option warrants allotted to the trustee might have been exercised, according to the plan, on the following dates:

- Parcels of option warrants vested until the end of 2008, as from January 5, 2009, and until January 4, 2011;
- Parcels of option warrants vested until the end of 2009, as from January 5, 2010, and until January 4, 2012;
- Parcels of option warrants vested until the end of 2010, as from January 5, 2011 and until January 4, 2013.

Each of the periods during which option warrant become exercisable under the plan, as stated above, shall be called hereunder, "the exercise period".

Option warrants allotted to the trustee on behalf of a grantee whose office was terminated, and which had not been exercised (and have not expired), and which are included in the parcels which have been vested in the grantee until the end of the last year of measurement preceding the date of termination of office, shall be exercisable until the earliest of the following dates: (1) 180 days since date of termination of office or 180 days from the beginning of the exercise period of each of the option warrants as stated above, whichever is the later; or (2) the end of the exercise period of each of the option warrants, as stated above, as the case may be.

The exercise price of each of the aforesaid option warrants as of December 31, 2010, was NIS 9.072.

The option warrants were divided into five equal annual installments in each of the years 2006 through 2010.

In view of the termination of office of the former Chairman of the Board, 1,618,055 option warrants, included in the portion for 2010, have expired. The balance of the option warrants, entitlement to which had come into effect, expired on June 30, 2010.

Entitlement to options will be subject, inter alia, to the yield on the Bank's shares (TSR - Total Shareholders' Return) in a specific calendar year, in a manner that ensures it will reach a least 85% of the average return on shares of other banks in the same period. The said condition was fulfilled in the years 2006 and 2007 and in 2009 in respect of the years 2008-2009, and therefore the former Chairman and the former President & CEO became entitled to the right to the annual tranche in respect of the said years. The said condition was not met in 2010, therefore the former President & CEO was not entitled to the lot in respect of this year. 3,236,110 option warrants of the former President & CEO expired on January 4, 2011, and the 3,236,110 balance of his option warrants is exercisable until June 30, 2011.

The economic value of the option warrants, for purposes of recording in the Bank's financial statements, was calculated according to the Monte Carlo method, i.e. accepted statistical quantitative method for purposes of pricing financial instruments, including options for employees. The economic value of all the option warrants allocated to the trustee on behalf of the former Chairman of the Board of Directors and the President & CEO according to the option plan, is calculated as of the date of approval by the general meeting, according to the closing rate of the Bank's shares on the stock exchange on the preceding day, was NIS 31.3 million.

In 2010 a reduction in expense in the amount of NIS 2.2 million was recorded in respect of the said benefit. (Expenses of NIS 19.8, 6.5 and 1.3 million were recorded in the years 2007, 2008 and 2009, respectively).

Actually, the former Chairman and President & CEO did not exercise option warrants granted to them under the said plan.

#### (4) Issue of Options to additional Members of Management

**General.** In February 2010, the Board of Directors decided to approve a "phantom option" plan to whom acted at the time as Head of the Corporate Banking Division (hereinafter: "offeree A") and to the Bank's legal counsel (hereinafter - "offeree B"), this in continuation to previous resolutions in their respect, including a resolution of January 2007, which, among other things, determined that the option plan to be offered to them shall be as similar as possible to the option plan granted to the Bank's officers, approved in March 2006 and

### 13. SHAREHOLDERS' EQUITY PREFERRED SHARES, SHARE BASED PAYMENT TRANSACTIONS AND DIVIDENDS (CONTINUED)

ratified in July 2006 (see 2 above), mutatis mutandis.

**"Phantom option" plan.** Offeree A and Offeree B will be entitled to a cash amount being the difference between the closing market price of the Bank's ordinary share on the trading day prior to the exercise date, multiplied by the number of shares resulting from the phantom options in respect of which an exercise notice had been given, and the exercise price multiplied by the same number of phantom options (hereinafter: "the amount of cash benefit"). To the amount of cash benefit shall be added the grossed up tax difference between the marginal tax applying to the offeree member of Management and the capital gains tax that would have been paid by him had he received the option warrants according to an option plan subject to Section 102 of the Income Tax Ordinance (the capital gains option). The grossed up tax amounts and the amount of cash benefit shall be known together as the "phantom award".

The exercise price of each of the phantom options shall be determined according to the closing market price of the Bank's ordinary share, on the last trading day prior to the date of appointment as Executive Vice President (hereinafter: "trading day") (NIS 9.3 and NIS 9.171, respectively), together with linkage increments to the CPI, as from the most recent CPI published prior to the last trading day before entry into office and until the known index in effect on date of exercise (hereinafter: "the exercise price"), subject to adjustments as detailed in the plan.

Offeree A has been offered 980,639 phantom options (instead of 1,176,767 options which were supposed to have been granted to him) and Offeree B has been offered 817,199 phantom options (instead of 980,639 options which were supposed to have been granted to her).

Offeree A and Offeree B will be entitled to phantom options in two portions, as follows:

- The first portion including 784,511 phantom options to Offeree A and 653,759 phantom options to Offeree B was granted to the offerees on February 24, 2010. The phantom options included in the first portion are exercisable within two years from the above date.
- The second portion including 196,128 phantom options to Offeree A and 163,440 phantom options to Offeree B to be granted to the offerees on February 24, 2011. The phantom options included in the second portion are exercisable within three years from the above date.

As of the date of the decision the exercise price was NIS 10.060 and NIS 9.923 respectively (taking into account the dividend distributed on October 6, 2008).

The offerees shall be entitled to the phantom options only if they will serve as officers of the Bank on the determining date. The plan includes provisions for the shortening of the exercise period and the pro-rata granting of the phantom options in cases of termination of employment as well as provisions regarding the modification of the plan under certain circumstances.

The exercise of the phantom options does not have any effect on the Bank's share capital.

The fair value of the options granted to the two offerees, based on the Black & Scholes model, amounts to NIS 2.811 million. The fair value, as stated, has been computed on the basis of the assumption that all the phantom options would be exercised on the last day of the exercise period determined in their respect and it does not take into account the fact that these are not marketable options and that the date determining the right to a part of the phantom options has not yet arrived. The total fair value of the phantom award, also taking into consideration the grossing up of the said tax differences, amounts to NIS 3.710 million.

It is emphasized that the above computation serves only as an indication of the cost of the phantom award, and that the actual cost may be different because it is affected by changes in the price of the Bank's shares during the period of the plan, as well as changes that might occur, if at all, in future tax rates.

The expense in respect of the first portion of the phantom options has been recognized in the income statement of the financial report for December 31, 2010 while the expense in respect of the second portion will be distributed over the period to its date of entitlement.

### **13. SHAREHOLDERS' EQUITY PREFERRED SHARES, SHARE BASED PAYMENT TRANSACTIONS AND DIVIDENDS (CONTINUED)**

At each reporting date, until the exercise of the phantom options, a calculation of the fair value of the plan shall be made, in accordance with the market terms at that date, and the resultant difference will be recognized in the income statement.

In view of the termination of office of Offeree "A" on December 31, 2010, he is not entitled to the phantom options comprising the second lot. The phantom options included in the first lot may be exercised by offeree "A" until June 30, 2011.

The expense recognized in the financial statements as of December 31, 2010, in respect of the said plan amounted to NIS 0.7 million (excluding payroll tax).

#### **E. DIVIDEND**

##### **(1) General**

The distribution of dividends by the Bank is subject to the provisions of the law, including limitation deriving from Directives of the Supervisor of Banks.

##### **(2) Restrictions on the distribution of dividends specified in the Governor's permit for the acquisition and holding of means of control in the Bank**

The permit issued on January 29, 2006 by the Governor of the Bank of Israel to the Bronfman-Schran Group to acquire and hold control means in the Bank, specified, among other things, the following restrictions:

- (a) No dividends shall be distributed from earnings retained by the Bank up to September 30, 2004. If losses were incurred after that date, no dividends shall be distributed until after such losses have been recovered. Furthermore, no dividends are to be distributed from gains on sale of the Bank's significant assets during the period of five years from date of the permit. After that date, dividends may be distributed from such gains subject to the prior written approval of the Supervisor (The Bank's retained earnings as of September 30, 2004, which, as stated, may not be distributed, amount to NIS 2,704 million).
- (b) Notwithstanding the aforementioned, dividends may be distributed from gains on sale of the Bank's significant assets during the period of five years from date of the permit, if all the following conditions exist:
  1. The sale results from legal requirements applying to the Bank;
  2. The distribution of dividends from such gains shall not cause a reduction in the minimum capital ratio that existed at the Bank prior to the sale of the said assets;
  3. The Bank's Board of Directors shall approve such distribution after having examined the needs of the Bank and its business plans;
  4. Prior approval of the Supervisor in writing has been given for such distribution after the Supervisor had examined the Bank's capital adequacy and the basis for the Board's decision.

##### **(3) Distribution of dividend in 2008**

The Special Meeting of Shareholders convened on September 22, 2008, approved of the Bank's Board of Directors' recommendation dated August 31, 2008, for the distribution in cash of a dividend in the amount of NIS 250 million, out of earnings of the years 2007-2008. The dividend was paid on October 23, 2008, to the shareholders that held the Bank's shares as of October 6, 2008 (the determining date). The amount distributed comprises approximately NIS 0.255 per share of NIS 0.1 par value (225%).

##### **(4) Distribution of a dividend in respect of preferred shares**

On September 2, 2010, the General Meeting of Shareholders resolved to approve as final dividend for 2009, the interim dividend of 6%, paid on December 30, 2009, to the holders of 40,000 6% cumulative preference shares of NIS 0.00504 par value each, in a total amount of GBP 24,000.

On November 1, 2010, the Bank's Board of Directors resolved to pay on December 30, 2010, an interim dividend of 6% to the holders of the said preferred shares, and to recommend to the annual General Meeting of Shareholders, that will convene in 2011, to declare such dividend as final.

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS

**General** - The capital adequacy as of December 31, 2010, is computed according to the standard approach in accordance with Proper Banking Management Directive Nos. 201 and 211 regarding "Measurement and capital adequacy" (hereinafter: "Basel II guidelines").

### 1. CAPITAL FOR CALCULATING RATIO OF CAPITAL

#### Reported amounts

	31 December	
	2010	2009
	in NIS millions	
Tier 1 capital post deductions	12,101	*10,700
Tier 2 capital post deductions	7,293	*6,469
<b>Total capital</b>	<b>19,394</b>	<b>17,169</b>

### 2. WEIGHTED CREDIT RISK ASSETS BALANCE

	31 December	
	2010	2009
	in NIS millions	
Credit risk	125,514	*125,641
Market Risk	2,907	2,752
Operational risk	13,233	12,969
<b>Total weighted credit risk assets balance</b>	<b>141,654</b>	<b>141,362</b>

For notes to the table see after item 4.

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

### 3. RATIO OF CAPITAL TO RISK ASSETS

Reported amounts

	31 December	
	2010	2009
	in %	
<b>A. The bank</b>		
Ratio of original tier 1 capital to risk assets	8.0	*7.1
Ratio of tier 1 capital to risk assets	8.5	*7.6
Ratio of total capital to risk assets	13.7	*12.1
<b>Ratio of total minimum capital required by the Supervisor of Banks</b>	9.0	9.0
<b>B. Significant subsidiaries</b>		
<b>1. Mercantile Discount Bank LTD. and its subsidiaries</b>		
Ratio of tier 1 capital to risk assets	11.0	**10.4
Ratio of total capital to risk assets	13.6	**12.2
<b>Ratio of total minimum capital required by the Supervisor of Banks</b>	9.0	9.0
<b>2. Discount Mortgage Bank LTD. and its subsidiaries</b>		
Ratio of tier 1 capital to risk assets	12.5	**12.4
Ratio of total capital to risk assets	18.3	**18.8
<b>Ratio of total minimum capital required by the Supervisor of Banks</b>	9.0	9.0
<b>3. Discount Bankcorp Inc.<sup>(1)</sup></b>		
Ratio of tier 1 capital to risk assets	12.5	12.5
Ratio of total capital to risk assets	14.7	14.9
<b>Ratio of total minimum capital required by the Supervisor of Banks</b>	<sup>(2)</sup> 8.0	<sup>(2)</sup> 8.0
<b>4. Israel Credit Cards LTD.</b>		
Ratio of tier 1 capital to risk assets	15.5	13.5
Ratio of total capital to risk assets	16.2	13.7
<b>Ratio of total minimum capital required by the Supervisor of Banks</b>	<sup>(3)</sup> 9.0	9.0

\* After deductions from the comprehensive capital according to Basel I with respect to balance of investments in shares and in subordinate capital notes of affiliated financial corporations and of non-consolidated subsidiaries.

\*\* Reclassified.

Footnotes:

(1) The data in this item was computed in accordance with the rules mandatory in the U.S.A.

(2) IDB New York, a subsidiary of Discount Bankcorp Inc., was classified by the FDIC as "well capitalized". Retaining the said classification requires the maintenance of a capital ratio, including the minimum ratio, of 10% and of a primary minimum capital ratio of 6%.

(3) In view of the approach by the Supervisor of Banks, ICC is required to maintain a total capital ratio of not less than 15%, starting from December 31, 2010 (see Note 33 A).

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

### 4. CAPITAL COMPONENTS FOR CALCULATING RATIO OF CAPITAL (CONTINUED)

Reported amounts

	31 December	
	2010	2009
	in NIS millions	
<b>A. Tier 1 capital</b>		
Equity	11,241	9,994
Minority interests in the equity of consolidated subsidiaries	328	298
Complex capital instruments	1,680	1,636
Less goodwill	(149)	*(176)
Less other intangible assets	(20)	*(44)
Less net gains on fair value adjustments of available for sale securities	(129)	*(56)
Less investments in non-realistic companies with significant influence	(774)	(825)
Less other deductions from tier 1 capital <sup>(1)</sup>	(76)	(127)
<b>Total tier 1 capital</b>	<b>12,101</b>	<b>10,700</b>
<b>B. Tier 1 capital</b>		
<b>1. Upper tier II capital</b>		
45% of net gains amount, pre related tax influence, on fair value adjustments of available for sale securities	90	42
General provision for doubtful debts	254	254
Complex capital instruments	1,322	*1,297
Other upper tier II capital components	2	2
<b>2. Lower tier II capital</b>		
Subordinated capital notes	6,475	5,826
<b>3. Amounts deducted from tier 2 capital</b>		
Investments in non-realistic companies with significant influence	(774)	(825)
Other deductions from tier 2 capital <sup>(1)</sup>	(76)	(127)
<b>Total tier 2 capital</b>	<b>7,293</b>	<b>6,469</b>

\* After deductions from the comprehensive capital according to Basel I with respect to balance of investments in shares and in subordinate capital notes of affiliated financial corporations and of non-consolidated subsidiaries.

Footnote:

(1) Deduction in respect of certain securitization risks.

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

**5. Policy regarding capital for the interim period.** The Basel Committee published in December 2009 draft recommendations in the matter of "Strengthening the resilience of the banking sector", and informed that it is its intension to publish a material part of the proposed changes as final recommendations as early as at the beginning of 2011, with effect as from December 31, 2012.

In his letter of June 30, 2010, the Supervisor of Banks informed that he is following developments in this respect and intends to examine the new recommendations in their final form with a view of modifying the existing directives applying in Israel, as the case may be.

In the interim period until the modification of the directives, the said letter requires banking corporations to take the following actions:

- To adopt until December 31, 2010, a target for the core capital ratio; this ratio is to relate to the core capital, less all deductions required by tier I, in accordance with Proper Banking Management Directive No. 202, "Measurement and capital adequacy - components of capital". The target has to be determined at a rate not lower than 7.5%;
- To submit to the Supervisor of Banks by the end of August 2010, a work plan designed to attain the said target;
- A banking corporation encountering difficulties, as stated above, should apply to the Supervisor of Banks in order to arrive at an agreed layout for reaching the target.
- To avoid the distribution of dividend, without prior approval from the Supervisor of Banks, if a bank has not attained the said target or if the distribution of the dividend will create such a situation.

In view of the above, the Bank's Board of Directors held a discussion regarding a proposed plan, which includes a target for the core capital ratio for the end of 2010, as well as a rising outline for the years 2011-2012. The plan submitted for approval of the Board of Directors is based on the examinations of several scenarios, the result of a number of which is that as of December 31, 2010, the Bank might not attain the required target. On August 31, 2010, the plan was submitted to the Supervisor of Banks and the Bank is acting in order to form an outline agreed with the Supervisor of Banks for attaining the target. The Supervisor of Banks informed on January 24, 2011, that the Bank may determine a core capital target of not less than 7.5% in effect until December 31, 2011 instead of December 31, 2010, on condition that certain terms determined by the Supervisor of Banks are fulfilled, including approval of a capital adequacy outline for maintaining a core capital target of not less than 7.5% until December 31, 2011, even if significantly different developments than those assumed at the base of the work plan occur. Furthermore, the Board of Directors shall receive a monthly report regarding compliance with the capital outline that had been determined, and that such report will also be submitted to the Supervisor of Banks. The Bank is required to form the said plan and submit it to the Supervisor of Banks no later than February 28, 2011.

It should be noted that in view of the agreement to be signed between FIBI and the Bank and in view of the approvals granted in respect thereof (see Note 6 above), in which a layout has been determined for the sale of the Bank's holdings in FIBI, the Supervisor of Banks has permitted the Bank to exclude from the core capital the deduction in respect of the Bank's investment in FIBI.

**The core capital ratio** as of December 31, 2010, computed in accordance with the above, reached a ratio of 7.9%.

### 6. Clarifications regarding hybrid capital instruments

#### A. Clarification regarding the recognition of hybrid capital instruments issued prior to the Basel II guidelines taking effect

At the Bank's request, the Supervisor of Banks clarified in a letter dated March 3, 2010, that until otherwise determined, the specific terms established for the recognition of hybrid capital instruments, as detailed in the approvals granted for each issue of the said instrument, continue to apply with respect to the particular issue even after the Basel II guidelines taking effect.

The Supervisor further clarified, to avoid doubt, that whenever the Bank is required to maintain capital adequacy ratios (overall, primary, original or other), including as a precondition for the recognition of hybrid capital instruments as a part of the Bank's capital base, such ratios shall not be changed, despite the change made from time to time in the criteria for the issue, and that they will be computed in accordance with the calculation method in practice at that date.

The above stated relates to issues made by the Bank as detailed in Sections 7 and 8 hereunder.

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

B. \_\_\_\_\_

### 7. The issue of hybrid tier I capital

#### A. Issue of hybrid tier I capital - Series "A"

**The issue of hybrid tier I capital in the years 2006-2007.** On December 31, 2006 subordinate capital notes, in its par value, were issued in the amount of NIS 750 million in a private placement, and on May 13, 2007 an additional NIS 250 million was issued to investors in a private placement. The Governor of the Bank of Israel approved that the abovementioned subordinate capital notes will be deemed hybrid capital instruments and will be recognized as part of the Bank's primary capital (tier I). On May 31, 2007, the Bank published a Prospectus for the listing for trade of subordinate capital notes.

**The issue of hybrid tier I capital in 2008.** The Bank issued on September 25, 2008, subordinated capital notes (Series "A"), by way of enlarging of an existing Series, listed for trade per Prospectus dated May 30, 2007, in a par value of approximately NIS 147 million, through a private issue to classified investors (as defined in the Securities Regulations (Offer of Securities to the Public), 2007). The said notes were issued in consideration for NIS 135 million, namely, i.e. at a discount of 14.6% of their adjusted value.

On September 22, 2008, the Supervisor of Banks approved the said capital notes as hybrid capital instruments recognized as part of the Bank's Tier I capital, as defined in Proper Banking Management Directive No. 311 - "The minimum capital ratio", subject to the following conditions:

- a. The capital notes are to be issued under terms identical to those of the capital notes issued as part of the existing Series;
- b. The rate of the Hybrid Tier I Capital is not to exceed 15% of the Bank's total Tier I capital;
- c. The capital notes are not and will not be pledged in favor of the Bank or in favor of its subsidiary companies.

The Bank complies with the said conditions.

**Additional issues of tier I hybrid capital Series "A".** The remainder of the not yet issued subordinated capital notes Series "A" amounted, at December 31, 2009, to NIS 853 million. It should be noted that the balance of the shares remaining in the Bank's authorized share capital, which may be used in the event of a compulsory conversion of capital notes Series "A" (83 million shares; see Note 13 C above) may enable additional issues in the amount of approximately NIS 202 million, and each additional issue in excess of the said amount will require the increase of the Bank's authorized share capital.

**Terms of the subordinated capital notes - Series "A".** The subordinate capital notes were issued for a period of 99 years and the principal will be repayable on January 1, 2106. The principal and interest on the notes are linked to the CPI and will bear annual interest as stated. The interest on the subordinate capital notes is payable quarterly.

The Bank is entitled, at its own discretion, to redeem the subordinate capital notes prematurely, after a minimum of 15 years from the issuance date, subject to the conditions stated in the notes and to approval from the Supervisor of Banks.

The subordinated capital notes will bear linked interest at the rate of 5.10%. In the event that the capital notes are not prematurely redeemed after fifteen years, they will bear interest at a variable rate, to be determined in advance for each period of five years, with the addition of step-up interest at a rate of 1% over the original spread determined for the first fifteen years (namely 2.495%).

The subordinate capital notes include special provisions, as detailed below, mainly compulsory conversion of the principal amount and/

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

or interest into ordinary "A" shares of NIS 0.1 par value each of the Bank, under certain circumstances determined by the Supervisor of Banks. In the event of conversion of the total principal amount of the capital notes and the allocation of shares in exchange for interest in respect of the full number of shares designated for such purpose in the Bank's authorized share capital, 398.5 million ordinary "A" shares of the Bank.

The subordinate capital notes are not secured by any pledge on the Bank's assets or by any other collateral. The Bank's liability for payment of the principal and interest on the capital notes is subordinate to all other liabilities of the Bank to creditors of any class, including to holders of subordinate capital notes that were issued or will be issued in the future by the Bank and/or its subsidiaries, and will be superior only to rights of the shareholders to the distribution of the balance of the Bank's assets upon liquidation. The Bank's liability for payment of the principal amount of the capital notes and the interest thereon will be equivalent, *pari passu*, to other liability notes and/or securities that will be issued by the Bank or by its subsidiaries, and which are approved by the Supervisor of Banks as primary capital instruments.

**Recognition of the capital notes as upper tier I capital.** The Governor of the Bank of Israel approved the Bank's inclusion of the capital notes as upper tier I capital.

Following are the basic conditions for recognition of the capital notes as upper tier I capital:

- (1) The ratio of capital to the Bank's risk assets should not fall below 10% as of the date of issuance of a compound capital instrument.
- (2) Hybrid tier I capital is required to comply with the designated conditions for compound capital instruments, as defined in Proper Banking Management Directive No. 311, included in secondary capital.
- (3) Structure of the issuance - The issuance should be implemented directly only by the Bank itself.
- (4) Quantity restriction - The ratio of the hybrid tier I capital should not exceed 15% of the total tier I capital as defined in Proper Banking Management Directive No. 311, including the hybrid tier I capital (hereinafter: "overall tier I capital").
- (5) Repayments - Only capital notes fully paid up in cash will be deemed hybrid tier I capital.
- (6) Non-accrual interest - In "special circumstances", as defined below, on the due date for payment of interest, such interest will not be payable and the entitlement of holders of the capital notes to interest will expire. Interest not paid as a result of existence of the special circumstances will not accumulate and will be erased after the payment date. Following are the special circumstances:
  - (a) The Bank's Board of Directors has determined that the Bank is unable to honor its obligations, which rank higher than the subordinate capital notes (series "A") or are equivalent thereto, or the Bank's independent auditors drew attention in their audit report or review report attached to the Bank's annual or interim financial statements, respectively, to notes to the financial statements regarding the Bank's inability to fulfill its obligations, as stated above;
  - (b) The Bank's Board of Directors has determined that probability exists that payment of the interest would create a situation in which the Bank will be unable to settle its existing and/or expected liabilities, or the Bank's independent auditors drew attention in their audit report or review report attached to the Bank's annual or interim financial statements, respectively, to notes to the financial statements regarding the probability of such situation;
  - (c) During six consecutive quarters, the financial statements for the last of which were published prior to the date for payment of the interest, the Bank did not report on accrued net income (i.e. if the simple addition of the quarterly amounts of the net earning or losses reported in the Bank's financial statements, for six consecutive quarters, constituted a negative amount);
  - (d) The Bank's last financial statements published prior to the date of the interest payment indicate that the Bank has no distributable profits.

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

- (7) Allotment of shares in respect of interest - In the case of erasure of interest, as described in 6 above, the Bank is empowered to issue shares to holders of the capital notes against the erased interest. Such shares may be issued only in respect of interest not paid in the same year, and shares may not be issued in respect of interest erased in prior years.
- (8) Sustaining of losses - The Bank is required to convert all outstanding balances of principal and interest in respect of the subordinate capital notes into ordinary "A" shares of the Bank, of the circumstances described below occur:
- (a) If the ratio of the overall tier I capital to the Bank's risk assets, as stated in the annual financial statements or in the Bank's quarterly interim financial statements for the reporting period, falls in a particular quarter below 6%, and does not recover within 90 days from the date of issue of the said financial statements, to a rate of at least 6%, conversion will be implemented immediately;
- (b) If the ratio of the tier I capital to the Bank's risk assets, excluding the hybrid tier I capital (hereinafter - "the original tier I capital"), as stated in the annual financial statements or in the Bank's quarterly interim financial statements for the reporting period, falls in a certain quarter below 5.5%, and does not recover until the date of publication of the financial statements for the following quarter to a rate of at least 5.5% (even if the ratio of the overall tier I capital exceeds 6% at that time), conversion will be implemented immediately;
- (c) If the ratio of the original tier I capital to the Bank's risk assets, as stated in the annual financial statements or in the Bank's quarterly interim financial statements for the reporting period, falls in a certain quarter below 6% but not lower than 5.5%, and does not recover to a rate of at least 6% until the end of the two quarters following that quarter, as stated in the Bank's interim financial statements, conversion will be implemented immediately (even if the ratio of the overall tier I capital exceeds 6% at that time), unless the Supervisor of Banks directs otherwise;
- (d) If the ratio of the original tier I capital, as stated in the annual financial statements or in the Bank's quarterly interim financial statements for the reporting period, falls in a certain quarter below 5%, immediate partial conversion will be implemented in an amount that would recover the original primary capital ratio of the Bank published for that quarter to at least 5%;
- (e) If the Bank's retained earnings become negative;
- (f) If the Bank's independent auditors drew attention in their audit report or review report attached to the annual financial statements or to the Bank's interim financial statements, respectively, to notes to the financial statements which express significant uncertainties regarding the continued existence of the Bank as a "going concern".
- (9) Change in terms, premature redemption, and/or increase in interest rate - the subordinate capital notes will be issued for a period of 99 years and may be redeemed at the discretion of the issuer, subject to advance written approval from the Supervisor of Banks, after a minimum period of 15 years. Additionally, other terms of the subordinate capital notes may not be changed without advance written approval from the Supervisor of Banks.
- Without detracting from this condition, one step-up of interest by up to 100 base points over the original margin determined for the first period of 15 years is enabled, after at least 15 years from the issuance date.
- (10) Subordination - Except for the rights of creditors in accordance with similar capital instruments, the capital notes are subordinate to claims of all other creditors, including holders of capital notes issued as secondary capital.
- (11) Collateral - The liabilities according to the capital notes are not secured by any collateral.
- (12) Issuance to related entities - The Bank will not issue subordinate capital notes to provident funds and/or mutual funds controlled and/or managed by the bank (insofar as this condition is at the Bank's discretion in the primary allocation).
- (13) Transparency - The terms of the issuance will be clear and disclosed, including full disclosure in the Bank's published annual financial statements of all conditions of the hybrid tier I capital, inter alia, the following details regarding the compound primary

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

capital: amount, components, share in the total overall primary capital and principal characteristics.

Regarding recognition of the capital notes as upper tier I capital, the Board of Directors adopted a capital adequacy policy according to which the Bank will maintain an original primary capital adequacy ratio (excluding the compound primary capital) of at least 6.5%, at all times.

For details regarding the issue of additional hybrid capital instruments, see Section 6(b) above.

### B. Issue of hybrid tier I capital - Series "B"

**Issue of hybrid tier I capital in March 2009.** In accordance with resolutions of the Board of Directors dated February 9, February 23 and March 25, 2009, The Bank entered into an agreement with Migdal Insurance Company Ltd. ( participation in profits), Migdal Insurance Company Ltd. (nostro) and Migdal Makefet Pension Funds and Provident Funds Management Ltd., each of them separately according to its share, for the private placement of NIS 350 million par value of the Bank's subordinated capital notes (Series "B") in a total consideration for NIS 350 million.

On March 26, 2009 the Supervisor of Banks approved the said capital notes as hybrid capital instruments recognized as part of the Bank's Tier I capital, as defined in Proper Banking Management Directive No. 311 - "The minimum capital ratio", subject to the following conditions:

- (a) The rate of the Hybrid Tier I Capital is not to exceed 15% of the Bank's total Tier I capital;
- (b) The ratio of the original tier I capital is not to fall below 6.5% at any time;
- (c) The capital notes are not and will not be pledged in favor of the Bank or in favor of its subsidiary companies.

The Bank complies with the said conditions.

**Terms of the subordinated capital notes - Series "B".** The principal on the subordinate capital notes will be repayable on January 1, 2106. The principal and interest on the notes are linked to the CPI and will bear annual interest as stated. The interest on the subordinate capital notes is payable quarterly. The Bank shall be entitled to announce, at its own discretion, the early redemption of the principal sum of the subordinated capital notes and of the linkage increments and interest accrued as of date of the actual early redemption, subject to the terms specified in the note, and subject to the prior approval of the Supervisor of Banks.

The subordinated capital notes will, in the period from date of issue and until December 31, 2021 (hereunder: "the first interest period"), carry linked interest at the rate of 8.7%. In the event that an early redemption will not occur on December 31, 2021, then the subordinated capital notes will carry interest at a variable rate to be fixed in advance for each period of five years, with the addition of a "step up" interest of 1% over the original margin fixed for the first interest period (namely, 7.13%).

The subordinate capital notes include special provisions, as detailed below, mainly compulsory conversion of the principal amount and/or interest into ordinary "A" shares of NIS 0.1 par value each of the Bank, under certain circumstances determined by the Supervisor of Banks. In the event of conversion of the total principal amount of the capital notes and the allocation of shares in exchange for interest in respect of the full number of shares designated for such purpose in the Bank's authorized share capital, 267 million ordinary "A" shares of the Bank, will be allocated in respect of the issued capital notes, as stated.

The subordinate capital notes are not secured by any pledge on the Bank's assets or by any other collateral. The Bank's liability for payment of the principal and interest on the capital notes is subordinate to all other liabilities of the Bank to creditors of any class, including to holders of subordinate capital notes that were issued or will be issued in the future by the Bank and/or its subsidiaries, and will be superior only to rights of the shareholders to the distribution of the balance of the Bank's assets upon liquidation. The Bank's liability for payment of the principal amount of the capital notes and the interest thereon will be equivalent, *pari passu*, to other liability notes and/or securities that will be issued by the Bank or by its subsidiaries, and which are approved by the Supervisor of Banks as primary capital instruments.

**The terms for recognition of the subordinated capital notes (series "B") as hybrid tier I capital.** The basic terms determined by

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

the Supervisor of Banks for the recognition of the subordinated capital notes as upper tier I capital are identical to the terms determined for Series "A" (as detailed in Section A above) with the following changes:

- The definition of "special circumstances" no longer includes the case of six consecutive quarters showing a loss (subsection (6) C).
- The following case was added to the definition of "special circumstances": where the Supervisor has instructed the cancellation of interest payments after realizing that a real danger exists that the interest payment might lead to a situation where the Bank would be unable to meet its obligations.
- Within the framework of the definition of cases where, if realized, an immediate conversion of the outstanding balance of principal and interest of the subordinated capital notes into ordinary "A" shares of the Bank would be effected, the definition of the term relating to the reduction in the proportion of the original tier I capital to below 5% (Section (8) (d)), was changed as follows: in the event that the proportion of the original tier I capital, as stated in the financial statements or in the Bank's interim financial statements, once in every quarter, fell in a particular quarter below 5%, the said conversion shall be effected immediately.

For details regarding the issue of additional hybrid capital instruments, see Section 6(b) above.

### 8. The issue of upper tier II capital

**Issue of upper tier II capital in 2009.** In 2009, Discount Manpikim issued NIS 1,252 million par value subordinated capital notes (Series 1), for a total consideration of NIS 1,258 million, designated as upper tier II capital.

**Terms of the subordinated capital notes to serve as upper tier II capital.** The subordinated capital notes will be issued for a period of 49 years; the principal sum of the subordinated capital notes will be repayable in one amount on a date to be determined in the first shelf offer report for the relevant series. The principal and interest of the subordinated capital notes are linked to the CPI. Interest on the said subordinated capital notes will be paid four times a year.

The Bank shall be entitled, at its discretion, to prematurely redeem the subordinated capital notes, starting with the end of the period to be announced in the shelf offer report and which in no case shall be shorter than ten years (hereinafter: "the initial period"), subject to the terms specified in the notes and subject to the approval of the Supervisor of Banks.

Until the end of the initial period, the capital notes will bear linked interest to be determined in the tender. In the event that the capital notes are not prematurely redeemed at the end of the initial period, then in the period beginning with the end of the initial period, they will bear interest at a variable rate, to be determined in advance for each period of five years, with the addition of step-up interest at a rate to be determined in the first shelf offer report, as stated.

The rights of the holders of the subordinated capital notes shall be deferred as regards claims by all other creditors of Discount Manpikim and of the Bank of any class, with the exception of holders of capital notes which constitute and/or will constitute from time to time the hybrid tier I capital issued by the Bank.

**Terms for the recognition of the subordinated capital notes as upper tier II capital.** Below are details of the terms specified by the Supervisor of Banks for the recognition of the subordinated capital notes as upper tier II capital:

1. Capital adequacy at date of issuance - at date of issue of the hybrid capital instrument, the ratio of capital to the Bank's risk assets shall not fall below 10%.
2. Original tier I capital ratio - the original tier I capital ratio shall not fall at any time below 6.5%.
3. Directive 311 - hybrid tier II capital must comply with the terms determined for hybrid capital instruments as defined in Section "C" (Definitions) of annex "A" to Proper Banking Management Directive 311 - "Minimum capital ratio", included in tier II capital.
4. During the five years prior to the final redemption date, the hybrid capital instruments are to be included in the tier II capital as though they were subordinated capital notes, in accordance with Section 2(b)(2) of annex "A" to Proper Banking Management Directive 311 - "Minimum capital ratio".

#### **14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)**

5. Structure of the issue - the issue shall be effected by the Bank or by a subsidiary thereof.
6. A quantitative restriction - the tier II capital may comprise up to 100% of the tier I capital and subordinated capital notes up to 50% of the tier I capital that was not issued in respect of market risks. This means that the upper tier II capital may reach up to 100% of tier I capital, though in actual fact, the potential for the issue of upper tier II capital ranges between the total amount of the tier I capital and the volume of the capital notes.
7. Redeemability - Only capital notes that have been fully paid up in cash may be considered upper tier II capital.
8. Collateral - the liability in accordance with the capital notes may not be secured by collateral.
9. Pledge on capital notes - the capital notes may not be financed and may not be pledged as security for a loan granted by the Bank or a subsidiary thereof.
10. Suspension of interest payments - Interest payments shall not be made if on their due date "suspending circumstances" prevail, as the term is defined below, and the payment thereof shall be deferred for unlimited periods. The suspending circumstances are:
  - (a) The Bank's Board of Directors has determined that the Bank is not able to honor on their due dates its liabilities that have preference over or that are equal to the subordinated capital notes, or where the Bank's independent auditor in his opinion or review report appended to the Bank's financial statements or the interim financial statements, as the case may be, has drawn attention to notes to the financial statements concerning the Bank's inability to honor its liabilities, as above.
  - (b) The Bank's Board of Directors has determined that reasonable concern exists that the payment of interest will cause a situation where the Bank will not be able to meet its existing and/or expected liabilities, or where the Bank's independent auditor in his opinion or review report appended to the financial statements or the Bank's interim financial statements, as the case may be, has drawn attention to notes to the financial statements mentioning the existence of such reasonable concern.
  - (c) Where according to the Bank's financial statements last issued prior to the interest payment date, the Bank has no distributable earnings.
  - (d) The Supervisor of Banks has ordered the suspension of interest payments after realizing that real concern exists that the payment of interest will cause a situation where the Bank would not be able to meet its liabilities.
11. Settlement of suspended interest payments - if at the date determined for the settlement of whatever interest payment it becomes clear that a change has taken place in the Bank's financial stability in a manner that suspending circumstances, as described in Section 10 above, exist, then payment of such interest would be suspended until such time as one or more of the conditions detailed hereunder exist, and provided that none of the suspending circumstances is still in existence and/or has ceased to exist.

These are the circumstances where upon the first coming into existence any of which, and subject to a determination by the Bank's Board of Directors that suspending circumstances no longer exist at that time, the suspended interest payments may be paid together with interest and linkage increments thereon:

  - (a) The Bank has declared the payment of dividend to the holders of any class of its shares.
  - (b) The Bank has announced a premature redemption, in full or in part, of the principal sum of the subordinated capital notes, or has redeemed the principal sum of the subordinated capital notes, in full or in part.
  - (c) A liquidation order has been issued against the Bank, however in such a case, settlement of the suspended interest payments is subject to the settlement of all the Bank's liabilities that take precedence over the principal and interest of the subordinated capital notes, or subject to another arrangement reached with the Bank's creditors that are preferable to the holders of the subordinated capital notes.
12. Non-payment of dividends - the Bank shall not pay a dividend to its shareholders so long as all the suspended interest payments have not been settled in full, this whether the declaration of the dividend had been made prior to the announcement by the Bank that

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

suspending circumstances emerged or made after such an announcement.

13. Premature redemption by the holder - the holder may not redeem the subordinated capital notes prematurely.
14. Premature redemption by the Bank - subject to restrictions detailed hereunder, the Bank may decide, based upon its judgment with no option to the holders of the subordinated capital notes, to prematurely redeem the principal of the subordinated capital notes, in full or in part, as the case may be, as well as the linkage increments and interest accrued in respect of the subordinated capital notes to date of the actual premature redemption, in respect of the principle of the subordinated capital notes this upon all the following conditions being materialized cumulatively:
  - (a) At least ten years have elapsed since the date of issue of the subordinated capital notes and the actual date of premature redemption.
  - (b) Premature redemption may only be made after receiving the prior approval of the Supervisor of Banks and on condition that the instrument shall be replaced by other capital of an identical or higher caliber, unless the Supervisor has determined that the capital adequacy of the corporation is adequate in relation to its risks.
  - (c) Effecting the premature redemption will not bring about any of the suspending circumstances, as defined in section 10 above, immediately after execution of the resolution for the premature redemption, and the Bank's Board of Directors has determined that even considering the premature redemption it does not expect suspending circumstances to emerge in the course of the twelve months following the date of the premature redemption.
15. Change in terms, premature redemption and/or determination of an interest mechanism - the capital notes are issued for a period of 49 years.
 

The terms of the capital notes may not be altered without the prior approval in writing of the Supervisor of Banks. Without derogating from this provision, and following at least ten years from date of issue (hereinafter: "the initial period"), a step-up of interest is permitted only once in the instrument's life time. The rate of increase in the interest shall not exceed 100 base points less the swap spread between the initial index base of the increased interest and the stepped-up index basis, or - 50% of the initial credit margin less the swap spread between the initial index base and the stepped-up index base.

Following the end of the initial period and if the subordinated capital notes are not prematurely redeemed at the end of the initial period, the capital notes shall bear interest at a variable rate in accordance with a predetermined and fixed basis to be established by the Trustee for the notes.
16. Subordination - The Bank's obligation for the payment of principal and interest of the capital notes shall be subordinate to all its other liabilities of whatever class, including liabilities towards the holders of subordinated capital notes issued or to be issued in the future by the Bank, and shall only take precedence over the rights of the Bank's shareholders to the reimbursement of the Bank's surplus assets upon liquidation, and over the rights of holders of other securities, the Bank's obligation in respect of which is recognized as tier I capital of the Bank, if and when the Bank will issue such securities. The status of the Bank's obligations, as stated above, shall not be altered as a result of the fact that the capital notes shall no longer be considered tier II capital of the Bank, for whatever reason. The Bank's obligation to pay the principal of the capital notes and the interest thereon stands parri passu with additional securities and/or additional securities that may be issued by the Bank or its subsidiaries and approved by the Supervisor of Banks as "hybrid capital instruments".
17. Allotment to related parties - The Bank shall not allot (to the extent that the matter depends on the Bank upon the initial issue) the hybrid capital notes to provident funds and/or mutual funds controlled and/or managed by the Bank.
18. Transparency - The terms of issue will be clear and disclosed. In this respect, full disclosure shall also be given in the Bank's annual financial statements issued to the public, to the terms of the hybrid tier II capital. Such disclosure will include, among other thing, the following details regarding the hybrid capital: its amount, composition, its share as a percentage of the total inclusive tier I capital as

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

well as its principal characteristics.

The terms described above are the basic terms for the recognition of the hybrid capital notes as upper tier II capital. Final approval shall be given only after a detailed examination of the Prospectus and terms of issue as detailed by the Bank in a letter to be based on the terms detailed in the letter of the Supervisor of Banks.

For details regarding the issue of additional hybrid capital instruments, see Section 6(b) above.

## 15. PLEDGES

**A.** IDB New York has pledged various loans and corporate bonds with the Federal Reserve Bank of New York (FRBNY). This pledge was made to secure credit from the FRBNY credit window as well as for credit within the framework of TAF tenders of this bank. The carrying value of the loans and securities pledged for FRBNY credit as of December 31, 2010 amounted to US\$1,588 million (NIS 5,635 million) [December 31, 2009: US\$1,739 million (NIS 6,563 million)].

In addition, IDB New York pledged securities and loans in favor of the Federal Home Loan Bank, in the amount of US\$298 million (NIS 1,059 million) as of December 31, 2010 as a collateral for deposits received from it [as at December 31, 2009: US\$419 million (NIS 1,582 million)].

**B.** IDB New York has sold securities, under buyback terms, in the amount of US\$2,340 million (NIS 8,303 million) as of December 31, 2010 [as at December 31, 2009: US\$2,331 million (NIS 8,800 million)].

**C.** Deferred notes issued by the Bank in accordance with a Prospectus of April 1997, are not secured by a pledge on the Bank's assets, except for a token first charge on a deposit of NIS 1.

**D.** The Bank is a member of the Euroclear Clearing House, which serves as a clearing system for transactions in securities traded on international markets, made through this clearing house. For this purpose, the Bank has pledged cash and securities in the amount of US\$15 million.

**E.** Discount Leasing Ltd. registered in favor of the State of Israel, a first floating charge on its assets, unlimited in amount, in respect of investment grants received.

**F.** Note 19 C 3 describes the risk fund established by the Ma'of clearing house. The Bank's share in the fund, deriving from the volume of the clearing activity on behalf of the Bank's customers as of December 31, 2010, amounted to NIS 37 million (December 31, 2009: NIS 35 million).

The balance of the security, which the Bank has to provide in favor of the clearing house (an off-balance sheet liability) based on scenarios devised by the Stock Exchange in respect of the activity of the Bank's customers and in respect of the Bank's activity itself (nostro) as of December 31, 2010, was NIS 99 million (2009: NIS 106 million).

According to the Memorandum and Bye Laws of the Ma'of clearing house all member of the clearing house, including the Bank signed pledge agreements to secure their liabilities in favor of the Ma'of clearing house and deposited liquid security only (State of Israel bonds and/or cash).

The Bank provided the Ma'of Clearing House with a first degree pledge on all monies that had been deposited by the Bank in an account in the name of the Ma'of Clearing House at the Stock Exchange Clearing House and at an account in the name of the Ma'of Clearing House in another bank, all as collateral for amounts that the Bank will be liable for in respect of Ma'of transactions to which it is responsible towards the Ma'of Clearing House. The obligation is subject to conditions, and the Bank is entitled, under certain conditions, to demand the repayment of certain amounts. Within the framework of these accounts the Bank has pledged bonds and cash in favor of the Ma'of Clearing House, the amount of which at December 31, 2010, totaled NIS 625 million (December 31, 2009: NIS 598 million).

Mercantile Discount Bank has created a similar pledge in favor of the Ma'of Clearing House. The value of the collateral in favor of the Ma'of Clearing House, as stated, amounted on December 31, 2010, to NIS 78 million (December 31, 2009: NIS 133 million).

**15. PLEDGES (CONTINUED)**

Balance of collateral\* provided to the Ma'of Clearing House:

	Balance as of December 31, 2010	Highest balance during the year	Average balance in 2010	Balance as of December 31, 2009
In NIS millions				
Cash	11	14	13	11
Securities	692	759	722	720

\* The reporting is made on the basis of the month-end balances.

**G.** As collateral for the obligations of Yatzil Finance and its subsidiaries towards the banks, the said companies registered an assignment by way of a pledge and a fixed and floating pledges on all their rights according to agreements with business houses for the discount of IsraCard, VISA, American Express and Diners Club Israel vouchers, and all the rights to receive monies and payments from IsraCard, ICC, American Express and Diners, under power of assignment of rights and under the business house agreement. As of balance sheet date there was no obligation towards the banks.

**H.** Israel Discount Bank (Switzerland) has pledged assets in the amount of CHF 32 million (December 31, 2009: CHF 30 million), as collateral for credit facilities in the amount of US\$0.5 million.

**I.** As detailed in Note 19 C 4 hereunder, in accordance with the requirements of the Articles of the Tel-Aviv Stock Exchange Clearinghouse Ltd. (hereinafter: "the Clearinghouse" or "Stock Exchange") Articles and the bylaws of the Clearinghouse, the Bank pledged as security for its obligations towards the Clearinghouse all the Bank's rights in the security deposit managed by the Clearinghouse (in which the Bank deposits securities) and all its rights in an account opened with another bank. The value of the collateral amounted on December 31, 2010, to NIS 144 million (as at December 31, 2009: NIS 142 million).

Mercantile Discount Bank has created a similar pledge in favor of the Stock Exchange Clearing House. The value of the collateral as of December 31, 2010, amounted to NIS 9 million (December 31, 2009: NIS 9 million).

Balance of collateral\* provided to the Stock Exchange Clearing House:

	Balance as of December 31, 2010	Highest balance during the year	Average balance in 2010	Balance as of December 31, 2009
In NIS millions				
Cash	13	13	13	12
Securities	140	146	140	139

\* The reporting is made on the basis of the month-end balances.

**J.** In July 2007, the Bank of Israel launched a system for the real-time settlement of large amounts (RTGS), enabling the swift and final transfer of funds between banks connected to the system, provided that the liquidity balance at these banks shall not fall below the volume required for effecting such money transfers.

In view of the new settlement arrangements, the Bank may require from time to time credit from the Bank of Israel for short periods of time. In order to secure the repayment in full of amounts due to the Bank of Israel with respect to such credit, as part of joining the security management system operated in this respect by the Stock Exchange Clearing House, the Bank registered on November 24, 2010, in favor of the Bank of Israel a first degree floating pledge on its holdings in Israel Government bonds, deposited at the Stock Exchange Clearing House

## 15. PLEDGES (CONTINUED)

in an account in the Bank of Israel's name (in addition to a floating pledge, at first charge, registered on these assets on July 26, 2007).

At the end of July 2007, the Bank deposited with the said account bonds valued, as at December 31, 2010, at NIS 4.61 billion (December 31, 2009: NIS 4.65 billion).

Mercantile Discount Bank has also registered a similar pledge in favor of the Bank of Israel and has deposited with the Bank of Israel account at the Stock Exchange Clearing House bonds in the amount of NIS 480 million (December 31, 2009: NIS 581 million).

	Balance as of December 31, 2010	Highest balance during the year	Average balance in 2010	Balance as of December 31, 2009
In NIS millions				
Details of the pledge:				
Pledged securities (market value)	5,093	5,327	5,134	5,230

\* The report is based on outstanding monthly balances.

- K.** In addition, the Bank and Mercantile Discount Bank make deposits from time to time with Bank of Israel, constituting (together with the securities deposited, as stated) the collateral for the credit granted by Bank of Israel to the Bank and to Mercantile Discount Bank, within the framework of the credit tender.

The bank and Mercantile Discount Bank did not participate in 2010 in the said credit tenders.

Details of the deposits:

	Balance as of December 31, 2010	Highest balance during the year	Average balance in 2010	Balance as of December 31, 2009
In NIS millions				
Deposits with the Bank of Israel	11,441	16,323	11,841	14,642

\* The report is based on outstanding monthly balances.

- L.** The Bank enters into Credit Support Annex (CSA) type agreements with foreign banks intended to minimize mutual credit risks arising on derivative trading between banks. According to these agreements, the value of the inventory of derivative transactions made by the parties is measured periodically, and in the event that the net exposure of one of the parties exceeds a predetermined limit, that party is obligated to transfer deposits to the other party by way of a pledge, until the date of the next measurement. As of December 31, 2010, the Bank allocated in favor of foreign banks deposits in a total amount of NIS 339 million (December 31, 2009: NIS 684 million).

- M.** The Bank deposits bonds with foreign brokers (in the United States) as collateral for option transactions performed by its customers by means of these brokers. The value of such collateral at December 31, 2010 amounted to NIS 83 million (December 31, 2009: NIS 41 million).

**15. PLEDGES (CONTINUED)**

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
In NIS millions				
<b>N.</b> The sources of the securities that had been received and which the Bank is entitled to sell or pledge, at their fair value, before setoffs effect:				
Securities against cash	42	332	42	332
<b>Total</b>	42	332	42	332
The sources of securities that had been received as collateral and securities of the Bank, at their fair value, before setoffs effect:				
Securities against cash	42	332	42	332
<b>Total</b>	42	332	42	332
<b>O.</b> Details of securities pledged to the lenders:				
	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
In NIS millions				
Available for sale securities	4,886	*7,251	3,460	5,468
Held-to-maturity bonds	2,315	325	2,037	-
<b>Total (as stated in the balance sheet)</b>	7,201	7,576	5,497	5,468

\* Reclassified.

These securities have been deposited as collateral with the lenders, who are not permitted to sell or pledge them.

## 16. EMPLOYEE BENEFITS

**A.** The Bank's liability and its subsidiaries for severance pay to their employees, based on the customary one month's salary for each year of employment, is fully covered by deposits with severance pay funds, by insurance policies and pension funds. The redemption value of the insurance policies and amounts accumulated in pension funds are not included in the balance sheet since they are neither controlled nor managed by the Bank or its subsidiaries.

Members of the Bank's Management are entitled to the customary severance payments, while several of whom are entitled also to an "adjustment" bonus of between 3 to 8 months' salary upon retirement pursuant to individual agreements signed with them, and in respect of which adequate provisions have been included. The pension liability of foreign subsidiaries, based on actuarial computations, is covered by current deposits into a recognized foreign pension fund.

In certain consolidated banking subsidiaries, several officers are entitled to "adjustment" bonus" equal to six to twelve months' salaries, and in respect of which adequate provisions have been included.

**B.** The Bank's employees and those of its consolidated subsidiaries in Israel are entitled to long-service bonuses equal to a certain number of monthly salaries, and to a certain number of additional vacation days, upon completing 20, 30 and 40 years of employment in the Bank. In accordance with instructions of the Supervisor of Banks the provision in respect of this liability is computed on an actuarial basis and stated at its present value. The capitalization rate, set by the Supervisor of Banks, on an actuarial computation is 4%, and considering the future payroll increases, the amount of the liabilities for employee rights, in respect of the Bank's employees, is capitalized at a payroll increase rate of 2.5%, similar to 2009. The financial statements include provisions for long-service bonuses totaling: Consolidated - NIS 443 million (2009: NIS 445 million); the Bank - NIS 358 million (2009: NIS 375 million).

An agreement with the representatives of the employees was signed in November 2007, regarding the "Jubilee vacation" days, according to which, among other things, the entitlement of new employees to "Jubilee vacation" was abolished.

**C.** The Bank's employees and its consolidated subsidiaries in Israel are entitled to annual vacation as provided by labor agreements in force, and subject to the guidelines of the Annual Vacation Law - 1951. The liability for vacation pay is recognized over the period of employment in which the right to paid vacation accumulates. The liability is determined on the basis of the most recent salary in the reporting period with the addition of deferred payments. The financial statements include provisions for vacation pay as follows: Consolidated - NIS 157 million (2009: NIS 147 million); and for the Bank - NIS 125 million (2009: NIS 116 million).

**D.** The Bank's employees and its subsidiaries are entitled to certain benefits after retirement. The said liability is computed on an actuarial basis using a discount rate of 4%, and is recognized over the period of employment of the employee. In addition, approx. thirty employees who accepted early retirement exchanged their retirement award with a pension for a determined period. This liability is presented at its discounted value based on a discount rate of 4%.

The amount of the provision at balance sheet date: Consolidated - NIS 534 million (2009: NIS 482 million); the Bank - NIS 457 million (2009: NIS 422 million).

**16. EMPLOYEE BENEFITS (CONTINUED)****E. THE PROVISION AND DEPOSITS FOR EMPLOYEES' SEVERANCE PAY ARE AS FOLLOWS:**

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
	in NIS millions			
Deposits	2,575	2,455	2,292	2,183
Provision	2,181	2,049	1,908	1,791
<b>Excess of deposit over provision</b>	394	406	384	392
The excess (shortage) of amounts deposited over the provision is included in the item:				
Other assets (Note 8)	397	410	384	392
Other liabilities (Note 12)	(3)	(4)	-	-
<b>Total, Net</b>	394	406	384	392

The Bank and its subsidiaries are not permitted to withdraw these deposits except for the purpose of making severance payments.

**F.** Several of the subsidiaries have adopted employee remuneration plans, according to which the General Managers and/or other employees of these subsidiaries are entitled to a bonus, the amount of which is based upon their business results. The necessary provisions in respect of these bonuses are included in the financial statements.

**G. An award plan for members of the Bank's management.** In March 26, 2006, the Bank's Board of Directors resolved to approve an award plan to members of the Bank's management, including the Internal Auditor. In terms of the plan the Bank is to grant to every member of management an annual award in respect of each year in which he served as member of management in the period from 2006 to 2010. The annual award would be derived in part from the rate of the annual return on equity and in part by the decision of the President & CEO (within the framework of an additional budget, the volume of which will also be derived from the annual rate of return on equity), in a differential manner according to his judgment, and in accordance with the extent of achievement of the specific targets set by him for each management member. The said distribution requires the approval of the Bank's Board of Directors.

The minimum annual rate of return required for a distribution of an award to members of management in a particular year, is 8.5%.

The Bank's Board of Directors is entitled to eliminate exceptional profits or losses, that do not stem from current operations, for the purpose of computing the rate of annual return on equity. The Bank's Board of Directors is entitled to change or cancel the award plan, in whole or in part, provided that the change or cancellation would take effect in the calendar year following the year in which the decision for cancellation or change was taken.

The award plan to members of the Bank's management, including the Internal Auditor, was ratified by the Audit Committee and by the Board of Directors at the meetings held on July 15 and 16, 2006. Since then, the Board of Directors decided from time to time to apply the said plan to newly appointed management members.

For details regarding a stock option plan for the Bank's officers, see Note 13 E (2) and (3). For details regarding a phantom option plan for the Bank's officers, see Note 13 E (1) and (4).

**H. Award plan to the Bank's employees and managers in 2008.** In March 2008, the Board of Directors approved an award plan to the Bank's employees and managers for 2008. The budget for the plan would be determined according to grades determined in the plan on the basis of the annual return to capital of earnings from ordinary operations. The aim of the plan is to create a structured relation between the Bank's success and the remuneration of employees and managers in the short and long term.

- I. IDB New York has a liability for the payment of pensions to its employees, in respect of which it has established a pension fund, in which contributions by the employer and by the employees are deposited. The annual deposits with the fund are based on calculations made by an independent actuary.

Following are the principal details concerning the said liability (in US\$ millions):

	December 31	
	2010	2009
	32	27
	18	17
	14	10
	14	10
	%	%
	5.22	5.80
	8.25	8.50
	4.25	4.25

**17. ASSETS AND LIABILITIES ACCORDING TO LINKAGE TERMS****CONSOLIDATED**

	December 31, 2010							Total
	Israeli currency		Foreign currency <sup>(1)</sup>			Non monetary items		
	Non-linked	Linked to the CPI	In US\$	In Euro	In other currencies			
in NIS millions								
<b>Assets</b>								
Cash and deposits with banks	12,626	618	3,087	1,088	768	-	18,187	
Securities	12,603	6,292	16,535	686	367	693	37,176	
Securities borrowed or purchased under resale agreements	45	-	-	-	-	-	45	
Credit granted to the public	65,359	19,160	25,651	5,523	2,973	-	118,666	
Credit granted to the Government	2	1,550	1	-	3	-	1,556	
Investments in affiliated companies	60	57	-	7	-	1,560	1,684	
Buildings and equipment	-	-	-	-	-	3,138	3,138	
Other assets	2,417	66	1,267	90	781	741	5,362	
<b>Total assets</b>	<b>93,112</b>	<b>27,743</b>	<b>46,541</b>	<b>7,394</b>	<b>4,892</b>	<b>6,132</b>	<b>185,814</b>	
<b>Liabilities</b>								
Deposits from the public	71,592	11,609	42,268	8,743	3,799	-	138,011	
Deposits from banks	1,463	485	1,262	114	63	-	3,387	
Deposits from the Government	231	75	155	-	-	-	461	
Securities loaned or sold under repurchase arrangements	-	-	7,227	-	-	-	7,227	
Subordinated capital notes	2,971	9,323	-	-	-	-	12,294	
Other liabilities	9,388	1,162	1,115	288	282	630	12,865	
<b>Total liabilities</b>	<b>85,645</b>	<b>22,654</b>	<b>52,027</b>	<b>9,145</b>	<b>4,144</b>	<b>630</b>	<b>174,245</b>	
Difference	7,467	5,089	(5,486)	(1,751)	748	5,502	11,569	
<b>Effect of non-hedging derivative instruments:</b>								
Derivative instruments (except for options)	(1,257)	(2,679)	2,269	2,287	(620)	-	-	
Options in the money, net (in terms of underlying asset)	(294)	-	527	(234)	1	-	-	
Options out of the money, net (in terms of underlying asset)	53	12	52	(116)	(4)	3	-	
<b>Total</b>	<b>5,969</b>	<b>2,422</b>	<b>(2,638)</b>	<b>186</b>	<b>125</b>	<b>5,505</b>	<b>11,569</b>	
Options in the money, net (discounted par value)	(360)	-	700	(340)	-	-	-	
Options out of the money, net (discounted par value)	(623)	472	572	(417)	(7)	3	-	

Footnote:

(1) Includes those linked to foreign currency.

## 17. ASSETS AND LIABILITIES ACCORDING TO LINKAGE TERMS (CONTINUED)

### CONSOLIDATED (CONTINUED)

	December 31, 2009						
	Israeli currency		Foreign currency <sup>(1)</sup>			Non monetary items	Total
	Non-linked	Linked to the CPI	In US\$	In Euro	In other currencies		
in NIS millions							
<b>Assets</b>							
Cash and deposits with banks	16,247	798	5,533	1,144	861	-	24,583
Securities	8,594	6,897	18,924	919	291	713	36,338
Securities borrowed or purchased under resale agreements	336	-	-	-	-	-	336
Credit granted to the public	59,498	19,021	25,679	6,836	3,392	-	114,426
Credit granted to the Government	-	1,517	302	-	1	-	1,820
Investments in affiliated companies	59	56	-	7	-	1,673	1,795
Buildings and equipment	-	-	-	-	-	3,178	3,178
Other assets	*2,016	34	*1,464	108	591	*1,128	5,341
<b>Total assets</b>	<b>86,750</b>	<b>28,323</b>	<b>51,902</b>	<b>9,014</b>	<b>5,136</b>	<b>6,692</b>	<b>187,817</b>
<b>Liabilities</b>							
Deposits from the public	68,048	12,982	45,559	11,233	4,003	-	141,825
Deposits from banks	1,694	411	1,390	210	19	-	3,724
Deposits from the Government	192	49	43	-	-	-	284
Securities loaned or sold under repurchase arrangements	-	-	7,651	-	-	-	7,651
Subordinated capital notes	2,422	9,107	-	-	-	-	11,529
Other liabilities	*8,278	737	*1,866	368	339	*924	12,512
<b>Total liabilities</b>	<b>80,634</b>	<b>23,286</b>	<b>56,509</b>	<b>11,811</b>	<b>4,361</b>	<b>924</b>	<b>177,525</b>
Difference	6,116	5,037	(4,607)	(2,797)	775	5,768	10,292
<b>Effect of non-hedging derivative instruments:</b>							
Derivative instruments (except for options)	(89)	(4,773)	3,021	2,676	(835)	-	-
Options in the money, net (in terms of underlying asset)	106	-	(138)	32	-	-	-
Options out of the money, net (in terms of underlying asset)	(270)	146	73	49	-	2	-
<b>Total</b>	<b>5,863</b>	<b>410</b>	<b>(1,651)</b>	<b>(40)</b>	<b>(60)</b>	<b>5,770</b>	<b>10,292</b>
Options in the money, net (discounted par value)	195	-	(246)	51	-	-	-
Options out of the money, net (discounted par value)	(1,924)	490	1,234	273	(76)	3	-

\* Reclassified.

Footnote:

(1) Includes those linked to foreign currency.

**17. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS (CONTINUED)****REPORTED AMOUNTS****Bank**

	December 31, 2010							Total
	Israeli currency		Foreign currency <sup>(1)</sup>			Non monetary Items		
	Non-linked	Linked to the CPI	In US\$	In EURO	In other currencies			
			in NIS millions					
<b>Assets</b>								
Cash and deposits with banks	16,894	9,253	2,495	746	229	-	29,617	
Securities	10,835	3,407	417	630	33	23	15,345	
Securities borrowed or purchased under resale agreements	45	-	-	-	-	-	45	
Credit granted to the public	42,777	6,597	10,999	5,144	2,653	-	68,170	
Credit granted to Governments	-	1,551	-	-	-	-	1,551	
Investments in affiliated companies	856	432	267	-	-	8,657	10,212	
Buildings and equipment	-	-	-	-	-	2,315	2,315	
Other assets	2,272	21	217	56	771	461	3,798	
<b>Total assets</b>	<b>73,679</b>	<b>21,261</b>	<b>14,395</b>	<b>6,576</b>	<b>3,686</b>	<b>11,456</b>	<b>131,053</b>	
<b>Liabilities</b>								
Deposits from the public	61,269	12,440	19,696	7,797	2,907	-	104,109	
Deposits from banks	1,136	110	1,904	173	42	-	3,365	
Deposits from the Government	102	75	-	-	-	-	177	
Subordinated capital notes	278	3,735	-	-	-	-	4,013	
Other liabilities	5,647	966	602	236	185	512	8,148	
<b>Total liabilities</b>	<b>68,432</b>	<b>17,326</b>	<b>22,202</b>	<b>8,206</b>	<b>3,134</b>	<b>512</b>	<b>119,812</b>	
Difference	5,247	3,935	(7,807)	(1,630)	552	10,944	11,241	
<b>Effect of non hedging derivative instruments:</b>								
Derivative instruments (except for options)	(1,292)	(2,318)	2,068	2,152	(610)	-	-	
Options in the money, net (in terms of base asset)	(355)	-	607	(253)	1	-	-	
Options out of the money, net (in terms of base asset)	99	12	10	(117)	(4)	-	-	
<b>Total</b>	<b>3,699</b>	<b>1,629</b>	<b>(5,122)</b>	<b>152</b>	<b>(61)</b>	<b>10,944</b>	<b>11,241</b>	
Options in the money, net (discounted nominal value)	(518)	-	862	(344)	-	-	-	
Options out of the money, net (discounted nominal value)	(503)	472	459	(421)	(7)	-	-	

Footnote:

(1) includes those linked to foreign currency.

## 17. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS (CONTINUED)

### REPORTED AMOUNTS

#### Bank (Continued)

	December 31, 2009						
	Israeli currency		Foreign currency <sup>(1)</sup>			Non monetary Items	Total
	Non-linked	Linked to the CPI	In US\$	In EURO	In other currencies		
in NIS millions							
<b>Assets</b>							
Cash and deposits with banks	18,614	9,125	3,100	504	191	-	31,534
Securities	7,029	4,397	1,094	855	18	58	13,451
Securities borrowed or purchased under resale agreements	336	-	-	-	-	-	336
Credit granted to the public	40,071	6,577	11,364	6,422	3,107	-	67,541
Credit granted to Governments	-	1,517	301	-	-	-	1,818
Investments in affiliated companies	826	438	287	-	-	8,500	10,051
Buildings and equipment	-	-	-	-	-	2,382	2,382
Other assets	1,875	15	526	73	561	513	3,563
<b>Total assets</b>	<b>68,751</b>	<b>22,069</b>	<b>16,672</b>	<b>7,854</b>	<b>3,877</b>	<b>11,453</b>	<b>130,676</b>
<b>Liabilities</b>							
Deposits from the public	58,297	13,587	21,341	9,699	2,998	-	105,922
Deposits from banks	1,741	145	1,650	287	141	-	3,964
Deposits from the Government	110	49	-	-	-	-	159
Subordinated capital notes	69	3,569	-	-	-	-	3,638
Other liabilities	4,486	621	896	273	201	522	6,999
<b>Total liabilities</b>	<b>64,703</b>	<b>17,971</b>	<b>23,887</b>	<b>10,259</b>	<b>3,340</b>	<b>522</b>	<b>120,682</b>
Difference	4,048	4,098	(7,215)	(2,405)	537	10,931	9,994
<b>Effect of non hedging derivative instruments:</b>							
Derivative instruments (except for options)	(117)	(4,392)	3,049	2,274	(814)	-	-
Options in the money, net (in terms of base asset)	119	-	(126)	7	-	-	-
Options out of the money, net (in terms of base asset)	(260)	146	57	57	-	-	-
<b>Total</b>	<b>3,790</b>	<b>(148)</b>	<b>(4,235)</b>	<b>(67)</b>	<b>(277)</b>	<b>10,931</b>	<b>9,994</b>
Options in the money, net (discounted nominal value)	102	-	(123)	21	-	-	-
Options out of the money, net (discounted nominal value)	(1,899)	490	1,187	298	(76)	-	-

Footnote:

(1) Includes those linked to foreign currency.

**18. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS AND MATURITY PERIODS<sup>(1)</sup>****CONSOLIDATED (IN NIS MILLIONS)****A. Anticipated Future Contractual Cash Flows as of December 31, 2010**

	On demand or within 1 month	Over 1 month and up to 3 months	Over 3 months and up to 1 year	Over 1 year and up to 2 years	Over 2 years and up to 3 years
<b>Israeli currency, non-linked:</b>					
Assets <sup>(6)</sup>	28,651	12,988	15,919	9,202	6,835
Liabilities	57,623	8,821	10,382	3,102	811
Difference	(28,972)	4,167	5,537	6,100	6,024
Derivative instruments (excluding options)	(4,124)	(354)	3,625	(420)	(54)
Options (in terms of underlying assets)	(89)	(125)	(256)	(10)	23
<b>Israeli currency, CPI-linked:</b>					
Assets	392	723	3,217	4,369	2,711
Liabilities	1,201	2,275	6,756	2,579	1,876
Difference	(809)	(1,552)	(3,539)	1,790	835
Derivative instruments (excluding options)	63	16	(78)	(485)	(789)
Options (in terms of underlying assets)	-	-	12	-	-
<b>Foreign currency-local activity<sup>(3)</sup>:</b>					
Assets <sup>(7)</sup>	5,385	4,585	3,630	1,882	2,491
Liabilities	18,922	8,153	5,601	442	37
Difference	(13,537)	(3,568)	(1,971)	1,440	2,454
Derivative instruments (excluding options)	4,832	3,476	(3,326)	(455)	(492)
Options (in terms of underlying assets)	89	125	242	9	(23)
<b>Foreign currency-foreign activity of extensions:</b>					
Assets	4,974	4,726	6,367	4,042	2,932
Liabilities	17,380	2,158	3,198	2,023	2,867
Difference	(12,406)	2,568	3,169	2,019	65
<b>Non-monetary items:</b>					
Assets	9	-	-	-	-
Liabilities	9	-	-	-	-
Difference	-	-	-	-	-
Options (in terms of underlying assets)	-	-	2	1	-
<b>Total:</b>					
Assets	39,411	23,022	29,133	19,495	14,969
Liabilities	95,135	21,407	25,937	8,146	5,591
Difference	(55,724)	1,615	3,196	11,349	9,378
Derivative instruments (excluding options)	771	3,138	221	(1,360)	(1,335)
Options (in terms of underlying assets)	-	-	-	-	-

\* Reclassified.

Footnotes:

- (1) This Note presents the anticipated future contractual cash flows in respect of assets and liabilities according to linkage base and according to the remaining period to the contractual maturity date of each cash flow. The data is shown net of the provision for doubtful debts the allocation of which over periods is made in accordance with an estimate based on the credit periods in respect of which they were made.
- (2) Includes past-due receivables totaling NIS 1,653 million (2009: NIS 1,821\* million).

	Over 3 years and up to 4 years	Over 4 years and up to 5 years	Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	Total cash flows	Balance sheet amount <sup>(4)</sup>		The contractual rate of return, in percentages <sup>(5)</sup>
							No fixed maturity date <sup>(2)</sup>	Total	
	3,843	3,264	13,806	5,020	638	100,166	2,236	93,112	4.59
	1,102	893	2,408	567	183	85,892	-	85,645	1.90
	2,741	2,371	11,398	4,453	455	14,274	2,236	7,467	2.69
	(66)	6	191	(26)	-	(1,222)	-	(1,257)	-
	19	17	77	123	(20)	(241)	-	(241)	-
	3,152	3,824	8,439	6,040	1,222	34,089	100	27,743	3.42
	1,370	1,437	5,667	2,493	-	25,654	-	22,654	3.38
	1,782	2,387	2,772	3,547	1,222	8,435	100	5,089	0.04
	(772)	(509)	(1,151)	(168)	-	(3,873)	-	(2,679)	-
	-	-	-	-	-	12	-	12	-
	1,153	1,074	2,495	247	1	22,943	122	20,779	2.75
	40	31	28	28	1	33,283	2	35,163	0.49
	1,113	1,043	2,467	219	-	(10,340)	120	(14,384)	2.26
	(190)	(91)	(114)	136	-	3,776	-	3,936	-
	(19)	(17)	(77)	(123)	20	226	-	226	-
	1,886	1,898	5,218	10,524	3,374	45,941	1,669	38,048	4.40
	1,126	681	3,194	-	-	32,627	102	30,153	1.94
	760	1,217	2,024	10,524	3,374	13,314	1,567	7,895	2.46
	-	-	-	-	-	9	6,123	6,132	-
	-	-	-	-	-	9	621	630	-
	-	-	-	-	-	-	5,502	5,502	-
	-	-	-	-	-	3	-	3	-
	10,034	10,060	29,958	21,831	5,235	203,148	10,250	185,814	4.15
	3,638	3,042	11,297	3,088	184	177,465	725	174,245	1.81
	6,396	7,018	18,661	18,743	5,051	25,683	9,525	11,569	2.34
	(1,028)	(594)	(1,074)	(58)	-	(1,319)	-	-	-
	-	-	-	-	-	-	-	-	-

(3) Includes linked to foreign currency.

(4) As included in Note 17 "Assets and liabilities according to linkage base", including off-balance sheet amounts in respect of derivatives.

(5) The contractual rate of return is the rate of interest discounting the expected future contractual cash flows presented in this Note in respect of a monetary item, to its balance sheet amount.

(6) Including credit current loan account, in the amount of NIS 5,374 million (2009: NIS 6,422 million) and an amount of NIS 1,854 million with no due date (2009: NIS 2,146 million).

(7) Including credit under credit current loan account terms, in the amount of NIS 1,068 million (2009: NIS 1,190 million) and an amount of NIS 141 million with no due date (2009: NIS 177 million).

## 18. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS AND MATURITY PERIODS<sup>(1)</sup> (CONTINUED)

### CONSOLIDATED (IN NIS MILLIONS)

#### B. Balance Sheet Amount at December 31, 2009

	On demand or within 1 month	Over 1 month and up to 3 months	Over 3 months and up to 1 year	Over 1 year and up to 2 years	Over 2 years and up to 3 years
Total:					
Assets	47,624	25,496	*26,402	18,325	12,228
Liabilities	85,165	26,770	30,498	8,232	6,125
Difference	(37,541)	(1,274)	(4,096)	10,093	6,103
Derivative instruments (excluding options)	(26)	(26)	13	(61)	(55)

\*Reclassified.

Footnotes:

- (1) This Note presents the anticipated future contractual cash flows in respect of assets and liabilities according to linkage base and according to the remaining period to the contractual maturity date of each cash flow. The data is shown net of the provision for doubtful debts the allocation of which over periods is made in accordance with an estimate based on the credit periods in respect of which they were made.
- (2) Includes past-due receivables totaling NIS 1,653 million (2009: NIS 1,821\* million).
- (3) Includes linked to foreign currency.
- (4) As included in Note 17 "Assets and liabilities according to linkage base", including off-balance sheet amounts in respect of derivatives.
- (5) The contractual rate of return is the rate of interest discounting the expected future contractual cash flows presented in this Note in respect of a monetary item, to its balance sheet amount.

Over 3 years and up to 4 years	Over 4 years and up to 5 years	Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	Total cash flows	Balance sheet amount <sup>(4)</sup>		The contractual rate of return, in percentages <sup>(5)</sup>
						No fixed maturity date <sup>(2)</sup>	Total	
10,751	7,268	27,181	21,908	5,650	*202,833	*11,017	187,817	4.07
4,544	4,564	13,105	4,906	71	183,980	648	177,525	1.74
6,207	2,704	14,076	17,002	5,579	18,853	10,369	10,292	2.33
(64)	(47)	(93)	(62)	-	(421)	-	-	-

## 18. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS AND MATURITY PERIODS<sup>(1)</sup> (CONTINUED)

### THE BANK (IN NIS MILLIONS)

#### A. Anticipated Future Contractual Cash Flows as of December 31, 2010

	On demand or within 1 month	Over 1 month and up to 3 months	Over 3 months and up to 1 year	Over 1 year and up to 2 years	Over 2 years and up to 3 years
<b>Israeli currency, non-linked:</b>					
Assets <sup>(6)</sup>	23,734	8,686	11,167	7,017	6,252
Liabilities	46,683	6,530	7,546	2,427	675
Difference	(22,949)	2,156	3,621	4,590	5,577
Derivative instruments (excluding options)	(4,153)	(363)	3,629	(420)	(54)
Options (in terms of base assets)	(90)	(69)	(213)	75	11
<b>Israeli currency, CPI-linked:</b>					
Assets	234	594	2,629	3,128	1,994
Liabilities	923	1,745	4,597	1,518	1,462
Difference	(689)	(1,151)	(1,968)	1,610	532
Derivative instruments (excluding options)	63	(34)	(84)	(534)	(768)
Options (in terms of base assets)	-	-	12	-	-
<b>Foreign currency-local activity<sup>(3)</sup>:</b>					
Assets <sup>(7)</sup>	5,039	4,188	3,618	1,773	2,412
Liabilities	17,475	8,550	5,409	430	27
Difference	(12,436)	(4,362)	(1,791)	1,343	2,385
Derivative instruments (excluding options)	4,866	3,470	(3,370)	(472)	(521)
Options (in terms of base assets)	90	69	201	(75)	(11)
<b>Foreign currency-foreign activity of extensions:</b>					
Assets	719	1,129	540	492	438
Liabilities	733	181	88	-	-
Difference	(14)	948	452	492	438
<b>Non-monetary items:</b>					
Assets	-	-	-	-	-
Liabilities	-	-	-	-	-
Difference	-	-	-	-	-
<b>Total:</b>					
Assets	29,726	14,597	17,954	12,410	11,096
Liabilities	65,814	17,006	17,640	4,375	2,164
Difference	(36,088)	(2,409)	314	8,035	8,932
Derivative instruments (excluding options)	776	3,073	175	(1,426)	(1,343)
Options (in terms of base assets)	-	-	-	-	-

\* Reclassified.

Footnotes:

(1) This Note presents the anticipated future contractual cash flows in respect of assets and liabilities according to linkage base and according to the remaining period to the contractual maturity date of each cash flow. The data is presented net of provisions for doubtful debts. In accordance with the amendment to the reporting directives, cash flows in respect of a liability having several optional contractual repayment dates, have been presented for 2010 in accordance with the earliest contractual due date. In 2009, such cash flows were presented according to the final repayment dates.

(2) Includes past-due receivables totaling NIS 1,223 million (2009: NIS 1,311\* million).

Over 3 years and up to 4 years	Over 4 years and up to 5 years	Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	Total cash flows	Balance sheet amount <sup>(4)</sup>		The contractual rate of return, in percentages <sup>(5)</sup>
						No fixed maturity date <sup>(2)</sup>	Total	
3,063	2,735	12,643	4,683	797	80,777	1,657	73,679	4.40
878	845	2,424	529	178	68,715	-	68,432	1.59
2,185	1,890	10,219	4,154	619	12,062	1,657	5,247	2.80
(66)	6	191	(26)	-	(1,256)	-	(1,292)	-
7	7	13	3	-	(256)	-	(256)	-
2,163	3,791	6,622	3,890	902	25,947	49	21,261	3.69
954	1,196	5,158	2,441	-	19,994	-	17,326	3.70
1,209	2,595	1,464	1,449	902	5,953	49	3,935	(0.01)
(752)	(492)	(785)	-	-	(3,386)	-	(2,318)	-
-	-	-	-	-	12	-	12	-
1,082	1,061	2,462	171	-	21,806	121	20,639	2.84
31	49	-	-	-	31,971	2	32,534	0.48
1,051	1,012	2,462	171	-	(10,165)	119	(11,895)	2.36
(215)	(111)	(433)	-	-	3,214	-	3,610	-
(7)	(7)	(13)	(3)	-	244	-	244	-
108	113	-	-	-	3,539	680	4,018	3.02
-	-	-	-	-	1,002	9	1,008	0.91
108	113	-	-	-	2,537	671	3,010	2.11
-	-	-	-	-	-	11,456	11,456	-
-	-	-	-	-	-	512	512	-
-	-	-	-	-	-	10,944	10,944	-
6,416	7,700	21,727	8,744	1,699	132,069	13,963	131,053	3.96
1,863	2,090	7,582	2,970	178	121,682	523	119,812	1.59
4,553	5,610	14,145	5,774	1,521	10,387	13,440	11,241	2.37
(1,033)	(597)	(1,027)	(26)	-	(1,428)	-	-	-
-	-	-	-	-	-	-	-	-

(3) Includes linked to foreign currency.

(4) As included in Note 17 "Assets and liabilities according to linkage base", including off-balance sheet amounts in respect of derivatives.

(5) The contractual rate of return is the rate of interest discounting the expected future contractual cash flows presented in this Note in respect of a monetary item, to its balance sheet amount.

(6) Including credit current loan account, in the amount of NIS 3,680 million (2009: NIS 4,650 million) and an amount of NIS 1,549 million with no due date (2009: NIS 1,848 million).

(7) Including credit current loan account, in the amount of NIS 856 million (2009: NIS 926 million) and an amount of NIS 140 million with no due date (2009: NIS 170 million).

## 18. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS AND MATURITY PERIODS<sup>(1)</sup> (CONTINUED)

### THE BANK (IN NIS MILLIONS)

#### B. Balance Sheet Amount at December 31, 2009

	On demand or within 1 month	Over 1 month and up to 3 months	Over 3 months and up to 1 year	Over 1 year and up to 2 years	Over 2 years and up to 3 years
Total:					
Assets	33,824	15,303	*16,848	13,410	8,518
Liabilities	56,615	20,967	20,645	4,701	3,333
Difference	(22,791)	(5,664)	(3,797)	8,709	5,185
Derivative instruments (excluding options)	(28)	(40)	14	(70)	(60)

\* Reclassified.

#### Footnotes:

- (1) This Note presents the anticipated future contractual cash flows in respect of assets and liabilities according to linkage base and according to the remaining period to the contractual maturity date of each cash flow. The data is shown net of the provision for doubtful debts the allocation of which over periods is made in accordance with an estimate based on the credit periods in respect of which they were made.
- (2) Includes past-due receivables totaling NIS 1,223 million (2009: NIS 1,311\* million).
- (3) Includes linked to foreign currency.
- (4) As included in Note 17 "Assets and liabilities according to linkage base", including off-balance sheet amounts in respect of derivatives.
- (5) The contractual rate of return is the rate of interest discounting the expected future contractual cash flows presented in this Note in respect of a monetary item, to its balance sheet amount.

Over 3 years and up to 4 years	Over 4 years and up to 5 years	Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	Total cash flows	Balance sheet amount <sup>(4)</sup>		The contractual rate of return, in percentages <sup>(5)</sup>
						No fixed maturity date <sup>(2)</sup>	Total	
8,782	4,937	18,892	7,587	1,483	*129,584	*14,355	130,676	3.61
2,144	2,444	8,335	4,195	73	123,452	524	120,682	1.26
6,638	2,493	10,557	3,392	1,410	6,132	13,831	9,994	2.35
(67)	(48)	(70)	(25)	-	(394)	-	-	-

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS**

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
in NIS millions				
<b>A. Off-Balance Sheet Financial Instruments</b>				
Contract balances or their stated amounts at year end				
Transactions involving credit risk:				
Letters of credit	1,446	1,318	694	656
Credit guarantees	3,571	2,951	2,183	2,506
Guarantees for home purchasers	4,979	4,249	3,363	2,430
Other guarantees and obligations <sup>(1)</sup>	5,521	*7,511	4,962	*6,855
Unutilized credit line for credit cards	13,999	13,476	4,184	4,749
Unutilized current loan account and other credit facilities in on-call accounts	8,596	9,482	7,645	8,568
Irrevocable commitments to extend credit approved but not yet granted <sup>(2)</sup>	19,837	*19,936	10,399	10,553
Commitment to issue guarantees	4,064	4,538	2,895	2,984
<b>B. Off-Balance Sheet Commitment at Year-End regarding activity based on loan repayments<sup>(3)</sup></b>				
Balance of loans granted out of deposits repayable according to the repayment of the loans <sup>(2)</sup>				
Israeli currency - non linked	1,319	1,044	1,282	1,005
Israeli currency - linked to the CPI	1,452	1,696	13	17
Foreign currency	705	595	705	595
<b>Total</b>	<b>3,476</b>	<b>3,335</b>	<b>2,000</b>	<b>1,617</b>

## Footnotes:

(1) see Note C 6.

(2) Including commitments to customers for granting credit within the framework of "an approval in principle and maintaining interest rates" in accordance with Proper Banking Management Directive No. 451 "Procedures for the granting of housing loans".

(3) Loans and deposits granted out of deposits, the repayment of which to the depositors is conditional upon the collection of these loans (or deposits), with a margin or with a collection commission (instead of a margin).

(4) Standing loans and government deposits made in respect thereof, totaling NIS 80 million (2009: NIS 97 million), have not been included in the table.

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS(CONTINUED)

### B. OFF BALANCE SHEET COMMITMENT AT YEAR-END REGARDING ACTIVITY BASED ON LOAN REPAYMENTS (CONTINUED)

#### 2. Cash flows in respect of collection commissions and interest margins of activity based on loan repayments - Consolidated

	December 31, 2010						2009*	
	Up to 1 year	Over 1 year and up to 3 years	Over 3 years and up to 5 years	Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	Total	Total
<b>In Israeli currency, non-linked:</b>								
Future contractual flows	-	-	-	1	6	-	7	8
Expected future flows based on Management's estimates of early repayments	-	-	-	1	6	-	7	8
Discounted expected future flows based on Management's estimates of early repayments <sup>(1)</sup>	-	-	-	1	3	-	4	4
<b>In Israeli currency, CPI-linked:</b>								
Future contractual flows	10	19	17	38	14	-	98	117
Expected future flows based on Management's estimates of early repayments	10	17	14	25	7	-	73	91
Discounted expected future flows based on Management's estimates of early repayments <sup>(2)</sup>	10	16	13	21	6	-	66	78
<b>In foreign currency:</b>								
Future contractual flows	2	3	1	1	-	-	7	7
Expected future flows based on Management's estimates of early repayments	2	3	1	1	-	-	7	7
Discounted expected future flows based on Management's estimates of early repayments <sup>(3)</sup>	2	2	1	1	-	-	6	7

#### 3. Information as to the granting of loans during the year by the mortgage banks:

	31.12.2010	31.12.2009
Loans out of deposits repayable according to the repayment of loans	3	15
Standing loans	3	-

\* Reclassified.

Footnotes:

(1) Discounted at the rate of 5.41% (2009: 5.50%).

(2) Discounted at the rate of 1.84% (2009: 2.65%).

(3) Discounted at the rate of 1.00% (2009: 1.50%).

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)****C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS**

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
	in NIS millions			
1. Long-term lease contracts - rent payable in future years <sup>(1)</sup> :				
First year	122	103	59	46
Second year	93	91	50	41
Third year	69	66	39	29
Fourth year	57	46	31	19
Fifth year	47	37	24	12
Sixth year and thereafter	196	155	69	22
<b>Total</b>	<b>584</b>	<b>498</b>	<b>272</b>	<b>169</b>
2. Commitment to acquire buildings and equipment	73	61	38	31

Footnote:

(1) For details as to long-term lease agreement, see section 16 hereunder.

3. The Bank and Mercantile Discount Bank, which are members of the Ma'of Clearing House Ltd., are responsible along with other Ma'of Clearing House members towards the Clearing House for any financial obligations resulting from option transactions conducted on the Stock Exchange. For this purpose, the Ma'of Clearing House established a risk fund. The share of the Bank in the risk fund as of December 31, 2010, amounts to NIS \_\_\_ million, comprising \_\_\_% of the total risk fund at that date. The two banks were required to provide collateral in favor of the Ma'of Clearing House by way of securities (Government bonds) in an amount that would cover their possible liability in respect of their share in the risk fund, as stated, as well as an additional amount derived from the volume of operations in this field of each of the banks (see Note 15 F). Each of the banks is also committed to pay the Ma'of Clearing House any monetary charge that may result from its operations and from the operation of their customers involving the writing of options traded within the framework of the Clearing House.
4. According to the articles of the Stock Exchange and the byelaws of the Tel Aviv Stock Exchange Clearing House, the members are committed towards the Clearing House to cover any amount resulting from the obligations on behalf of themselves or their customers as well as for other Stock Exchange members who are not members of the Clearing House and their customers, in respect of transactions conducted by way of the Clearing House. Furthermore, each member is also responsible for his share of the Risk Fund, established for this purpose, based on the clearing ratio of turnovers of the members. As collateral for their obligations towards the Clearing House, the Bank and Mercantile Discount Bank pledged their rights to accounts maintained at the Clearing House (in which securities are deposited) and at another bank (in which cash is deposited). (See Note 15 I).
5. a) The Bank is committed to indemnify the subsidiary Tachlit Investment House Ltd. (hereinafter - "Tachlit") in respect of professional liability lawsuits filed against it in excess of the insured amount not to be fall below US\$5 million, purchased by Tachlit. The amount of indemnification is limited to US\$4.5 million in accordance with a claim that will be received from Tachlit until March 31, 2011. On January 1, 2010, the Bank replaced the letter of indemnification granted in the past to Tachlit by a letter of guarantee as alternative to insurance according to the Engagement in Investment Consulting and in Investment Portfolio Management (Equity capital and insurance) Regulations, 2000. The letter of guarantee is granted for the settlement of any amount up to NIS 18,126 thousand, linked to the CPI of November 1998, payable or which might become payable by the company and/or its employees or executives (hereinafter: "the debtor") in respect of any liability stemming from the professional responsibility of the debtor towards a customer of the company,

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

in accordance with the terms of the letter of guarantee. The guarantee is in effect until May 31, 2011, inclusive.

- b) Tachlit is committed towards Tachlit Global Dollar Ltd., held by Tachlit at the rate of 20%, and toward Synergetica Ltd., which owns approximately 80% of Tachlit Global Dollar Ltd., to transfer to Tachlit Global Dollar Ltd., a company that issues basket certificates, a total amount not exceeding US\$1 million, to cover its current operating expenses and to fulfill its obligations towards the holders of its basket certificates. The Bank granted Tachlit an indemnification as collateral for the said commitment.

A similar indemnification from the Bank, in an identical amount, was given by the Bank in respect of Tachlit Basket Certificates Ltd. The indemnifications granted by the Bank, as stated, have expired upon the consummation of the transaction for the sale of the basket certificates operations (see Subsection \_\_\_ below), following which the Bank no longer holds (indirectly) means of control in the companies Tachlit Global Dollar Ltd. and Tachlit Basket Certificates Ltd.

- c) Mercantile Discount Bank committed to indemnify Mercantile Capital Markets Ltd. and Mercantile LKN Ltd. (formerly Mercantile Mutual Funds Ltd.) (wholly owned subsidiaries of Mercantile Discount Bank), with respect to claims that might be submitted against them in respect of professional liability in excess of amounts stated in the insurance policies purchased in their name. The letters of indemnity are in effect until March 31, 2011, and are limited in amounts as follows: Mercantile Capital Markets Ltd - US\$6 million; Mercantile LKN Ltd. - US\$1.3 million.

Furthermore, Mercantile Discount Bank accepted in 2010, an obligation to indemnify Mercantile Investments Ltd. in respect of possible future monetary charges up to an amount of NIS 42 million.

6. Consolidated subsidiaries of the Bank are engaged in providing a variety of trusteeship services and serve, inter alia, as trustees for certain debentures issued to the public according to a prospectus and which are traded on the Stock Exchange.
7. a) The previous Articles of Association of the Bank, which were amended in March 2002, prescribed that the Bank shall indemnify any person who serves or served as a representative of the Bank, or at its request, as a Director in another company in which the Bank has an interest, for the expenses incurred by such person in connection with legal proceedings instituted against him in respect of acts of commission or omission in the course of fulfilling his duties as a Director of such other company, and for an amount he is ordered to pay under a judgment handed down in such legal proceedings, including by way of a settlement to which the Bank has agreed, unless the judicial authority in such proceedings has found that the acts as aforesaid on the part of such person were performed not in good faith. The Bank is entitled to issue a letter of indemnity to any such Director of another company, including a Director of the Bank who serves as a Director in the other company, at terms and conditions approved by the Board of Directors. Accordingly, the Bank has issued letters of indemnity, unlimited as to amount, to Directors who serve or served at the Bank's request in other companies held, directly or indirectly, by the Bank.
- b) According to the Articles of Association of the Bank, any employee or clerk of the Bank who is not an executive officer, will be indemnified out of the funds of the Bank for any liability incurred by him in his capacity as an employee or clerk of the Bank in defending himself in any legal proceedings, whether civil or criminal, in which a judgment is given in his favor or in which he is acquitted, and the Bank is entitled to indemnify him for any financial liability imposed on him in favor of another person for an act done in his capacity as an employee or clerk of the Bank.
- c) The Articles of Incorporation of certain consolidated subsidiaries of the Bank allow for indemnification of officers under certain conditions, subject to the provisions of the Law. Certain companies in certain cases granted such indemnification.
- d) Discount Manpikim Ltd., a wholly owned and controlled subsidiary of the Bank, has granted indemnification to its Directors, with respect to a financial liability that might be imposed on any of them and with respect to reasonable legal expenses in connection with a prospectus for the public issue and the listing for trade of subordinated capital notes, published in March 2004, in a total amount of NIS 500 million, under terms specified in the letter of indemnification. In any event, the maximum amount of the indemnification

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

payable to all Directors as a group will not exceed the gross proceeds of the said issue. Discount Manpikim Ltd. has granted its Directors identical indemnification in connection with a prospectus regarding the offer to the public and the listing for trade of subordinated capital notes issued in November 2004, in a total amount of NIS 600 million.

- e) Discount Manpikim Ltd. granted in September 2006 indemnification to directors as well as the CEO of the company with respect to monetary liability that might be imposed on any of them and with respect to reasonable litigation expenses in connection with a shelf prospectus for the issue and listing for trade of subordinated capital notes, dated September 2006, and this under terms specified in the letter of indemnification. In any event, the maximum amount of the indemnification granted to all of the directors and to the CEO as a whole shall not exceed the gross proceeds of the said issue, and in any case no more than NIS 1.5 billion. In September 2007, Discount Manpikim Ltd. approved a similar indemnify to the CEO appointed subsequently to the issue of the shelf prospectus, regarding shelf offering reports to be published subsequently to the date of the resolution, in accordance with the said shelf prospectus.
- f) Discount Manpikim Ltd. granted in February 2008 indemnification to directors as well as the CEO of the company with respect to monetary liability that might be imposed on any of them and with respect to reasonable litigation expenses in connection with a shelf prospectus for the issue and listing for trade of subordinated capital notes, dated February 2008, and this under terms specified in the letter of indemnification. In any event, the maximum amount of the indemnification granted to all of the directors and to the CEO as a whole shall not exceed the gross proceeds of the said issue, and in any case no more than NIS 2 billion.
- g) Discount Manpikim Ltd. granted in February 2009 indemnification to directors as well as the CEO of the company with respect to monetary liability that might be imposed on any of them and with respect to reasonable litigation expenses in connection with the issue of subordinated capital notes in accordance with the amended a shelf prospectus dated December 24, 2008, and this under terms specified in the letter of indemnification. In any event, the maximum amount of the indemnification granted to all of the directors and to the CEO as a whole shall not exceed the gross proceeds of the said issue, and in any case no more than NIS 3 billion.
- h) Concurrently with approval of the engagement in an agreement for the sale of the provident fund management activity, the Bank committed to indemnify Discount Gemel Ltd. and its executive officers under conditions and circumstances in which the Bank is permitted to grant such indemnification in accordance with the relevant provisions of the Companies Law, with respect to their activity as officers of the company relating to approval of the sale agreement and implementation of the said sale, including any financial liabilities, expenses, consultation with legal and other experts, as required, and reasonable litigation expenses, provided that the cumulative amount required to be paid by the Bank shall not exceed the consideration receivable by the Bank under the sale agreement, and provided that realization of the indemnification will not impair the capital adequacy ratio, which the Bank is required to maintain under Proper Banking Management Directive No. 311, all as stated in the indemnification letter.
- i) The agreement for the sale of the provident fund management activity included indemnification arrangements whereby indemnification would be granted in respect of any claim or request submitted until the end of the seven years following the closure date (June 2007), against Clal Insurance, Clal Gemel or any officers thereof, though not against the sold provident funds, the cause of which would be acts of commission or omission by the Bank, Discount Gemel Ltd. or officers thereof committed prior to the closure date. Full indemnification would be given with respect to matters relating to claims by employees. In respect of other matters, the indemnification would amount to 50% and would be limited to a cumulative amount exceeding US\$1 million. In any event, the cumulative amount of the indemnification shall not exceed the total consideration for the transaction, with the addition of interest and linkage inceremnts.
- j) The agreement for the sale of the Ilanot-Discount shares, specified indemnification arrangements to be provided by the Bank in respect of a claim or demand that may be submitted during the seven years following the date of consummation of the transaction (June 18, 2006) against Ilanot-Discount the purchaser or officers thereof, on grounds of acts of omission or commission by the Bank, Ilanot-Discount or its

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

officers, performed in the period prior to the said consummation date, in respect of which no provisions had been included in the financial statements of Ilanot-Discount for the year 2005. The indemnification in respect of matters relating to claims by employees or by officers regarding taxes, levies or other obligatory payments will be in full. The indemnification with respect to other matters will be at the rate of 50% and will be limited to a cumulative charge in excess of US\$1 million. In any event, the cumulative amount of the indemnification shall not exceed the overall consideration for the transaction with the addition of interest and linkage increments.

- k) **Responsibility Insurance of Officers.** On May 22, 2008 a General Meeting approved the Bank's acquisition of a responsibility insurance policy for officers, as follows: the insurance policy will be issued by Clal Insurance Company Ltd, and will constitute a joint policy for the Bank and for its subsidiaries in which the Bank holds, directly or indirectly, 50% or more of the equity or voting rights. The policy also includes officers appointed by the Bank to serve in a company in which the Bank holds less than 50% of the equity or voting rights. The policy is in effect for the period April 1, 2008 through March 31, 2009, with maximum coverage in the amount of US\$100 million for an event and for the period. The insurance premium for the policy is US\$550 thousand. The Bank's part (not including the subsidiaries) in the said premium will not exceed US\$330 thousand. The coverage for claims regarding breach of money laundering legislation is US\$5 million only, for supervisory responsibility only. In the event of claims against any officers, the officer shall not bear any deductible. The Bank will bear participation (deductible) in the amount of US\$75 thousand per event.

The insurance policy is applicable, with the same conditions, for present officers and for officers in the Bank prior to the period of the insurance policy, including two former officers who served as directors in subsidiaries and who are also controlling shareholders in the Bank.

On June 3, 2009, the Annual General Meeting of shareholders approved the engagement of the Bank in a policy with respect to the responsibility of officers of the Bank and of companies in which the Bank holds, directly or indirectly, an interest of 50% or more in the equity or voting therein. The policy is for a period of one year as from April 1, 2009 and until March 31, 2010. The details of the policy are as described above (except for the change according to which the insurance premium will amount to US\$900 thousand, and the Bank's share excluding the subsidiaries will not exceed US\$540 thousand).

- l) **Advance exemption and a commitment to indemnify of directors and other officers.** On June 26, 2007 a special General Meeting approved advance exemption from responsibility of directors and other officers in the Bank and of former directors and officers in the Bank (according to a list of individual names), for damage caused to the Bank as a result of breach of the requirement for caution toward the Bank, except as a result of breach of the requirement for caution in respect of distribution, all subject to qualifications detailed in the decision, derived from the Bank's articles regarding exemption from responsibility.

The abovementioned special General Meeting also approved a commitment for indemnification of directors and other officers in the Bank and of former directors and officers in the Bank (according to a list of individual names), in respect of monetary liabilities levied on them and in respect of reasonable legal expenses, subject to a limit on the total amount of the indemnification payable to officers in the Bank and to officers in subsidiaries of 10% of the Bank's shareholders' equity, as reflected in the most recent financial statements published prior to the actual date of the indemnification, and subject to the indemnification amount not impairing the minimum capital adequacy ratio in accordance with Regulation 311 of the Proper Banking Management Regulations. The indemnification will be provided in respect of any action implemented in connection with the subjects detailed in the indemnification letter in effect for directors and officers in the Bank, subject also to fulfillment of additional conditions customary in such indemnification letters.

The above-mentioned indemnification will be provided only in the event that the monetary liability and/or expenses are not covered by a third party, including an insurance company.

Concurrently with the passing of the above resolutions, the special meeting of shareholders resolved to approve the amendment of certain bye-laws of the Bank, regarding the granting of exemption and indemnification to Directors and other Officers of the Bank.

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

The abovementioned special General Meeting also approved a commitment for indemnification of other directors and officers in the Bank as of the date of the decision (as detailed in the list appended to the announcement of the General Meeting), in respect of monetary liabilities levied on them and in respect of reasonable legal expenses, all in connection with mobilization of tier I capital implemented in the Bank in December 2006 and May 2007. The commitment for indemnification is limited to the amount of the mobilization (NIS 1 billion), subject, that in each event:

- (1) Realization of the indemnification will not impair the minimum capital adequacy ratio in accordance with the Proper Banking Management Regulations;
- (2) Realization of the indemnification will not impair the required original tier I capital ratio (without hybrid tier one capital) of at least 6.5% at any time.

Following approval by the Audit Committee dated June 28, 2009, the Bank's Board of Directors approved on July 12, 2009, the granting of exemption and indemnification to Directors and other Officers appointed subsequently to June 2007 (the date on which the General Meeting of shareholders approved the granting of exemption and indemnification to acting Officers and to Officers that had acted in the past) as well as to Directors and other Officers that may be appointed in the future, excluding controlling shareholders in respect of whom a specific resolution is required. In this framework, certain amendments to the indemnification letter have been approved, which will apply also to Directors and Officers who had been issued indemnification letters in June 2007. The General Meeting of Shareholders approved the said resolution on August 27, 2009.

m) **Exemption and a commitment to indemnify of Directors and Officers of Mercantile Discount Bank.** On November 29, 2009, Mercantile Discount Bank's General meeting of Shareholders approved the granting of a commitment to indemnify and exemption to Directors and other Officers of Mercantile Discount Bank and providing a commitment for the indemnification of other Directors and officers and of certain of its subsidiaries, who held office at Mercantile Discount Bank and at those subsidiaries since the year 2002 onwards. The said the commitment to indemnify and exemption were granted in accordance with principles and group limitations approved by the Bank's board in July 2009.

8. The practice of the Bank is to grant, from time to time, and at terms and circumstances customary in the banking business, letters of commitment and of indemnification, limited or unlimited in amount, and for limited or unlimited periods, and everything in the ordinary course of business of the Bank. Inter alia, such letters of indemnity are granted within the framework of the regulations of the Clearing House as to lost checks; are granted to Receivers and Liquidators; are granted in respect of negligence claims, to providers of various services including assessors, project manager etc; to customers in respect of lost check books; to credit card companies as part of the accountability with them; or indemnification granted as part of a contractual obligation.

This includes a full indemnification granted by the Bank to an assessor, in respect to any damage, which might be caused to him as a result of rendering valuation opinions, except in the case where gross negligence or malfeasance might be found; and a similar indemnification that the Bank gave to an expert who had provided the bank with an economic opinion.

9.
  - a) In November 2008, the Bank signed a guarantee, unlimited in amount, in favor of the VISA Europe organization, securing all liabilities of ICC, applying due to the status of ICC as a member of the VISA Europe organization, this in relation to the transactions of VISA connected to the operations of ICC both in Israel and abroad. ICC has signed an indemnification letter in favor of the Bank with respect to the said guarantee.
  - b) The Bank issued a guarantee in the amount of US\$26 million, in favor of the MasterCard Worldwide organization, to secure the activity of ICC within the framework of the Organization.
  - c) As security for the liabilities of E.R.N. (Israel) Ltd., an affiliated company of ICC, towards a certain commercial bank, the Bank has

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

issued a guarantee in the amount of NIS 8 million.

d) As security for the liabilities of ICC concerning payments to Government offices by means of credit cards, the Bank has issued a guarantee in favor of the State in the amount of NIS 3 million.

10. Within the framework of permits granted to the Bank for the construction of a building at 156 Herzl Street, Tel Aviv, the Bank is obligated to the Tel Aviv Municipality to bear the costs involved in evacuating tenants from the plot. To the best of the Bank's knowledge as at the date of the financial statements, the Municipality had not yet begun evacuating the tenants from the plot, and the Bank is unable to assess the cost of its participation in the evacuation of tenants as aforesaid.

11. Various actions against the Bank and its consolidated subsidiaries:

Various actions are pending against the Bank and its consolidated subsidiaries. These include class action suits and requests to approve actions as class action suits. Among others, allegations are raised in these claims with regard to the unlawful debiting of interest and/or the debiting of interest not in accordance with agreements, subjecting one service to another service, failure to execute instructions, applications for the confirmation of attachment orders in respect of attachments served by third parties on the assets of debtors which they allege are held by the Bank, the unlawful debiting of accounts, mistakes in value dates, the invalidity of collateral security and the realization thereof, applications for injunctions ordering the Bank to refrain from paying out bank guarantees or documentary credit, as well as allegations pertaining to provident funds, securities, construction loans, applications for the removal of restrictions on an account pursuant to the Dishonored Checks Law, 1981. In the opinion of the Management of the Bank, which is based, inter alia, on legal opinions and/or on the opinion of managements of its consolidated subsidiaries, which are based upon the opinion of their counsels, respectively, as the case may be, adequate provisions have been included in the financial statements, where required.

The total exposure with respect to claims filed against the Bank and its consolidated subsidiaries, whose prospects of materializing, in whole or in part, has been assessed as reasonably possible, amounts to approximately NIS 1,061 million.

11.1 In November 1999 a former customer of the Bank submitted to the Tel-Aviv District Court a claim against the Bank in the amount of NIS 456 million.

In the action, the plaintiff alleges wrongful doings made in his accounts until 1989. According to the plaintiff, who maintained a business account with the Bank, the Bank exploited his mental and physical condition, and made use of his account and the accounts of his family members as if they belonged to the Bank, while opening dozens of additional accounts without permission, concealing information, forging signatures, taking out loans in the name of the plaintiff, buying and selling securities fictitiously and embezzling funds.

Hearing of evidence in respect of this claim commenced in January 2004 and ended in November 2009.

The Bank, inter alia, raised an argument of obsolescence and the Court determined that this argument will be considered in the framework of the verdict.

Based on the opinion of legal counsel, management of the Bank believes that the amount of the claim is excessive and the arguments of the plaintiff are baseless.

During 2010, the parties submitted the concluding briefings and are now awaiting the decision of the Court.

11.2 On September 1, 2004, an application for exemption from the Court fee was submitted to the Tel Aviv District Court in connection with a suit in a sum of NIS 500 million brought by the liquidators of a company against forty defendants, one of which was the Bank. The Court partially accepted the request for exemption and determined the fee at NIS 320 thousand.

The suit against the Bank turns on three causes only, which relate to alleged injury valued at US\$4 million in respect of a transaction undertaken between the company in liquidation and a third party involving the sale of an asset mortgaged to the Bank, which, according to the liquidators' assertions, was sold for less than its true value, the release of the shareholders of one of the companies in the group from

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

their guarantees in relation to the debts of the company to the Bank totaling NIS 3 million; and the return of deferred payment orders to the company in liquidation without the items passing through the company's bank account, thus causing injury valued at NIS 9 million. It should be noted that the liquidators claim that the behavior of the Bank as described above led to the final liquidation of the company without any specific claims having been made by the liquidators as to the injury attributable to the Bank in relation to this cause of action.

On November 29, 2009, the Bank resubmitted a motion for the amendment of the claim brief so that it will accurately define the amount of the claim against it. The motion is still pending.

In addition, the Bank motioned for the in limine dismissal of the claim on the grounds of limitation. The motion was dismissed and on November 16, 2008, the Bank filed a request to the District Court for permission to appeal the said decision, the hearing of which has been suspended until the conclusion of the moderation process between the parties. The moderation process has been ended in November 2010 without an agreement. Hearings were held on February 13 and 20, 2011, of the said motion for approval of the appeal. The Court allotted the parties dates for the completion of their arguments in writing and following the filing thereof the Court will hand down its decision.

**11.3** On June 19, 2006, an action was filed together with a motion for its approval as a class action against the State of Israel and 31 other defendants, including the Bank, Mercantile Discount Bank, Discount Gemel and the Provident funds of Mercantile Discount Bank. The claimants allege that the defendants have unlawfully received payments in respect of foreclosures imposed by those who were granted execution through the magnetic media. The principal claim is that the defendants do not provide the service required by law, in that they do not provide full and detailed information in their reply to the Bailiff Office, and accordingly are not entitled to the payment determined in the regulations.

The amount of the claim against all defendants totals NIS 233 million. The claim does not specify the amount claimed from each of the defendants. The Bank estimates that the maximum exposure of the companies of the Discount Group involved in this case for the restitution claim would not exceed NIS 10 million.

On November 24, 2010, the Supreme Court dismissed of the appeal filed by the Bank, Mercantile Discount Bank and additional defendants, against the ruling of the District Court not to admit the motion for dismissal in limine of the lawsuit. In view of the dismissal of the appeal, as stated, a hearing of the motion for approval of a class action suit was fixed for June 2, 2011.

**11.4** Hereunder are details regarding a class action suit, which has been appealed against as such:

A lawsuit was filed on September 12, 2006, against the Bank, Bank Leumi Le'Israel B.M. ("Bank Leumi") and Bank Hapoalim Ltd. ("Bank Hapoalim") (together: "the defendant banks"), as well as a motion for approval of the lawsuit as a class action suit. The Plaintiff assessed the amount claimed at NIS 7 billion in respect of all the defendant banks, reserving the right to amend this amount in accordance with developments during the course of the litigation.

The Plaintiff argued that most of the credit to the public is concentrated in the hands of the defendant banks, and that they coordinated among themselves the prices applying to five parameters in everything relating to credit.

The Plaintiff alleges that the similarity in prices of the five parameters at the defendant banks indicates the existence of coordination between them that resulted in huge profits to these banks and caused enormous damage to the public and to the economy.

The Plaintiff's claim is that it has a cause of action both under the Restrictive Trade Practices Law, there being a prohibited binding arrangement, and under the Banking Law (Service to customer), as it is argued that the defendant banks exploited customers' distress, their ignorance and inexperience in order to provide them with banking services under unreasonable terms.

The relief requested by the Plaintiff is a retroactive reduction in the prices of the five parameters charged during the past ten years for all customers of the defendant banks. Alternatively, the Court is asked to rule a different relief in favor of all members of the class or in favor of the public.

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

On January 21, 2007, the District Court admitted the Plaintiff's motion to recognize the lawsuit as a class action suit on grounds derived from the Restrictive Trade Practices Law (hereinafter: "the decision of the District Court").

In its ruling, the Court noted, inter-alia, that the Restrictive Trade Practices Authority (hereinafter: "the Authority") is conducting a widespread criminal investigation "the largest ever conducted by the Authority regarding suspicion of felonies committed by the banking industry in contravention of the Restrictive Trade Practices Law, 1988", as noted in the letter of the legal counsel for the Authority dated May 20, 2007, which had been attached by the Plaintiff to the material presented to the Court.

In this respect, it should be noted that the Commissioner issued on April 26, 2009, a ruling as detailed in Section 14 below.

On April 9, 2008, the Plaintiff appealed the decision of the District Court to dismiss the motion of the Plaintiff for approval of the lawsuit as a class action suit, also on grounds of prevention of harm to the customer under the Banking Law, as well as the District Court's ruling that the Plaintiff does not have a personal cause of action against Bank Hapoalim. At the request of the Claimant and with the consent of the parties, the appeal filed by the Claimant against the dismissal of the claim against the banks based on the Banking Law, was withdrawn on November 28, 2010.

On April 15, 2008, the banks applied to the Supreme Court for permission to appeal the decision of the District Court. On May 29, 2008, the Supreme Court ruled that the Attorney General to the Government of Israel should consider joining the proceedings.

The Attorney General presented on May 30, 2010, his response. The position of the Attorney General of the Government supports that of the banks in the appeal, according to which the claim should not be approved as a class action suit, due to the lack of satisfactory evidential matter demonstrating the existence of a binding arrangement. The Attorney General recommended that the case be returned to the District Court in order to examine the existence of additional evidence, which might serve as a proper basis for approval of a class action suit.

After consideration of the motions for appeal filed by the banks against the decision recognizing the lawsuit as a class action suit, as well as the brief and the position of the Attorney General to the Government, the Supreme Court instructed in its decision that the motions be heard by an expanded panel of the Court.

The President of the Supreme Court decided that the appeal be presented to a 7 judge panel.

The hearing of the class action was suspended by the District Court until a ruling is given by the Supreme Court in the request for permission to appeal. Hearing of the appeal was held on March 13, 2011. The decision of the Court has not yet been received.

- 11.5** On November 23, 2006, a lawsuit was filed to the Jerusalem District Court together with a motion for its approval as a class action suit against the Bank, Bank Hapoalim BM and Bank Leumi Le Israel BM ("the defendant banks").

The claimants assess the amount of the claim at between NIS 5.2 and NIS 5.6 billion for all the defendants, while they reserve the right to amend the claim brief. In the claim brief the claimants argue that the defendant banks charge the private household sector interest at an exorbitant rate, which is much higher than the interest rate charged to the commercial and business sectors, this without any economic and commercial justification. According to the claimants, they have a cause of action under the Restrictive Trade Practices Law, due to the defendant banks constituting, as alleged by them, a "a concentration group", which according to them misuses its monopolistic power, while reducing competition and causing harm to the public and because, as they claim, there exists prima facie a binding contract between the defendant banks, and also under the Banking Law (Service to customer) and under the Consumer Protection Law in respect of - according to their claim - misleading consumers with respect to the accepted price for credit service to the household sector and to the determination of interest rates while utilizing their distress and ignorance for engaging them in transactions at unreasonable terms and/or for the purpose of receiving consideration that exceeds the accepted consideration.

The Bank responded to the motion to approve the claim as a class action suit.

On May 15, 2008, the Court decided to stay the proceedings until a ruling is given in the appeal filed by the banks with respect to the

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

action described in item 11.4 above.

The Plaintiffs requested permission to appeal against the Courts decision to stay the proceedings. On July 7, 2008 the Supreme Court rejected the request.

- 11.6** On June 30, 2008, a motion for the approval of an action as a class action suit against the Bank, Bank Hapoalim and Bank Leumi, was submitted to the Tel Aviv District Court. The core issue of the suit rests on the Plaintiffs' claim that, since the end of the 1990's and possibly even earlier, the three defendant banks created a cartel coordinating the prices of commissions charged to their customers. The Plaintiffs further claim that the banks have created an unlawful restrictive business practice regarding the rates of the various commissions charged to customers. As alleged by the Plaintiffs, as a result of the cartel, the price paid by the public is higher than the price that would have been paid had competition not been prevented by the cartel.

The causes for the action are as follows: Violation of Section 4 of the Antitrust Law the Plaintiffs request that the rules applying to a concerted group/ monopoly, as these terms are defined in the said Law, should apply to the defendant banks; a material misrepresentation in accordance with the Consumer Protection Law; violation of Section 2 of the Fiduciary Law; violation of the provisions of the Unlawful Creation of Wealth Law.

The Plaintiff estimates the gap between commissions actually charged and the commissions that would have been charged had the banks not acted as they did, at 25%. Based on this assessment, the Plaintiffs claim an overall damage for all member of the group of NIS 3.5 billion. The Bank's share in the claimed amount is 22% (namely an amount of NIS 770 million).

The Bank filed its response on March 19, 2009.

Documents which, according to the Claimants, had been seized by the Antitrust Commissioner were attached, among other things, to this motion. In this respect, it should be noted that the Commissioner issued on April 26, 2009, a ruling as detailed in Section 14 below.

According to the decision of the District Court of October 7, 2009, the claim will be heard together with the claim described in Section 12.3 hereunder. The Court ordered a stay in the hearing of the motion for approval until a decision is given in the appeal against the decision of the Commissioner, to be submitted by the banks to the Antitrust Tribunal (as described in section 14 below).

- 11.7** Two motions for approval of an action as a class action suit were submitted on August 4, 2008 to the Jerusalem District Court, one against the Bank, Discount Gemel Ltd. (hereinafter: "the Manager") and the Commissioner of the Capital Market, Insurance and Savings at the Ministry of Finance (hereinafter: "the Commissioner"), and the other against the Bank, Bank Leumi Le'Israel BM, KAHAL - Employee Training Funds Management (1996) Ltd. (hereinafter: "the Manager") and the Commissioner.

The Plaintiffs claim that they were members of the provident funds managed by the Managers as well having current accounts at the Bank. According to the Plaintiffs, the banks unlawfully took possession of the consideration monies received in respect of the "transfer of control over the assets of the provident funds, the management thereof and trusteeship thereon", this instead of passing on the consideration to the members of the provident funds proportionally to their share in the assets of the provident funds, the consideration monies being the profit generated by the assets of the funds. The Claimants argue that the provident funds management companies and the selling banks have violated various laws and fiduciary duties.

The amount of damages claimed is the amount of the consideration received in each of the transactions. The damages are attributed both to the Bank that received the consideration, unlawfully as alleged by the Plaintiffs, and to the Manager. Accordingly, the amount of damages claimed in one of the actions is NIS 607 million and in the other action (relating to the Bank and Bank Leumi) NIS 260 million.

The principal relief requested is to order the Defendants to transfer the consideration to the provident funds in favor of their members and to order the Defendants to pay damages to the members of the provident funds as the Court sees fit. The Court is also motioned to issue various declaratory relief relating to the conduct of the Bank and the Manager.

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

On March 27, 2011, the District Court dismissed the motion for approval of the action as a class action suit.

- 11.8** An action was filed on September 28, 2008 with the Tel Aviv District Court against the Bank, Bank Leumi, Bank Hapoalim and Otsar Ha'Hayal Bank.

The motion was filed on behalf of all those who had traded through investment portfolio managers in options on the TA 25 Index, using bank accounts held with the defendant banks, the respondent banks having charged such accounts with a commission named "realization commission".

The Claimants argue that the banks have furtively charged a "realization commission" at the rate of 0.5% of the amounts due to the option holders upon expiry of the options, this without providing proper and sufficient disclosure.

The Claimants further argue that the "realization commission" was charged by the Defendants despite the fact that they do not have to take any action justifying such a commission, and that no reasonable ratio exists between the rate of the commission and the so called action required from the Defendants and that the respondent banks did not receive approval of Bank of Israel for charging such a commission. The combined damage to all members of the group is estimated by the Claimants at NIS 672 million. The Claimants do not disclose the amount of the damage attributed to each of the Defendants.

The Bank filed its response on February 9, 2009. The case is fixed for October 9 and 10, 2011, for the continued hearing of proof.

- 11.9** On October 29, 2009, two companies submitted a lawsuit against the Bank, Mercantile Discount Bank and five additional banks, requesting a declarative ruling according to which the defendant banks are not entitled to charge the Claimants with violation interest in the amount of NIS 840 million, but only with an amount of NIS 37 million. Alternatively, the banks are entitled to charge the Claimants only with interest and linkage increments, and accordingly, the accounts of the Claimants should be credited with the difference in the amount of NIS 521 million.

The Claimants argue that the violation interest constitutes an agreed compensation, and therefore the Court is entitled to reduce it under Section 15 of the Contract Law ("Relief"), 1970, as no reasonable relation exists between the agreed compensation and the amount of damage caused to the banks as a result of the violation. The reduction in the violation interest is called for also by the interpretation of the agreements according to the opinion of the parties. Charging the Claimants with violation interest comprises an unjust enforcement of the agreement. The banks' insistence on charging the Claimants with violation interest comprises lack of good faith and its collection by the banks constitutes illegal creation of wealth.

According to the Claimants, the principal rationale for the circumstances that justify the reduction in interest is the length of time between the date of the receivership and the date of sale of the shares.

The Bank's share in the alleged damage, based on its share in the credit consortium, is 10% and that of Mercantile Discount Bank is 4%. In accordance with the decision of the District Court, The Claimants filed a monetary claim of NIS 830 million.

On March 29, 2010, the banks filed a defense brief. During 2010, procedures for the disclosure of documents were conducted.

The case is fixed for the months of March, April and May 2011, for the hearing of proof.

- 11.10** On November 2, 1997 a law suite was filed with the Tel-Aviv District Court and a motion to approve the filing of a class-action suit against DMB and against three additional mortgage banks regarding the charging of commissions for life assurance and property insurance of borrowers. It was argued, inter alia, that the Bank compelled the plaintiffs to purchase these insurance policies as a condition for signing the loan and mortgage agreements. The amount set in the class-action suit is NIS 500 million, with no specific allocation to the banks involved. Whereas, with respect to another request to approve an action as a class action, in a matter practically identical, the Court had already handed down its decision, which was appealed against, the Judge presiding in this case has decided that it will be heard only after the Supreme Court will issue a judgment in principle on the matters in dispute that were raised in the appeal against the ruling already

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

given with respect to the other motion.

- 11.11** On June 2, 2009, a lawsuit was filed with the Tel Aviv District Court against Discount Mortgage Bank together with a motion to approve the suit as a class action suit.

The claimant and her deceased husband were borrowers of Discount Mortgage Bank and provided that bank with a life assurance policy as collateral for the repayment of the loan in case of death of one of the borrowers. Following the death of the husband the remaining borrower wished to act on the policy and accordingly Discount Mortgage Bank informed the assurance company of the balance of the loan with the addition of an early repayment charge.

According to the claimant, adding the early repayment charge was illegal, and the claim should be admitted on the following grounds: contractual grounds, the illegal creation of wealth, lack of proper disclosure and misleading the customer.

In the motion for approval of a class action, the claimant requests the Court to instruct Discount Mortgage Bank to refund early repayment charges collected over the past seven years on loans where one of the borrowers had passed away. The total amount of this claim, as assessed by the claimant, totals not less than NIS 75 million.

Preliminary discussions have been held in this case, at the conclusion of which, the Court instructed the parties to sum up their arguments and set the hearing of the decision to January 13, 2011. The parties have submitted their summations to the Court. On January 11, 2011, the Clerk of the Court informed that the hearing set for January 13, 2011, will not take place, and that the decision will be delivered to the parties.

- 12.** Requests to approve certain actions against the Bank and its consolidated subsidiaries as class action suits and other actions for which it is not possible at this stage to evaluate their prospects of success:

A class action suit and requests to approve certain actions as class action suits are pending against the Bank and its consolidated subsidiaries, which in the opinion of the Bank's, which is based on legal opinions and/or on the opinion of managements of its consolidated subsidiaries, which is based on the opinions of their Counsels, respectively, as the case may be, it is not possible at this stage to evaluate their prospects of success, and therefore no provision have been included in respect therewith.

- 12.1** On June 19, 2000, two borrowers of DMB filed with the District Court a petition for approval of an action as a class action suit against DMB and against the Israel Phoenix Insurance Co. Ltd. ("Phoenix"), where the properties of the borrowers are insured. The action is for an amount of NIS 105 million.

The borrowers claim, inter alia, that DMB has insured their properties for amounts which exceed their reinstatement value, since the insured amounts included the land component, and that the sum insured was increased in excess of the increase in the Consumer Price Index.

On September 10, 2000, DMB filed its response to the petition for approval of a class action suit, in which the Court is requested to dismiss the petition in limine and as regards its substance. It should be noted that Phoenix Insurance also responded to the petition requesting the Court dismiss the petition in limine and as regards its substance. On October 29, 2000, the claimants submitted their reply to the above response, in which they repeat the request for approval of a class action suit.

On December 25, 2000, the Court decided that the arguments raised in this petition were similar to the arguments raised in the pleas for approval of class actions discussed in 11.10 above, and consequently the Court decided to defer the hearing of the said petition until after the verdict is given in those other pleas. The Supreme Court rejected on April 4, 2001, a plea for permission to appeal this decision.

In its decision of December 25, 2000, the District Court did not determine that proceedings against Phoenix Insurance should also be deferred. Phoenix Insurance petitioned the Supreme Court for permission to appeal in this respect. On January 28, 2002, the Supreme Court admitted the plea of Phoenix Insurance and ordered to stay proceedings against it at the District Court as well.

The case was transferred for hearing at the District Court of the Central Region.

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

The District Court of Central Region decided to suspend the hearing of the case until after a ruling is given at the Supreme Court, in accordance with the decision that had already been taken in this case by the District Court in 2000.

- 12.2** A motion for exemption from Court fees regarding a lawsuit in the amount of NIS 96 million filed with the Tel Aviv District Court on February 6, 2008. The motion was filed by the controlling shareholder of a company, being a debtor of the Bank, in respect of which a receivership order and a liquidation order had been issued.

The Plaintiff claims that the Bank, in a negligent manner lacking good faith, had applied for a receivership order against the company and at a later date also applied for an order to liquidate the company despite the fact that the total value of the company's assets exceeded the amount of the debt to the Bank.

The Plaintiff attributes to the Bank the responsibility for the acts and/or omissions of the Receiver and/or of the Liquidator of the company, which as alleged by him, caused the company heavy damage.

On the face of it, the claim against the Bank has no legal and/or factual grounds and the amounts claimed are most excessive.

On April 9, 2008, the Bank submitted its response to the motion for exemption from Court fees. The continued hearing of the motion for exemption from Court fees took place on February 28, 2010. The case has been fixed for written summations, following which a decision will be given. At this early stage, prior to the ruling in the motion for exemption from Court fees, it is not possible to assess the prospects of the action.

The Claimant passed away in April 2010, and accordingly, the Executors of his estate must inform whether they wish to continue the proceedings. In February 2011, the representative of the Claimant filed a motion for the replacement of the deceased Claimant by his legal heirs. The Court has not yet decided in the matter, neither has a date been fixed for the hearing.

As long as exemption is not granted or the Court fee is not paid, the lawsuit is not considered as filed.

- 12.3** On May 12, 2009, an action was filed against the Bank, Bank Leumi, Bank Hapoalim, Mizrahi-Tefahot Bank and the First International Bank together with a motion to approve the action as a class action suit.

The action is based on the statement of the Antitrust Commissioner (see item 14 below) according to which binding arrangements regarding the communication of information with respect to commissions had existed between the defendant banks.

The Claimants argue that a binding arrangement had existed between the said banks with respect to commission rates charged by these banks and that the banks established a coordinated policy, which, as alleged by the claimants, was typified by prohibited cooperation and exchange of information.

The Claimants argue that the banks created between them a binding arrangement in contravention of Sections 2 and 4 of the Antitrust Law and that according to Section 50 of that Law an act of commission or omission in contravention of the provisions of the Law constitute a damaging injustice.

The class defined in the action constitutes all customers of the defendant banks, both private and business customers, in the period from 1990 to 2004. The total damage for all the defendant banks is assessed for the purpose of the action at approximately NIS 1 billion, with no allocation between them. The Claimants reserve the right to amend the amount of the damage claimed following receipt of the full data from the banks.

On October 7, 2009, the District Court rejected the motions submitted for the in limine dismissal of the claim and instructed that the hearing of this claim should be incorporated with the claim discussed in Section 11.6 above. The Court ordered a stay in the hearing of the motion for approval until a decision is given in the appeal against the Commissioner's ruling, to be submitted by the banks to the Antitrust Tribunal. (see item 14 hereunder).

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

**12.4** On February 24, 2011, Discount Mortgage Bank received notice of a motion for approval of a class action in the matter of charging an early repayment commission on commercial loans, filed with the Tel Aviv District Court. The Claimant is a corporation that had received a loan for the purchase of a commercial property, and upon the early repayment of the loan was charged with an early repayment commission. It is being claimed that Discount Mortgage Bank calculated incorrectly the early repayment commission in a manner that contradicts the procedures of the Bank of Israel and the provisions of the law. The Claimant further argues that in this way, Discount Mortgage Bank illegally collected amounts of NIS tens of millions in each year. The Claimant seeks to represent the customers who had been charged with an early repayment commission in the last seven years, to obtain an order for the restoration of the commission illegally charged, together with interest and linkage increments, and for the indemnification of the Claimant, as representative of the class, in a total amount of 25% of the amount claimed.

**13.** Certain requests for approval of class actions against FIBI:

The financial statements of FIBI in describing details of requests for approval of class actions that are pending against this bank and against its subsidiaries, and with respect to which management of FIBI, after consulting with legal advisors, is unable to estimate, at this stage, the prospects of these claims and therefore no provision has been made therein, make mention of the following procedure:

In 1997, claims were brought in the Tel Aviv District Court against two subsidiaries of FIBI - the First International Mortgage Bank Ltd. and Atzma'ut Mortgage and Development Bank Ltd. (hereinafter: "the mortgage banks in the First International Group"), which in the meantime have been merged into FIBI, and against other mortgage banks, in which it was claimed that the said banks unlawfully charged borrowers with a commission relating to life assurance and property insurance policies, and that the borrowers are entitled to the refund of such amounts. These claims total approximately NIS 1.5 billion (in nominal values). A petition to approve these actions as a class action suits was also filed. The said claims and petition did not include the manner of calculation of the said amount; neither did they include details as to what part of the amount is attributed to the mortgage banks in FIBI Group.

In November 1997, the Court ruled as to the action filed in July 1997, according to which it dismissed the claim in the form of a class action according to the Banking Law (Service to customer), 1981, and the Restrictive Practices Law, 1988. Nevertheless, the Court ruled that it was possible to hear a claim for a declarative relief under Section 29 of the Civil Code Regulations, with respect to causes of action created prior to May 10, 1996 (date of publication of the amendments to these Laws regarding class actions).

In December 1997, the said banks applied to the Supreme Court for permission to appeal against the said judgment, as well as petitioned the court to stay execution of the proceedings until judgment is passed in this appeal. The request for permission to appeal and for the stay of execution has been admitted by the Supreme Court.

In a hearing held by the Supreme Court in the above appeal on November 25, 2001, the parties accepted the suggestion of the Court to stay the hearing of the appeals until a judgment is given in another appeal case pending at the Supreme Court, in which a fundamental decision is to be given in the matter of the status, applicability and terms of Section 29 of the Civil code Regulations, a question standing at the heart of the said appeal.

On April 2, 2003, a judgment was given in that other appeal in the matter of the status and applicability of Section 29 for the purpose of submitting a class action. Therefore, on April 10, 2003, the Supreme Court decided that the parties submit their arguments in writing as to the continuation of the appeal proceedings. All the parties have already submitted their briefs as stated. The decision of the Supreme Court in the matter has not yet been given.

On September 1, 2005, a decision was given in the further hearing in the matter of the status and application of Regulation 29, which left the ruling as is. This ended, for the time being, the use of Regulation 29 as an instrument for serving class action suits.

Pursuant to the Class Action Suits Law, 2006, published on March 12, 2006, new arrangements have been established, essentially different from the laws in existence prior to the enactment of the above law, as regards to the filing of class action suits. According to the law, the

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

Court is empowered to also apply the provisions of the new law to actions that had been pending prior to its enactment, under terms specified in the law. Until the date of publication of these financial statements, no such motions have been filed by any of the claimants as stated above. According to the recommendation of the Supreme Court, all parties agreed to refer the case to mediation procedures.

If the said motions were granted, the earnings of FIBI Group would be reduced in this field.

14. On March 19, 2008, following an investigation conducted since 2004 by the Antitrust Authority, within the framework of which many documents and computer material had been seized and Bank employees interrogated, including a member of management, the Authority informed the Bank that in view of the investigation findings, the Antitrust Commissioner is studying the possibility of applying the authority conferred on her by law and determine that binding arrangements had existed between Bank Hapoalim Ltd., Bank Leumi Ltd., Mizrahi-Tefahot Bank, the First International Bank Ltd. and the Bank (hereinafter: "the banks"), in the matter of communicating information regarding to commissions ("the considered determination"). The Bank was given a chance to submit its position in writing to the Commissioner before she takes a decision whether to make use of the said authority.

In September 2008, the Bank submitted to the Commissioner its position in writing within the framework of hearing, in which the Bank presented in great detail the factual and legal reasons supporting its argument that there is no place for the Commissioner to make use of her authority to determine that a binding arrangement had in fact existed.

In January 2009, the Authority suggested to the banks the possibility of forming an "agreed order" as an alternative to the publication of the decision being considered. In this respect it is suggested that the "agreed order" shall include a cash payment of NIS 290 million, to be allocated between the banks, so that the share of the Bank in this amount will be NIS 80 million. The Authority also suggested that the "agreed order" will include agreed limitations on the communication of information between banks, as well as the mapping and regulation of all collaborative activities between them.

In February, 2009, the Bank informed the Authority that it rejects the said suggestion for an "agreed upon order".

On April 26, 2009, the Bank received the decision of the Antitrust Commissioner, given under Section 43(a)(1) of the Antitrust Law, 1988, according to which the Commissioner states that binding arrangements had existed between the banks regarding the communication of information with respect to commissions, and that according to the findings in her possession, such binding arrangements had been in effect since the beginning of the 1990's and until the beginning of the investigation initiated in the matter by the Antitrust Authority in November 2004.

According to the Commissioner's decision, communication of information in the said statement constitutes a binding arrangement within the meaning of the Antitrust Law.

The Commissioner further stated that in accordance with Section 43(e) of the said Law, the said statement serves as prima facie evidence for everything determined therein in any legal proceedings.

The Bank disputes the ruling, its findings and conclusions. An appeal against the decision of the Commissioner was filed on March 24, 2010. Following several extensions granted to the Commissioner, her response brief to the appeal was filed on February 22, 2011. A preliminary discussion has been set to April 3, 2011.

15. Israel Discount Capital Markets and Investments Ltd. (hereinafter: "DCMI") is a partner in several venture capital funds, private investment funds and in this respect is obligated to invest in these funds.

As of December 31, 2010, DCMI has a commitment to additional investments in 15 such entities amounts totaling US\$155.4 million (as of December 31, 2009, US\$185.9 million).

DCMI owns approximately 19.6% of the equity of Menif. DCMI's board of directors has approved a commitment of guarantees for projects up to an amount of US\$17.3 million. As of December 31, 2010, guaranties have been provided in the amount of NIS 51.3 million (December 31, 2009 - NIS 47 million).

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

In addition, as of December 31, 2010, the Bank is committed to invest US\$4.1 million in a venture capital fund. Furthermore, Mercantile Discount Bank has a commitment to invest in five venture capital funds amounts totaling US\$2 million, as of December 31, 2010.

**16. Sale of properties:**

a) On September 19, 2002, the Bank signed an agreement for the sale of a warehouse area in Ashdod of some 37 dunams, in consideration for US\$6.1 million. The Bank is committed to lease an area of some 15.2 thousand square meters, of which a built-up area of 6.5 thousand square meters, for a period of 11 years, at an annual cost of US\$309 thousand. On June 12, 2010, the Bank signed an agreement for the sub-lease of the property until the end of the lease period. The terms of the sub-lease agreement are the same terms determined in the lease agreement, mutatis-mutandis, and subject to the terms determined in the sub-lease agreement.

b) On June 4, 2004, the Bank signed an agreement with another party for the sale of the building in Ramat-Gan, which had previously been designed to serve as the offices of the Bank's management, as well as for the sale of additional rights in the property, present and future. The proceeds of the sale amount to NIS 229 million. The bank has undertaken to lease for a period of ten years an area of 430 sq. mtrs. In the commercial floor and an area of 2,145 sq. mtrs. in the office floors, in consideration for US\$578 thousand per annum (two floors out of the 20 floors being built).

**17. Mercantile Discount Bank has committed to compensate the members of the "Mercantile Central Severance Pay Fund" in the event that the value of their rights in the Fund falls below the nominal amount deposited by them with the Fund. According to an agreement between Mercantile Discount Bank and the purchasers of the control over the operations its provident funds, Mercantile Discount Bank's guarantee was supposed to expire in August 2011 at the latest. Following several extensions granted to the Commissioner, her response brief to the appeal was filed on February 22, 2011.**

**18. An agreement for provision of services to government employees.** On April 1, 2007, the Bank was informed of its success in a tender issued by the Accountant General at the Ministry of Finance, for the granting of loans, credit facilities and other banking services to State employees (services provided till then by Yahav Bank for State Employees Ltd.). The period of this engagement is for seven years beginning on January 1, 2008. On May 10, 2007 the Bank signed an agreement in this regard.

Within the framework of this tender, the Bank will establish a special deposit for seven years in the amount of NIS 1.036 billion, for the purpose of granting loans and credit facilities to State employees. At the end of the period the principal amount of the deposit will be repaid to the Bank together with CPI linkage increments. (The Accountant General is entitled to interest in respect of the loans and credit facilities granted out of the deposit funds, as well as interest on the balance of the deposit).

Loans to State employees so entitled are granted under subsidized terms (the interest rate determined is the lower between two thirds of the prime rate and two thirds of the cumulative amount of the nominal inflation rate, with the addition of 2%) out of funds of the deposit. The Bank is also obligated to provide credit facilities of up to an amount of NIS 7,000 (out of the deposit funds) under the same terms, to each State employee who opens a current account with the Bank and has his monthly salary credited to this account. The Bank is entitled to provide credit in amounts exceeding NIS 7,000 out of Bank funds, at an interest rate not exceeding the prime rate + 1.4%.

Under the terms of the tender, the charges that the bank is entitled to collect are restricted to the amounts stated in an annex to the tender; a large part of the retail banking services is provided free of charge. As to other services not stated in the agreement, the Bank may collect a maximum of 70% of the amount of the charge stated in the tariff of the Bank.

According to the terms of the tender, the Bank is to provide services to State employees at at least 50 branches in locations determined in the tender terms.

**19. An agreement for provision of services to the teaching staff.** On July 11, 2007, the Bank was informed of its success in tender issued by the Accountant General for the granting of subsidized loans to teachers and of conditional loans to education students (services provided

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

at that time by the First International Bank of Israel Ltd.). The loans are to be granted at the Bank's responsibility. On September 26, 2007, the Bank signed an agreement in this matter. The engagement period is for five years, as from November 1, 2007.

Within the framework of the tender, the Bank has transferred to a special deposit an amount of NIS 360 million for five years, which is to serve for the granting of loans to teachers only. At the end of the period, the principal amount will be repaid to the Bank together with CPI increments (the Accountant General will be entitled to interest on the loans granted out of the deposit funds as well as interest on the balance of the deposit). Loans to students, granted out of the State budget, are conditional and could be converted into grants according to criteria of the Ministry of Education.

**20. Sale of investment in KFS.** On March 30, 2009, DCMI signed an agreement for the sale to Karden of all of its holdings in the shares of KFS - 11.01% of the issued and paid share capital of KFS at date of issue - in consideration for Euro 38.5 million. This amount is paid as follows: An amount of Euro 30 million was paid upon signing the agreement and an amount of Euro 8.5 million is payable at the end of seven years from date of the agreement, without interest. In addition to the above, the Bank has approved a new credit facility to the Karden Group in amounts exceeding the said consideration amount.

At the same time, DCMI signed an option agreement for the purchase of 5% of the share capital of KFS by way of an issue of shares. The Option is exercisable within six years from date of signing the agreement, at an exercise price of Euro 386 million together with interest of 5% per annum (subject to adjustments specified in the agreement). For the purpose of interest accumulation, exercise of the option in the course of the first two years, will be considered as though the option was exercised at the end of two whole years. The option is exercisable at any time within the said period of six years, unless this period is shortened following the listing for trade of the KFS shares or another event of their sale (as these are specified in the option agreement). If and when DCMI exercises the option, then it will be entitled to rights including a "tag along" right in the case of sale of a controlling interest by Karden and the right to participate in future allotments of shares. The shares of DCMI are also subject to the right of first refusal by Karden, and all subject and in accordance with the terms prescribed in the option agreement.

Being cautious, the Bank did not take into account, in computing the provision for impairment, the economic value attributed to the option. A loss of NIS 18 million was recognized in the financial statements as of March 31, 2009, in respect of the realization of the investment in KFS (most of which was in respect of exchange rate differentials recorded in relation to this investment up to realization date), on top of provisions for impairment in the amount of NIS 85 million, recorded in 2008.

**21. Investment in activities abroad.** In September 2007 an agreement for investment in two companies owned by Mayer Cars and Trucks Co. Ltd. (hereinafter: "the Mayer Group") was signed. The Bank, through DCMI, has committed itself to investing an amount of up to Euro 40 million in Mayer (Keshet) Real Estate Ltd. (hereinafter: "Mayer Real Estate") and an amount of up to Euro 30 million in Mayer Europe Ltd. (hereinafter: "Mayer Europe"). The Bank's said commitment is subject to the commitment of the Mayer Group to make a parallel investment of an amount of up to Euro 160 million in Mayer Real Estate and an amount of up to Euro 120 million in Mayer Europe.

The investment in the said companies would entitle DCMI to an equity interest of 20% and to the right to appoint one of five Directors in each of these companies.

Up until December 31, 2010, DCMI invested an amount of Euro 11.5 million in the two companies of the Mayer Group (December 31, 2009: Euro 11.1 million).

**22. Sale of the remaining interest in Mercantile Discount Bank's provident fund activities.** In July 2007, Mercantile Discount Bank entered into an agreement with a group of investors, for the sale of its control (51%) of the activities of its provident funds. According to the said agreement, the activities of the provident funds were transferred to Hadas Mercantile Provident Funds, in which Mercantile Discount Bank held a 49% interest.

On April 13, 2010, Mercantile Discount Bank informed Hadas Arazim Ltd. of its intention to exercise the PUT option, received under the

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

said agreement, for the sale of its 49% interest in Hadas Mercantile Provident Funds.

Within the framework of the process conducted by the parties for the implementation of the realization notice, a dispute arose between Mercantile Discount Bank and the purchasers' group regarding the proper interpretation of certain sections in the agreement relating to the computation of the sale proceeds. The amount in dispute is estimated at between NIS 14 and NIS 16 million. The parties are negotiating to solve the dispute in accordance with the layout predetermined in advance in the agreement.

Concurrently, on August 10, 2010, the parties signed an agreement, according to which the purchasers' group paid Mercantile Discount Bank on August 17, 2010, the amount which is not in dispute (in the amount of NIS 54 million) and deposited with a trustee a bank guarantee in the amount of NIS 10 million, to serve as security in the event that the position of Mercantile Discount Bank will be accepted at the conclusion of the dispute. In view of the above, Mercantile Discount Bank recorded in the financial statements a net profit in the amount of approx. NIS 28 million, derived from the amount that is not in dispute between the parties.

- 23. Sale of the basket certificate operations.** On November 2, 2010, the Bank and Tachlit, a wholly owned subsidiary of the Bank, signed a binding memorandum of understanding (hereinafter - "the Memorandum") with Dash Apex Holdings Ltd. (hereinafter - "Dash"), Synergetica Ltd. (controlled by Michael Davis) (hereinafter - "Synergetica") and Mr. Michael Davis. In accordance with the Memorandum, Tachlit will sell to Synergetica its full share of the basket certificates and indices products operations conducted under the brand name of "Tachlit basket certificates", including its shares in the companies through which the said operations are being conducted (hereinafter - "the sold operations" and the "designated companies" respectively), this in consideration for NIS 68 million, subject to adjustments as specified in the Memorandum. The transaction was consummated on March 22, 2011. The net gain in respect of this transaction, expected to be recorded by Tachlit in the first quarter of 2011, amounts to NIS 24 million. The transaction was consummated on March 22, following fulfillment of conditions precedent, including, among other things, obtaining all regulatory approvals required for the transaction and completion of the due diligence review by DS. Both the Bank and Tachlit granted various indemnifications as part of the transaction.
- 24. Sale of the mutual funds management operations of Mercantile Discount Bank.** On September 21, 2010, an agreement was signed for the sale of the mutual funds management operations of Mercantile Discount Bank in consideration for NIS 6.5 million. The transaction was consummated on October 17, 2010. The net gain derived from this transaction amounted to NIS 5 million.
- 25. Sale of properties owned by Mercantile Discount Bank.** On October 31, 2010, and on November 7, 2010, Mercantile Discount Bank and a subsidiary of which signed agreements for the sale of properties owned by them for a total consideration of NIS 37.2 million. Possession of the properties is expected to pass to the purchasers at the end of April 2011, subject to the fulfillment of conditions precedent specified in the agreements. The expected net gain on sale of the properties is assessed at NIS 22 million, which will be recognized in the second quarter of 2011 (subject to consummation of the transactions).
- 26.**
- a. Chairman of the Board during the period of November 1997 to January 2006 (hereinafter: "Past Chairman of the Board") ended his tenure of office on January 31, 2006, following the closing of the transaction for the sale of a controlling interest in the Bank. His remuneration and terms of employment were approved by the general meetings of shareholders held on January 15, 1998, October 5, 1999 and June 14, 2004, including his entitlement to regular severance pay and an adaptation award equal to full twelve months salary.
  - b. In 2004, the board of directors of the Bank decided that in the event that the past Chairman would have to terminate his tenure of office following a change in ownership of the Bank due to privatization, then he would be entitled to a payment equal to a full fifteen months salary in addition to the amounts due to him in accordance with the personal contract with him. This issue was on the agenda of the general meeting of shareholders held in June 2004, but was not discussed at that meeting.
  - c. In 2004, the board of directors of the Bank resolved to approve the past Chairman an additional remuneration of 6.5% as from July 2004, together with an award equal to seven months salary (comprising 89% of the award approved to the President and CEO of the

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

- Bank). These matters have not yet been brought for approval by the general meetings of shareholders.
- d. In May 2005, the board of directors of the Bank resolved to approve the past Chairman an award in the amount of NIS 1,255 thousand. This matter has not yet been brought for approval by the general meetings of shareholders.
- e. Without derogating from the resolutions detailed in items b to d above, the Bank intended to bring for approval of the board of directors of the Bank a proposal for a one-time payment of NIS 10 million to the past Chairman, as compensation for the termination of his tenure as Chairman of the board of directors and to express appreciation for his outstanding contribution to the Bank.
- f. The financial statements include full provisions in respect of items b to d stated above. A specific provision has not been included in respect of Section E above, however a general provision has been included in respect of contingent liabilities.
- g. In a letter dated March 26, 2006, the controlling shareholders of the Bank informed the Accountant General at the Ministry of Finance and the CEO of M.I. Holdings Ltd. of their intention to bring for approval of the authorized organs of the Bank, as the case may be, the proposals for various payments to the past Chairman of the board of directors of the Bank, as detailed in items b to e above. The controlling shareholders clarified that, for the sake of propriety they deemed it proper to bring to the attention of the Government the proposed payments by the Bank to the past Chairman, as detailed above, though, in their opinion, such payments are not considered payments to an interested party within its meaning in the agreement for the sale of the controlling interest in the Bank, and therefore do not require the consent of the Government.
- h. In a letter dated March 26, 2006, the Accountant General at the Ministry of Finance informed that the State opposes the intended payments as detailed in the above said letter of the controlling shareholders (see g above).
- i. On January 8, 2009, the former chairman of the Board of Directors submitted, through his representative, a demand for the payment of various amounts in respect of his term of office at the bank (hereunder: "the demand letter").
- j. In the demand letter, the representative of the former Chairman of the Board suggested that the issue be submitted to the decision of a third party, in order to avoid referring the case to the Court.
- k. The Bank's Board of Directors of the Bank discussed the demand letter, and with a view of finding the most appropriate way of settling the dispute with the former Chairman, the Bank, in a letter dated March 8, 2009, informed the representative of the former Chairman, as follows:
1. The Board of Directors of the Bank decided to appoint an independent expert, to be agreed upon by the parties, in order to examine and decide what the fair and appropriate remuneration to be paid to the former Chairman of the Board should be (over and above the amounts that were paid to him pursuant to the terms of the employment arrangements with him), this in view of his activity in the Bank, among other things, in the crisis years that the Bank had experienced, his contribution to the Bank's recovery, and his activity in the last year prior to the termination of his office.
  2. In order for the Bank to be able to act as above, without being bound by any former obligations of the Bank, the former Chairman of the Board will be asked to inform in writing that he forgoes any claim or demand based on a cause of action derived from former obligations of the Bank towards him, if any, and to the extent that any shall arise, except for his demand for an appropriate and fair remuneration for his activity, contribution to the Bank and his retirement.
- l. On March 16, 2009, the representative of the former chairman informed that he agrees to the Bank's demand.
- m. On March 18, 2009, the Bank and the former Chairman applied to Prof. Yaakov Ne'eman to act as above. It was further agreed that the proceedings before him shall be conducted in accordance with the First Addendum to the Arbitration Law, 1968; each party will bear its own costs while the arbitrator fee and its allocation to the parties will be decided by the arbitrator. It should be noted that the former Chairman limited his claim to an amount of NIS 17 million (this amount was provided in the books of the Bank as part of a

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

specific and non-specific provisions).

- n. On that day, March 18, 2009, the first meeting in front of Prof. Ne'eman was held, in which, among other things, two witnesses on behalf of the former Chairman were heard. The Bank has not yet presented its arguments with respect to the demand of the former Chairman.
- o. On March 25, 2009, the representatives of the State of Israel and of M.I. Holdings Ltd. sent the Bank and the controlling shareholders a letter in which they argue, among other things, that the Bank's consent to the said proceedings without prior notice to the State and without enabling it to participate in the proceedings, is in contradiction to the law and prevents the State from stating its position in the matter. In continuation, the State requested to cancel the arbitration process and to revert the issue to the approval of the authorized organs in the Bank. Without derogating from the above, The Bank was requested to freeze the proceedings before the arbitrator and to verify that no decisions be taken before the discussion is resolved. The Bronfman-Schron Group also announced that will join the demand by the State to suspend all proceedings and refrain from taking any decisions until the matter is entirely clarified and discussed in full with the State.
- p. In the Bank's opinion, the consent of the shareholders, including the State, is not required for these proceedings. The process implemented is a proper one, appropriate to the circumstances and the Bank's benefit and is lawful. Notwithstanding, the Bank and the Past Chairman applied to Prof. Ne'eman for a stay of three weeks in the proceedings in order to clarify the matter with the controlling shareholders and the State. It was agreed that in the event that Prof. Ne'eman will not be able to continue acting as an expert arbitrator in the matter due to his expected appointment as a Government Minister, then the matter will be forwarded to another expert arbitrator, the identity of whom has been agreed upon by the parties.
- q. After discussions of this issue, representatives of the State announced, in a letter dated May 27, 2009, that they insist on their objection to making the payments to the former Chairman and to continuation of the arbitration proceedings. The State representatives added that this position is also endorsed by Bronfman-Schron Group. The State's position was, inter alia, that making the payments is subject to approval by the General Meeting of Shareholders.

The representatives of the former Chairman of the Bank have recently approached the Bank requesting fulfillment of the Bank's commitments and resumption of negotiations in front of an external expert, as agreed. The Bank has not yet responded to this approach.

## 20. DERIVATIVE INSTRUMENT ACTIVITY - VOLUME, CREDIT RISK AND DUE DATES

### GENERAL

1. Transactions in derivative financial instruments involve market, credit and liquidity risks.
  - a. The activity of the Bank involves exposure to various risks, including market risk. The market risk includes, inter-alia, linkage base, interest and exchange rate fluctuation risks, in the correlation characteristics between the various economic parameters, etc. As part of the overall Bank's strategy for the management of exposure to market risk, as stated above, the Bank combines in its financial asset and liability management and as a market maker, a wide range of derivative financial instruments. Among these financial instruments are: Forward transactions, IRS, FRA, SWAP, options purchased and written by the Bank, which hedge against changes in foreign currency exchange rates, inflation rates, interest rates, share indices, embedded options, etc.
  - b. The credit risk involved in these transactions derives from the fact that the stated amount of the transaction does not necessarily reflect its credit risk. Such risk is measured according to the maximum amount of the loss that the Bank might sustain if the other party to the transaction will not honor its terms, net of amounts subject to enforceable set-off agreements.
 

The credit risk during the period of engagement is assessed at the amount that a similar engagement would have cost, had it been entered into at the reporting date with the same customer and for the period remaining until its expiration. The Bank's policy as regards the collateral required in respect of customer derivative financial instrument transactions resembles the policy regarding other credit

## 20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

### GENERAL (CONTINUED)

granted, excluding customers' Ma'of activity.

The collateral comprises various types. The Bank may also grant to customers' credit facilities without collateral, as the case may be.

- c. Market liquidity risk derives from the fact that it might not be possible to contain rapidly the exposure involved, mainly in markets of low level trading.
2. Where a derivative instrument is not intended as a qualified hedging, it is stated according to its fair value, and changes in fair value being taken currently to the income statement. Some of these derivatives are intended and qualified as fair value hedging and cash flow hedging, while others are purchased and written as part of the asset and liability management of the Bank (ALM).
3. It is possible for the Bank to enter an agreement that in itself does not constitute a derivative instrument but which contains an embedded derivative. In respect of each contract the Bank evaluates whether the economic characteristics of the embedded derivative are not clearly and closely connected to those of the hosting agreement, and examines whether an independent instrument with the same terms of the embedded instrument would have agreed with the definition of a derivative instrument. Where the above terms are fulfilled, the embedded derivative is separated from the hosting agreement, treated as a derivative in its own right and stated in the balance sheet together with the hosting agreement at its fair value, changes in its fair value being taken currently to the income statement. Where the Bank is unable to reliably identify and measure an embedded derivative for the purpose of its separation from the hosting agreement, the agreement as a whole is stated in the balance sheet at fair value.
4. The Bank maintains a written documentation of all hedging relations between hedging instruments and the items hedged, as well as the object and strategy of risk management by way of creating the various hedging transactions.  
The documentation includes the specific identification of the asset, liability, the firm commitment or the anticipated transaction, which were determined as the hedged item, and the manner in which the hedging instrument is expected to hedge against risks involved in the hedged item. The Bank assesses the effectiveness of hedging relations both at the beginning of the transaction and on a continuing basis, in accordance with its risk management policy.
5. The Bank discontinues its hedging accounting from the following points onward when:
  - a. It has been determined that the derivative is no longer effective, setting off the changes in fair value or the cash flows of the hedged item;
  - b. The derivative has expired, sold, cancelled or realized;
  - c. The designation of the derivative as a hedging derivative is discontinued, due to the probability of the execution of the transaction being remote.
  - d. A firm hedging commitment no longer complies with the definition of a firm commitment.
  - e. Management cancels the designation of the derivative as a hedging derivative.When hedging accounting is discontinued due to the fact that a derivative is no longer qualified as hedging an effective fair value, the derivative will continue to be stated in the balance sheet at its fair value, however the hedged asset or liability will no longer be adjusted for changes in fair value. When hedging accounting is discontinued due to the fact that the hedged item no longer qualifies as a firm commitment, the derivative will continue to be stated in the balance sheet at fair value and every asset or liability which previously were stated based on the recognition as a firm commitment shall be removed from the balance sheet and recognized as income or loss in the income statement for the reported period.
6. Fair value hedging  
Certain derivatives are being designated by the Bank as hedging fair value. The changes in the fair value of derivatives hedging against exposure to changes in fair value of an asset or liability, are currently recognized in the income statement, as well as the changes in the fair value of the hedged item, that could be related to the risk being hedged.

**20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES****A. VOLUME OF ACTIVITY ON A CONSOLIDATED BASIS**

	December 31, 2010				
	Interest rate contracts		Foreign	Contracts	Commodities
	Shekel/CPI	Other	currency contracts	on shares	and other contracts
in NIS millions					
1. Par value of derivative instruments					
A. Hedging derivatives <sup>(1)(2)</sup>					
Swaps	-	-	-	-	-
<b>Total</b>	-	-	-	-	-
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-				
B. ALM derivatives <sup>(1)(3)</sup>					
Futures contracts	-	5,887	-	-	-
Forward contracts	1,082	7,284	12,468	-	-
Marketable option contracts					
Options written	-	-	310	-	-
Options purchased	-	-	293	-	-
Other option contracts					
Options written	-	-	15,098	355	-
Options purchased	-	-	15,046	3	-
Swaps	-	45,831	28,306	-	-
<b>Total</b>	1,082	59,002	71,521	358	-
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	23,485			
C. Other derivatives <sup>(1)</sup>					
Forward contracts	40	110	695	1,745	3,979
Marketable option contracts					
Options written	-	-	225	3,754	1
Options purchased	-	-	225	3,754	1
Other option contracts					
Options written	-	521	373	147	13,946
Options purchased	-	408	638	174	12,899
Swaps	-	1,176	15	-	-
<b>Total</b>	40	2,215	2,171	9,574	30,826
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	563			
D. Credit derivatives and SPOT foreign currency swap contracts					
SPOT foreign currency swap contracts	-	-	5,164	-	-

## Footnotes:

(1) Excluding credit derivatives and SPOT foreign currency swap contracts.

(2) In accordance with the decision to cancel the purpose of derivatives as hedging instruments in effect as from January 1, 2010, there were no hedging derivatives in 2010.

(3) Derivatives comprising a part of the asset and liability management system which were not designated for hedging relations.

## 20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

### A. VOLUME OF ACTIVITY ON A CONSOLIDATED BASIS (CONTINUED)

	December 31, 2009				
	Interest rate contracts		Foreign currency contracts	Contracts on shares	Commodities and other contracts
	Shekel/CPI	Other			
	in NIS millions				
1. Par value of derivative instruments					
A. Hedging derivatives <sup>(1)</sup>					
Swaps	-	1,378	-	-	-
<b>Total</b>	-	1,378	-	-	-
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate		1,312			
B. ALM derivatives <sup>(1)(2)</sup>					
Futures contracts	-	2,009	-	-	-
Forward contracts	1,039	9,950	15,618	-	-
Marketable option contracts					
Options written	-	-	*266	-	-
Options purchased	-	-	*398	-	-
Other option contracts					
Options written	-	-	*11,794	755	-
Options purchased	-	-	*11,732	3	-
Swaps	-	39,846	15,294	-	-
<b>Total</b>	1,039	51,805	57,102	758	-
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	20,718			
C. Other derivatives <sup>(1)</sup>					
Forward contracts	68	113	630	1,489	1,744
Marketable option contracts					
Options written	-	-	*12	4,202	33
Options purchased	-	-	*12	4,202	33
Other option contracts					
Options written	-	55	*1,148	153	13,565
Options purchased	-	55	*1,027	160	12,711
Swaps	-	1,064	-	-	-
<b>Total</b>	68	1,287	2,829	10,206	28,086
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	493			
D. Credit derivatives and SPOT foreign currency swap contracts					
SPOT foreign currency swap contracts	-	-	4,630	-	-

Footnotes:

(1) Excluding credit derivatives and SPOT foreign currency swap contracts.

(2) Derivatives comprising a part of the asset and liability management system which were not designated for hedging relations.

**20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)****A. VOLUME OF ACTIVITY ON A CONSOLIDATED BASIS (CONTINUED)**

December 31, 2010					
	Interest rate contracts		Foreign currency contracts	Contracts on shares	Commodities and other contracts
	Shekel/CPI	Other			
in NIS millions					
<b>2. Gross fair value of derivative instruments</b>					
<b>A. Hedging derivatives</b>					
Positive gross fair value	-	-	-	-	-
Negative gross fair value	-	-	-	-	-
<b>B. ALM derivatives</b>					
Positive gross fair value	-	1,047	911	1	-
Negative gross fair value	55	1,261	1,827	2	-
<b>C. Other derivatives</b>					
Positive gross fair value	1	53	59	81	47
Negative gross fair value	1	45	24	80	46
December 31, 2009					
	Interest rate contracts		Foreign currency contracts	Contracts on shares	Commodities and other contracts
	Shekel/CPI	Other			
in NIS millions					
<b>A. Hedging derivatives</b>					
Positive gross fair value	-	9	-	-	-
Negative gross fair value	-	66	-	-	-
<b>B. ALM derivatives</b>					
Positive gross fair value	1	831	*718	1	-
Negative gross fair value	59	1,004	*1,086	5	-
<b>C. Other derivatives</b>					
Positive gross fair value	1	41	*51	138	218
Negative gross fair value	1	35	*45	127	217

\* Reclassified.

## 20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

### B. DERIVATIVE INSTRUMENT CREDIT RISK BASED ON THE COUNTERPART TO THE CONTRACT, ON A CONSOLIDATED BASIS

	December 31, 2010					
	Stock markets	Banks	Dealers/ brokers	Governments and central banks	Others	Total
	In NIS millions					
Gross positive fair value of derivative instruments <sup>(1)</sup>	41	1,724	28	-	407	2,200
Net of set-off agreements	5	44	-	-	40	89
Balance of assets deriving from derivative instruments <sup>(2)</sup>	36	1,680	28	-	367	2,111
Off-balance sheet credit risk in respect of derivative instruments <sup>(3)</sup>	111	9,115	24	53	3,602	12,901
<b>Total credit risk in respect of derivative instruments</b>	<b>147</b>	<b>10,795</b>	<b>52</b>	<b>53</b>	<b>3,969</b>	<b>15,012</b>

Footnotes:

- (1) Of which, NIS 72 million of positive gross fair value of derivative instruments.
- (2) Of which, a balance of non-related derivative instruments of NIS 2,039 million reflected in the item "Other assets".
- (3) Off-balance sheet credit risk in respect of derivative instruments (including derivative instruments having a negative fair value) as computed for the purpose of limitations on a single borrower indebtedness.

	December 31, 2009					
	Stock markets	Banks	Dealers/ brokers	Governments and central banks	Others	Total
	In NIS millions					
Gross positive fair value of derivative instruments <sup>(1)</sup>	52	1,309	78	-	570	2,009
Net of set-off agreements	5	22	-	-	72	99
Balance of assets deriving from derivative instruments <sup>(2)</sup>	47	1,287	78	-	498	1,910
Off-balance sheet credit risk in respect of derivative instruments <sup>(3)</sup>	112	8,187	26	-	2,969	11,294
<b>Total credit risk in respect of derivative instruments</b>	<b>159</b>	<b>9,474</b>	<b>104</b>	<b>-</b>	<b>3,467</b>	<b>13,204</b>

Footnotes:

- (1) Of which, NIS 74 million of positive gross fair value of derivative instruments.
- (2) Of which, a balance of non-related derivative instruments of NIS 1,836 million reflected in the item "Other assets".
- (3) Off-balance sheet credit risk in respect of derivative instruments (including derivative instruments having a negative fair value) as computed for the purpose of limitations on a single borrower indebtedness.

**20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)****C. DUE DATES – PAR VALUE: CONSOLIDATED YEAR END BALANCES**

December 31, 2010					
	Up to 3 months	From 3 months to 1 year	From 1 Year to 5 years	Over 5 years	Total
In NIS millions					
Interest rate contracts					
Shekel/CPI	40	225	572	285	1,122
Other	9,228	15,949	20,090	15,950	61,217
Foreign currency contracts	49,489	24,146	2,242	2,979	78,856
Contracts on shares	9,513	142	277	-	9,932
Commodities and other contracts	30,524	3	299	-	30,826
<b>Total</b>	<b>98,794</b>	<b>40,465</b>	<b>23,480</b>	<b>19,214</b>	<b>181,953</b>
December 31, 2009					
	Up to 3 months	From 3 months to 1 year	From 1 Year to 5 years	Over 5 years	Total
In NIS millions					
Interest rate contracts					
Shekel/CPI	170	433	354	150	1,107
Other	7,575	14,939	15,714	16,242	54,470
Foreign currency contracts	39,818	17,232	1,769	3,742	62,561
Contracts on shares	10,464	234	266	-	10,964
Commodities and other contracts	24,168	3,714	204	-	28,086
<b>Total</b>	<b>82,195</b>	<b>36,552</b>	<b>18,307</b>	<b>20,134</b>	<b>157,188</b>

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## 21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS

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### A. GENERAL

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The instruction of Bank of Israel regarding the determination of the fair value of financial instruments (the "instruction"), was applied based on the methods and principal assumptions described hereunder. Nothing in the data presented hereunder should be taken as an indication of the economic value of the Bank, nor does the data purport to assess such value.

### B. FAIR VALUE OF FINANCIAL INSTRUMENTS

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Most of the financial instruments of the Bank do not have a ready "market price" because there is no active market in which they are traded. Therefore, in accordance with the instruction, fair value is based on accepted pricing models, such as the present value of future cash flows discounted at a rate which reflects the estimated risk level related to the financial instrument.

Assessing the fair value by discounting future cash flows and determining the discount rate, is subjective. Therefore, the data for most of the financial instruments given hereunder, does not serve as an indication for the realization value of the financial instrument on the reporting date. Discounting the future cash flows was made, where possible, by discount rates in effect at the reporting date, without taking into consideration fluctuations in interest rates. Using different discount rates assumptions, may result in significantly different fair value amounts. This relates particularly to financial instruments bearing a fixed interest rate or non-interest bearing. Additionally, in arriving at the fair value amounts, no consideration was given to commissions receivable or payable as part of the business activity, neither do they include the tax effect.

It should be further noted, that the differential between the book value of the financial instrument and its fair value, may never be realized, as the Bank usually holds the financial instrument to maturity.

In consequence of the above, it should be stressed that the data included in this Note, is no indication of the value of the Bank as a going concern.

Furthermore, due to the wide range of valuation techniques and possible assessments used in determining the fair value, and in view of the methods and assumptions used in applying the instruction, care should be taken when examining the fair value data itself as well as when comparing it with the fair value data presented by other banks.

### C. METHODS AND MAIN ASSUMPTIONS USED IN ESTIMATING THE FAIR VALUE OF FINANCIAL INSTRUMENTS

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**Bank deposits, non-marketable bonds and loan notes and credit to the Government** - discounting future cash flows at rates at which the Bank transacted business at the reporting date.

**Marketable securities** - market value for securities traded on an active market, or quotations of international providers of prices for securities traded on an inactive market.

**Credit to the public** - Fair value of the balance of credit to the public was determined at the present value of future cash flows using an appropriate discount rate. The present value is measured in respect of the future cash inflows (principal sum and interest) separately for each loan, at a rate of interest reflecting the risk level inherent in the credit.

Determination of the risk level has, to the extent possible, been made, on the basis of a grading model used at present by the Bank, which reviews the level of risk inherent in the debt in accordance with financial and other indices. It should be noted that as of December 31, 2010, the Bank has classified some 97% of the indebtedness which has to be classified according to the directives of the Supervisor of Banks (December 31, 2009: 96%).

In certain cases, where grading data is not available, the segmentation is made on the basis of an overall evaluation of the risk level relating to the business sectors in which the borrowers operate. In this respect, it should be noted that the general risk level, as evaluated for a particular business sector, is not necessarily identical to the risk level of a particular borrower operating in that sector, none the less, to the risk level relating to the credit which the Bank grants to that borrower.

## 21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS

### C. METHODS AND MAIN ASSUMPTIONS USED IN ESTIMATING THE FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

The discount rates used were generally determined according to interest rates applying to similar transactions effected at the reporting date.

**The fair value of problematic debts**, net of the provision for loan losses, was calculated using discount rates reflecting the high credit risk involved.

Increasing the discount interest rate by 1 percentage point would have reduced the fair value of the problematic debts by NIS 74 million. Increasing the discount interest rate by 0.1 percentage point would have reduced the fair value of the problematic debts by NIS 4 million (compared to NIS 54 million and NIS 6 million, respectively, as of December 31, 2009).

Cash flows in respect of mortgages have been evaluated on the basis of an early repayment forecast based on a statistical model. Discounting the said cash flows in accordance with expected repayment dates instead of the contractual repayment dates, reduced the fair value of the mortgages, particularly in the CPI linked segment, by NIS 199 million (compared to NIS 218 million at December 31, 2009).

In any event, these discount rates are not less than the higher interest rate applying to transactions made by the Bank at the reporting date. The general, supplemental and special provisions for doubtful debts were not deducted from the balance of outstanding credit for the purpose of calculating the cash flows when determining the fair value.

**Deposits and subordinated capital notes** - Capitalizing future cash flows at a rate at which the Bank pays interest on similar deposits, or on the issue of similar bond and loan notes at the reporting date, Based on parameters, such as: the size of the deposit, the period of the deposit, type of linkage. Marketable subordinate capital notes are stated at market value.

Cash flows in respect of deposits were evaluated on the basis of an early withdrawal forecast based on a statistical model. Discounting the said cash flows in accordance with expected withdrawal dates instead of the contractual withdrawal dates, increased the fair value of the deposits, particularly savings deposits in the CPI linked segment, by NIS 15 million (compared to NIS 46 million at December 31, 2009).

**Financial instruments (except for derivatives and marketable financial instruments) for an initial period of up to three months and at a variable market interest rate** - Some of the subsidiaries assume that the balance stated in the balance sheet reflects fair value.

**Derivative financial instruments** - Such financial instruments, which have an active market, were evaluated at their market value, and where several such markets exist, the evaluation was made in accordance with the most active market.

Derivative financial instruments which are not traded on an active market were evaluated according to models in use by the Bank in its current operations and which take into account the risks involved in the financial instrument: market, credit and other risks.

**Off balance sheet financial instruments which involve credit risk** - The fair value is presented according to the outstanding balance of commissions on the said transactions, which approximate fair value. The fair value of irrevocable commitments to grant credit, which were approved but not yet executed, does not differ materially from the value of these commitments, as they are presented in Note 19 A.

## 21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS (CONTINUED)

### D. COMPOSITION - CONSOLIDATED

	December 31, 2010			
	(1)	(2)	Total	Fair value
in NIS millions				
<b>Financial assets:</b>				
Cash and deposits with banks	2,494	15,693	18,187	18,337
Securities	29,790	7,386	37,176	37,205
Securities borrowed or purchased under resale agreements	-	45	45	45
Credit to the public	23,190	95,476	118,666	119,296
Credit to the Government	5	1,551	1,556	1,556
Investment in affiliated companies	119	5	124	121
Other financial assets	3,543	-	3,543	3,543
<b>Total financial assets</b>	<b>59,141</b>	<b>120,156</b>	<b>179,297</b>	<b>180,103</b>
<b>Financial liabilities:</b>				
Deposits from the public	14,601	123,410	138,011	138,394
Deposits from banks	641	2,746	3,387	3,613
Deposits from the Government	125	336	461	472
Securities loaned or sold under buy-back arrangements	-	7,227	7,227	7,868
Subordinated capital notes	8	12,286	12,294	13,569
Other financial liabilities	10,618	-	10,618	10,618
<b>Total financial liabilities</b>	<b>25,993</b>	<b>146,005</b>	<b>171,998</b>	<b>174,534</b>

**21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS (CONTINUED)****F. COMPOSITION - CONSOLIDATED (CONTINUED)**

	December 31, 2009			
	(1)	(2)	Total	Fair value
	in NIS millions			
<b>Financial assets:</b>				
Cash and deposits with banks	*4,132	*20,451	24,583	24,603
Securities	33,699	2,639	36,338	36,360
Securities borrowed or purchased under resale agreements	-	336	336	336
Credit to the public	23,571	90,855	114,426	115,736
Credit to the Government	2	1,818	1,820	1,820
Other financial assets	3,627	-	3,627	3,627
<b>Total financial assets</b>	<b>65,148</b>	<b>116,104</b>	<b>181,252</b>	<b>182,585</b>
<b>Financial liabilities:</b>				
Deposits from the public	14,130	127,695	141,825	142,100
Deposits from banks	*87	*3,637	3,724	4,501
Deposits from the Government	10	274	284	295
Securities loaned or sold under buy-back arrangements	*	*7,651	7,651	8,202
Subordinated capital notes	288	11,241	11,529	12,320
Other financial liabilities	10,408	-	10,408	10,408
<b>Total financial liabilities</b>	<b>24,923</b>	<b>150,498</b>	<b>175,421</b>	<b>177,826</b>

\* Reclassified.

Footnotes:

- (1) Financial instruments the stated amounts of which approximate their fair value – instruments stated in the balance sheet at market value or which are for an initial period not exceeding three months, or based on market interest varying at frequencies of up to three months.
- (2) Other financial instruments.

## 21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS (CONTINUED)

### F. COMPOSITION - THE BANK

	December 31, 2010			
	(1)	(2)	Total	Fair value
in Nis millions				
<b>Financial assets:</b>				
Cash and deposits with banks	384	29,233	29,617	29,790
Securities	13,072	2,273	15,345	15,384
Securities borrowed or purchased under buy-back agreements	-	45	45	45
Credit to the public	3,345	64,825	68,170	68,156
Credit to the Government	-	1,551	1,551	1,551
Investment in investee companies	-	1,555	1,555	1,552
Other financial assets	2,722	-	2,722	2,722
<b>Total financial assets</b>	<b>19,523</b>	<b>9,482</b>	<b>119,005</b>	<b>119,200</b>
<b>Financial liabilities:</b>				
Deposits from the public	718	103,391	104,109	105,050
Deposits from banks	182	3,183	3,365	3,361
Deposits from the Government	-	177	177	178
Subordinated capital notes	-	4,013	4,013	4,412
Other financial liabilities	6,416	-	6,416	6,416
<b>Total financial liabilities</b>	<b>7,316</b>	<b>110,764</b>	<b>118,080</b>	<b>119,417</b>

**21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS (CONTINUED)****F. COMPOSITION - THE BANK (CONTINUED)**

	December 31, 2009			
	(1)	(2)	Total	Fair value
in Nis millions				
<b>Financial assets:</b>				
Cash and deposits with banks	*	*31,534	31,534	31,880
Securities	*13,399	*52	13,451	13,451
Securities borrowed or purchased under buy-back agreements	-	336	336	336
Credit to the public	3,478	64,063	67,541	67,518
Credit to the Government	-	1,818	1,818	1,818
Investment in investee companies	-	1,551	1,551	1,624
Other financial assets	2,427	-	2,427	2,427
<b>Total financial assets</b>	<b>19,304</b>	<b>99,354</b>	<b>118,658</b>	<b>119,054</b>
<b>Financial liabilities:</b>				
Deposits from the public	772	105,150	105,922	106,787
Deposits from banks	*957	*3,007	3,964	3,967
Deposits from the Government	-	159	159	158
Subordinated capital notes	-	3,638	3,638	3,881
Other financial liabilities	5,299	-	5,299	5,299
<b>Total financial liabilities</b>	<b>7,028</b>	<b>111,954</b>	<b>118,982</b>	<b>120,092</b>

\* Reclassified.

Footnotes:

- (1) Financial instruments the stated amounts of which approximate their fair value – instruments stated in the balance sheet at market value or which are for an initial period not exceeding three months, or based on market interest varying at frequencies of up to three months.
- (2) Other financial instruments.

E. On January 1, 2008, the Bank's subsidiary IDBNI adopted FAS No. 157, Fair Value Measurements ("FAS No. 157"). The standard defines, among other things, fair value; establishes a consistent framework for measuring fair value; and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis.

FAS No. 157 clarifies that fair value is an "exit" price, representing the amount that would be received when selling an asset or paid to transfer a liability in an orderly transaction between market participants. Fair value is thus a market based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, FAS No. 157 establishes a three tier fair value hierarchy, which prioritizes the inputs to valuation techniques used to measuring fair value as follows:

- Level 1 - Inputs which are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 - Inputs which are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Including quoted prices in markets that are not considered to be active.
- Level 3 - Inputs which are unobservable and significant to the fair value measurement.

## 21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS (CONTINUED)

Fair value measurements at December 31, 2010 using				
	Quoted prices in active markets for identical Assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	Total fair value
in US\$ millions				
<b>Assets:</b>				
Trading account securities, at fair value	-	16	-	16
Available for sale securities at fair value	6	3,331	-	3,337
Unrealized gain on derivatives	2	15	-	17
<b>Liabilities:</b>				
Unrealized loss on derivatives	2	13	-	15

Fair value is based upon quoted market prices when available. If listed prices or quotes are not available fair value is based upon internally developed models that primarily use market based or independently sourced market parameters as inputs, including, but not limited to, yield curves, interest rates, equity or debt prices, and credit curves. In addition to market information, models also incorporate transaction details, such as maturity and cash flow assumptions.

IDBNY reviews and updates the fair value hierarchy classifications on a quarterly basis. Changes from one quarter to the next that are related to the observability of inputs to a fair value measurement may result in a reclassification from one hierarchy level to another.

A description of the methods and significant assumptions utilized in estimating the fair value of available for sale securities follows:

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid government securities and exchange traded securities.

If quoted market prices are not available for the specific security, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. Such securities would generally be classified within Level 2 of the valuation hierarchy and include such instruments as mortgage related securities, corporate bonds, preferred stock, and municipal securities.

In certain cases where there is limited activity or less transparency around inputs used for the valuation, securities are classified within Level 3 of the valuation hierarchy. In valuing certain collateralized mortgage and debt obligations and high yield debt securities, the determination of fair value may require benchmarking to similar instruments or analyzing default and recovery rates. For collateralized debt obligations (CDOs), external price information is not available. Therefore CDOs are valued using market standard models to model the specific collateral composition and cash flow structure of each deal. Key inputs to the model consist of market spread data for each credit rating, collateral type, and other relevant contractual features.

The methods described above may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while IDBNY believes its valuation methods are appropriate and consistent with those of other market participants the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

## 22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES

### A. BALANCES:

December 31, 2010										
	Interested parties <sup>(1)</sup>						Related parties held by the Bank <sup>(1)</sup>			
	Controlling Shareholders <sup>(2)</sup>		Others Shareholders <sup>(3)</sup>		Directors and President <sup>(4)</sup>		Affiliated		Others <sup>(5)</sup>	
	(6)	(7)	(6)	(7)	(6)	(7)	(6)	(7)	(6)	(7)
in NIS millions										
<b>Assets:</b>										
Deposits with banks	-	-	-	-	-	-	15	95	-	-
Securities <sup>(8)</sup>	-	-	-	-	-	-	1	1	398	413
Credit granted to the public	(A)	(A)	17	64	25	35	232	288	258	670
Investments in affiliated companies <sup>(8)</sup>	-	-	-	-	-	-	1,684	1,684	-	-
Other assets	-	-	-	1	-	-	23	62	-	-
<b>Liabilities:</b>										
Deposits from the public	1	7	8	139	-	2	284	1,063	168	564
Deposits from banks	-	-	-	-	-	-	200	595	-	-
Subordinated capital notes	-	-	-	-	-	-	16	17	-	-
Other liabilities	-	-	-	-	8	8	31	31	-	-
Shares (included in shareholders' equity)	2,923	2,923	-	-	-	-	-	-	-	-
Credit risk in off-balance-sheet financial instruments <sup>(9)</sup>	3	3	4	21	-	1	1,003	1,063	46	87

(A) In addition, a controlling shareholder gave a personal guarantee in the amount of NIS 10 million for credit received by a third party. For notes to the tables see after Note D.

## 22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)

### A. BALANCES (CONTINUED):

December 31, 2009										
	Interested parties <sup>(1)</sup>						Related parties held by the Bank			
	Controlling Shareholders <sup>(2)</sup>		Others Shareholders <sup>(3)</sup>		Directors and President <sup>(4)</sup>		Affiliated companies		Others <sup>(5)</sup>	
	(6)	(7)	(6)	(7)	(6)	(7)	(6)	(7)	(6)	(7)
in NIS millions										
<b>Assets:</b>										
Deposits with banks	-	-	-	-	-	-	118	367	-	-
Securities <sup>(8)</sup>	-	-	3	3	-	-	-	-	379	417
Credit granted to the public	(A)	(A)	50	62	42	42	292	1,457	280	320
Investments in affiliated companies <sup>(8)</sup>	-	-	-	-	-	-	1,795	1,795	-	-
Other assets	-	-	-	-	-	-	53	77	-	1
<b>Liabilities:</b>										
Deposits from the public	4	26	16	16	1	5	747	2,835	250	696
Deposits from banks	-	-	-	-	-	-	422	780	-	-
Subordinated capital notes	-	-	-	-	-	-	18	19	-	-
Other liabilities	-	-	-	-	8	8	9	30	-	-
Shares (included in shareholders' equity)	2,598	2,598	-	-	-	-	-	-	-	-
Credit risk in off-balance-sheet financial instruments <sup>(9)</sup>	3	3	18	18	11	11	2,004	2,011	44	53

(A) In addition, a controlling shareholder gave a personal guarantee in the amount of NIS 16 million for credit received by a third party

For notes to the tables see after Note D.

## 22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)

### B. SUMMARIZED RESULTS OF TRANSACTIONS WITH RELATED AND INTERESTED PARTIES

	For the year ended December 31, 2010				
	Interested parties <sup>(1)</sup>		Related parties held by the Bank <sup>(1)</sup>		
	Controlling Shareholders <sup>(2)</sup>	Others Shareholders <sup>(3)</sup>	Directors and president <sup>(4)</sup>	Affiliated companies	Others <sup>(5)</sup>
	in NIS millions				
Income from financing activities before provision for doubtful debts**	-	3	2	(32)	12
Provision for doubtful debts	-	-	(6)	(12)	-
Non-financing income	-	-	-	14	17
Non-financing expenses***	-	-	(23)	(23)	-
<b>Total</b>	-	3	(27)	(53)	29

	For the year ended December 31, 2009				
	Interested parties <sup>(1)</sup>		Related parties held by the Bank <sup>(1)</sup>		
	Controlling Shareholders <sup>(2)</sup>	Others Shareholders <sup>(3)</sup>	Directors and president <sup>(4)</sup>	Affiliated companies	Others <sup>(5)</sup>
	in NIS millions				
Income from financing activities before provision for doubtful debts*	-	4	1	120	10
Non-financing income	-	-	-	5	5
Non-financing expenses**	-	-	(27)	(3)	-
Net loss from extraordinary items	-	-	-	(17)	-
<b>Total</b>	-	4	(26)	105	15

\* See Note D.

\*\*See Note C.

### C. BENEFITS FROM THE BANK AND CONSOLIDATED SUBSIDIARIES TO INTERESTED PARTIES:

	For the year ended December 31, 2010		For the year ended December 31, 2009	
	Directors and President and CEO <sup>(4)</sup>		Directors and President and CEO <sup>(4)</sup>	
	Total benefit	Number of benefit Recipients	Total benefit	Number of benefit Recipients
	in NIS millions			
Interested parties employed by the Bank or on its behalf	12	2	17	2
Directors who are not employed by the Bank or on its behalf	6	*18	5	*16
<b>Total</b>	18	20	22	18

\* Including five and two Directors who retired during 2010 and 2009 respectively.  
For notes to the tables see after Note D.

## 22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)

### D. RESULTS OF FINANCING TRANSACTIONS (BEFORE PROVISION FOR DOUBTFUL DEBTS) OF THE BANK AND ITS CONSOLIDATED COMPANIES WITH RELATED AND INTERESTED PARTIES\*

	Consolidated			Of which from Affiliated Companies		
	2010	2009	2008	2010	2009	2008
in NIS millions						
<b>A. On assets</b>						
Credit granted to the public	15	116	80	3	105	69
Deposits with Banks	-	1	-	-	1	-
<b>Total</b>	<b>15</b>	<b>117</b>	<b>80</b>	<b>3</b>	<b>106</b>	<b>69</b>
<b>B. On liabilities</b>						
Deposits from the public	(6)	(14)	(42)	(10)	(16)	(38)
Deposits from the banks	(21)	(6)	(20)	(21)	(6)	(20)
Subordinated capital notes	-	(2)	(2)	-	(2)	(2)
Other liabilities	-	-	-	-	-	-
<b>Total</b>	<b>(28)</b>	<b>(22)</b>	<b>(64)</b>	<b>(32)</b>	<b>(24)</b>	<b>(60)</b>
<b>C. On Derivative Financial Instrument</b>						
Financing income (expenses) from other transactions	(4)	32	6	(4)	32	4
<b>Total</b>	<b>(4)</b>	<b>32</b>	<b>6</b>	<b>(4)</b>	<b>32</b>	<b>4</b>
<b>D. Other</b>						
Other financing income	2	9	2	1	6	5
Other financing expenses	-	-	-	-	-	-
<b>Total</b>	<b>2</b>	<b>8</b>	<b>1</b>	<b>1</b>	<b>6</b>	<b>5</b>
Total expenses from financing activities before provision for doubtful debts	(15)	135	23	(32)	120	18

\* In respect of transactions made on the same terms that would have been made with a person that is not a related or interested party.

Footnotes: (relating to Note 22 A,B & C):

- (1) Interested party - as defined by Securities Regulations. Related party - as defined in Opinion 29 of the Institute of Certified Public Accountants in Israel, but is not an interested party.
- (2) Controlling shareholder – as defined in the Securities Law.
- (3) Whoever holds 5% or more of the issued share capital of the banking corporation or of the voting rights therein, whoever is entitled to appoint one or more of the directors of the corporation or its general manager.
- (4) Including spouses and their infant children.
- (5) A corporation in which a banking corporation holds 10% or more of its issued share capital or of the voting rights therein, or is entitled to appoint 10% or more of the members of its board of directors or is entitled to appoint its president & CEO, and another corporation that a related party holds 25% or more of its issued share capital or of the voting power therein or of the right to appoint its directors.
- (6) The balance at balance sheet date.
- (7) The highest balance during the year on the basis of month-end balances.
- (8) Details of these items are included also in the following notes:  
Securities - Note 3.  
Investments in Investee Companies - Note 6.  
Guarantees - Note 19A.
- (9) Credit risks relating to off-balance sheet financial instruments, as computed for the purpose of the limitations on indebtedness of a borrower.

**23. INCOME FROM FINANCING ACTIVITIES BEFORE PROVISION FOR DOUBTFUL DEBTS**

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
	in NIS millions					
<b>A. On Assets**</b>						
Credit granted to the Public	3,042	6,105	6,558	1,486	3,474	3,488
Credit granted to the Governments	36	19	66	37	18	63
Deposits with the Bank of Israel and cash	123	201	(1)	121	57	20
Deposits with Banks	(197)	521	(160)	499	1,150	545
Securities borrowed or purchased under buy-back agreements	4	2	5	4	2	5
Bonds <sup>(1)</sup>	34	1,160	1,342	338	550	737
Other assets	19	24	-	18	24	-
<b>Total</b>	<b>3,061</b>	<b>8,032</b>	<b>7,810</b>	<b>2,503</b>	<b>5,275</b>	<b>4,858</b>
<b>B. On Liabilities**</b>						
Deposits from the public	2,486	(2,537)	(1,779)	1,000	(2,256)	(1,376)
Deposits from the Government	(48)	(4)	(5)	(1)	(1)	(1)
Deposits from the Bank of Israel and cash	-	-	(21)	-	-	(21)
Deposits from banks	122	(70)	(216)	100	(6)	(44)
Securities loaned or sold under buy-back arrangements	185	(179)	(328)	-	(3)	(4)
Subordinated capital notes	(838)	(885)	(763)	(304)	(354)	(359)
<b>Total</b>	<b>1,907</b>	<b>(3,675)</b>	<b>(3,112)</b>	<b>795</b>	<b>(2,620)</b>	<b>(1,805)</b>
<b>C. In Respect of Derivative Financial Instruments and Hedging Activities</b>						
Net expenses in respect of ALM derivative instruments***	(722)	*(323)	*(727)	(642)	*(330)	*(649)
Income (expenses) net in respect of other derivative instruments	1	*53	*10	(2)	*7	*7
<b>Total</b>	<b>(721)</b>	<b>(270)</b>	<b>(717)</b>	<b>(644)</b>	<b>(323)</b>	<b>(642)</b>
<b>D. Other</b>						
Commissions on financing activities	177	171	139	107	106	84
Other financing income	312	425	(18)	226	289	83
Interest income on problem debts	104	95	87	73	48	48
Other financing expenses	(10)	(21)	(62)	(4)	(29)	(62)
<b>Total</b>	<b>583</b>	<b>670</b>	<b>146</b>	<b>402</b>	<b>414</b>	<b>153</b>
<b>Total income from financing activities before provision for doubtful debts</b>	<b>4,830</b>	<b>4,757</b>	<b>4,127</b>	<b>3,056</b>	<b>2,746</b>	<b>2,564</b>
Of which: Net exchange differences	302	45	(121)	484	33	6

\* Reclassified.

\*\* Including the effective component of hedging relations.

\*\*\* Derivative instruments comprising a part of the assets and liabilities management system of the Bank, which were not designed for hedging relations.

Footnote:

(1) Financing income generated by mortgage backed securities (MBS) amounted to US\$105 million for the year ended December 31, 2010 (2009: US\$113 Million, 2008: US\$128 Million). Following translation of such income into Shekels and the recording of the effect on this investment of exchange differences due to the change in the exchange rate of the U.S. Dollar as against the Shekel, an expense of NIS 345 Million for the year ended December 31, 2010 was recorded in respect of the said securities (2009: income of NIS 140 million 2008: income of NIS 599 million).

### 23. INCOME FROM FINANCING ACTIVITIES BEFORE PROVISION FOR DOUBTFUL DEBTS (CONTINUED)

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
in NIS millions						
<b>E. Results of Activity in Investments in Bonds<sup>(1)</sup></b>						
Accrual basis, financing income (expenses) from bonds:						
Held-to-maturity	27	71	(22)	89	-	-
Available for-sale	(66)	931	1,261	179	404	656
Trading	73	158	103	70	146	81
<b>Total included in income on assets from financing activities</b>	<b>34</b>	<b>1,160</b>	<b>1,342</b>	<b>338</b>	<b>550</b>	<b>737</b>
Provision for decline in value of held-to-maturity bonds	(42)	-	-	-	-	-
Gains on sale of available-for-sale bonds	272	393	209	182	251	133
Losses on sale of available-for-sale bonds	(1)	(5)	(7)	(1)	(5)	(2)
Provision for decline in value of available-for-sale bonds	(8)	(119)	(311)	(3)	(10)	(57)
Net realized and unrealized gains (losses) from adjustment of trading bonds to fair value*	1	13	(58)	1	34	(40)
<b>Total included in other financing income</b>	<b>222</b>	<b>282</b>	<b>(167)</b>	<b>179</b>	<b>270</b>	<b>34</b>
<b>Total from investments in bonds</b>	<b>256</b>	<b>1,442</b>	<b>1,175</b>	<b>517</b>	<b>820</b>	<b>771</b>
<b>F. Details of the Net Effect of Derivative Instruments Hedging Earnings From Financing Operations</b>						
Financing expenses in respect of assets (item A)	-	(19)	(103)	-	(19)	(103)
Financing expenses in respect of liabilities (item B)	-	-	(1)	-	-	(1)

\* Of which: a part of the gains and losses relating to trading bonds that are still on hand at balance sheet date.  
Consolidated – NIS (37) million, the Bank - NIS (39) million (2009: consolidated - NIS 79 million, the Bank - NIS 76 million, 2008: consolidated - NIS (12) million, the Bank – NIS (32) million).

Footnote:

(1) Financing income generated by mortgage backed securities (MBS) amounted to US\$105 million for the year ended December 31, 2010 (2009: US\$113 Million, 2008: US\$128 Million). Following translation of such income into Shekels and the recording of the effect on this investment of exchange differences due to the change in the exchange rate of the U.S. Dollar as against the Shekel, an expense of NIS 345 Million for the year ended December 31, 2010 was recorded in respect of the said securities (2009: income of NIS 140 million, 2008: income of NIS 599 million).

**24. OPERATING COMMISSIONS**

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
	in NIS millions					
Ledger fees	633	*655	*614	399	*414	*399
Credit cards	914	1,010	937	104	106	102
Operations in securities and in certain derivative instruments	338	339	306	231	249	218
Commissions from the distribution of financial products	81	55	37	72	50	35
Management, operational and trusteeship services for institutional bodies	35	49	30	-	16	-
Handling credit	254	*221	*223	142	*125	*139
Conversion differences	119	*135	*165	92	*106	*135
Foreign trade services	58	*57	*67	46	*46	*53
Net income from credit portfolio services	19	20	19	5	5	5
Other income	96	*92	*106	59	*65	*59
<b>Total operating fees</b>	<b>2,547</b>	<b>2,633</b>	<b>2,504</b>	<b>1,150</b>	<b>1,182</b>	<b>1,145</b>

\* Reclassified.

**25. NET GAIN (LOSSES) FROM INVESTMENTS IN SHARES**

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
	in NIS millions					
Gains on sale of shares available-for-sale	26	171	7	6	136	7
Losses and provision for decline in value of available-for-sale shares	(33)	(36)	(117)	(26)	(19)	(67)
Net realized and unrealized gains (losses) from adjustment of trading securities to fair value <sup>(1)</sup>	8	5	(7)	9	(1)	(1)
Dividends from available-for-sale or trading shares	30	57	<sup>(2)</sup> 168	1	27	<sup>(2)</sup> 59
<b>Total from investments in shares</b>	<b>31</b>	<b>197</b>	<b>51</b>	<b>(10)</b>	<b>143</b>	<b>(2)</b>

Footnotes:

(1) Of which part of the income (loss) related to trading shares that are still on hand at balance sheet date: consolidated: NIS 7 million, Bank: NIS 7 million, (2009-consolidated: NIS (1) million, Bank: NIS (1) million, 2008-consolidated: NIS (5) million, Bank: NIS (1) million).

(2) Including a dividend received from VISA Europe, in the amount of NIS 110 million (consolidated), and NIS 24 million (for the Bank).

**Additional details**

A. Sale of VISA Inc. shares - at the end of 2008, within the framework of the distribution of the proceeds from the public offering made by Visa International among the members of the VISA Europe Organization, ICC and the Bank received Visa Inc. shares, which had a lock-up period until March 25, 2011. On January 21, 2010, the board of directors of VISA International announced a plan for the release from the trading limitations.

During 2010, ICC and the Bank realized shares of VISA Inc. recognizing gains of NIS 26 million (NIS 6 million for the Bank).

B. In 2010, DCMI received dividends on shares held by it in an amount of NIS 27 million (2009: NIS 19 million).

C. In 2010, the Bank recorded a provision for impairment and recognized losses on realization in respect of a fund of hedge funds in the amount of NIS 26 million (2009 - NIS 19 million; 2008 - NIS 67 million).

## 25. NET GAIN (LOSSES) FROM INVESTMENTS IN SHARES (CONTINUED)

- D. During 2009, the Bank realized the balance of the "Bezeq" shares, which served as collateral that a certain borrower received from a consortium of banks. The share of the Bank and of Mercantile Discount Bank Ltd. in the proceeds of the realization of these shares, net of fees and expenses of the Receiver, amounted to NIS 439 million (the Bank: NIS 314 million). The Bank and Mercantile Discount Bank Ltd. recorded in this respect, in these financial statements, gains before tax in the amount of NIS 121 million (the Bank: NIS 87 million). For details regarding a lawsuit filed against the Bank, Mercantile Discount Bank and additional banks, See Note 19 C hereunder, Section 11.9.
- E. During 2009, dividends in respect of "Bezeq" shares in the amount of NIS 38 million (consolidated) and NIS 27 million (the Bank) were received (2008 - NIS 38 million and NIS 26 million, respectively; 2007 - NIS 70 million and NIS 50 million, respectively).
- F. During 2009, the Bank realized the balance of the "HOT" shares, which had been received as part of a creditors' arrangement with a certain borrower, for a total consideration of NIS 55 million, and recorded gains in the amount of NIS 22 million. (In 2008 "HOT" shares in the total amount of NIS 21 million were realized, in respect of which gains before tax in the amount of NIS 13 were recorded).
- G. During 2009, the Bank sold shares in "Harel" for a total consideration of NIS 190 million. In respect of the said realization the Bank recorded gains before tax in the amount of NIS 25 million.

## 26. OTHER INCOME

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
	in NIS millions					
Management fees from consolidated subsidiaries	-	-	-	4	4	3
Profit from severance pay funds	64	260	-	59	229	-
Other income	19	*1	*18	65	*52	*58
<b>Total other income</b>	<b>83</b>	<b>261</b>	<b>18</b>	<b>128</b>	<b>285</b>	<b>61</b>

\* Reclassified.

**27. SALARIES AND RELATED EXPENSES**

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
	in NIS millions					
Salaries	2,169	2,135	2,009	1,349	1,338	1,262
Expense resulting from share based payment transactions** <sup>(1)</sup>	7	2	15	7	2	15
Severance pay, pension, continuing education fund, seniority bonuses, vacation and medical insurance	384	*467	464	246	304	302
National Insurance and payroll taxes	451	*434	392	327	316	301
Other related expenses	116	102	112	59	62	63
Adjustment of reserves for salary-related expenses due to changes in salaries during the year	56	29	114	39	27	100
Voluntary retirement program expenses <sup>(2)</sup>	7	6	-	7	6	-
<b>Total salaries and related expenses</b>	<b>3,190</b>	<b>3,175</b>	<b>3,106</b>	<b>2,034</b>	<b>2,055</b>	<b>2,043</b>
Includes: Overseas salaries and related expenses	408	445	405	17	18	19
** Of which an expense resulting from transactions treated as share based payment transactions settled by capital instruments.	-	2	15	-	2	15

\* Reclassified.

Footnotes:

(1) See Note 13 E.

(2) Including payroll tax.

**28. OTHER EXPENSES**

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
	in NIS millions					
Advertising	219	169	218	90	59	92
Communications	128	132	132	67	69	65
Computer services	130	*149	*190	97	*101	*149
Office expenses	32	31	38	16	15	18
Insurance	63	82	39	11	14	8
Professional services	172	154	162	71	55	67
Directors' fees	15	14	11	6	5	4
Instruction and training	26	15	16	12	10	13
Fees	52	42	43	23	24	27
Amortization of goodwill	25	33	34	-	-	-
Other	431	458	408	124	117	130
<b>Total other expenses</b>	<b>1,293</b>	<b>1,279</b>	<b>1,291</b>	<b>517</b>	<b>469</b>	<b>573</b>

\* Reclassified.

## 29. PROVISION FOR TAXES ON OPERATING INCOME

### A. COMPOSITION:

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
	in NIS millions					
Taxes for current year	534	420	263	188	133	56
Taxes for previous years	13	26	(7)	-	5	(20)
<b>Total current taxes</b>	<b>547</b>	<b>446</b>	<b>256</b>	<b>188</b>	<b>138</b>	<b>36</b>
Addition (deduction):						
Deferred taxes for current year	(75)	103	(18)	(8)	50	(41)
Deferred taxes for previous years	(5)	(42)	(69)	-	(33)	(45)
<b>Total deferred taxes</b>	<b>(80)</b>	<b>61</b>	<b>(87)</b>	<b>(8)</b>	<b>17</b>	<b>(86)</b>
<b>Total provision for taxes (tax saving) on operating profit</b>	<b>467</b>	<b>507</b>	<b>169</b>	<b>180</b>	<b>155</b>	<b>(50)</b>
Includes taxes (tax saving) of foreign subsidiaries	77	99	32	(12)	4	11

### B. RECONCILIATION BETWEEN THE THEORETICAL TAX WHICH WOULD APPLY HAD THE OPERATING INCOME BEEN TAXED AT THE STATUTORY TAX RATE APPLYING TO A BANK IN ISRAEL, TO THE PROVISION FOR TAXES ON OPERATING INCOME, AS CHARGED IN THE STATEMENT OF INCOME:

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
Statutory tax rate on banks in Israel	35.34%	36.21%	36.80%	35.34%	36.21%	36.80%
	in NIS millions					
Income tax at the statutory tax rate	367	494	211	151	163	(24)
Income tax (tax savings) on:						
Income of foreign subsidiaries	62	14	2	-	-	14
General and supplemental provision for doubtful debts	6	2	2	6	3	5
Income exempt from tax or taxed at preferred rates	11	(3)	(3)	11	-	-
Adjustment differences on depreciation and capital gains	1	22	(2)	1	25	(1)
Other non-deductible expenses	34	45	43	9	16	18
Losses and timing differences (utilization), net, in respect of which no deferred tax assets were recorded	(8)	(44)	23	(1)	(41)	-
Profit tax on payroll tax	-	-	15	-	-	12
Change in the balance of deferred taxes resulting from the change in tax rates	3	24	(15)	3	17	(9)
Taxes for prior years	8	(16)	(76)	-	(28)	(65)
Income of Israeli subsidiaries	(17)	(31)	(31)	-	-	-
<b>Provision for taxes (tax saving) on income</b>	<b>467</b>	<b>507</b>	<b>169</b>	<b>180</b>	<b>155</b>	<b>(50)</b>

## 29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)

- C.** (1) Final tax assessments have been issued to the Bank for the tax years up to and including 2005. Final withholding tax assessments have been issued to the Bank for the years up to and including 2005. Following the settlement of the income tax assessment for the year 2003, and the settlement of withholding tax assessments for the years 2003-2005, excess provisions for tax amounting to NIS 40 million were reversed in 2008. At the beginning of September 2009, the Bank received a final assessment in respect of the 2004-2005 tax years. The final assessment has no material effect on the Bank's business results, as the demanded taxes reflect timing differences.
- (2) In December 2010, "non-agreed" tax assessments were issued to the Bank for the 2010 tax year. In January 2011, the Bank filed an objection to the said assessment. The amount of tax in dispute for the said tax year is NIS 138 million (including interest and linkage). The Bank's Management believes that adequate provisions have been included in the books of the Bank in respect of its tax liability for the said year.
- (3) The major consolidated subsidiaries have received final tax assessments, or assessments deemed final, for tax years between 2003 to 2006.
- (4) On December 26, 2010, "non-agreed" tax assessments for the years 2006-2008, were issued to Mercantile Discount Bank. Mercantile Discount Bank disputes the position of the tax authorities and on January 12, 2011, filed an appeal against these assessments. In the opinion of Management of Mercantile Discount Bank, adequate provisions were included in the books of the Bank in respect of its tax liability for the said years.
- D.** Following the submission of a Income tax adjustment statement for the year 2007 at the end of 2008, an excess provision of NIS 22 million, included in the financial statements as of December 31, 2007 on the basis of an estimate, was reversed in 2008.
- E.** The consolidated balance as of December 31, 2010, of the carry forward tax losses, deductibles and timing differences amounted to NIS 196 million (December 31, 2009: NIS 184 million).
- F.** On February 9, 2000, the Bank's shares in IDB New York were transferred to Discount Bancorp. Inc. (hereinafter - "Bancorp"), a wholly-owned holding subsidiary of the Bank, registered in the State of Delaware, U.S. The transfer of the shares to Bancorp was made at their value in the Bank's books, in consideration for shares issued by Bancorp.
- The transfer of the shares was made in accordance with the provisions of Section 104A of the Israeli Income Tax Ordinance. The Bank is obligated to pay taxes in Israel with respect to the said transfer of shares, if and when such shares will be sold. The Bank has provided the Israeli Income Tax Authorities with a guarantee as to the payment of such taxes.
- G.** In August 2005 the Income Tax Ordinance Amendment Law (No. 147) - 2005 (hereinafter - "the Amendment") was published. The Amendment provides for a gradual reduction in the rate of company tax, down to a rate of 25% as from the 2010 tax year and thereafter.
- On July 14, 2009, the Knesset passed the Economic Efficiency Act (Legislation amendments for the implementation of the economic program for the years 2009 and 2010), 2009, which stipulated, among other things, an additional gradual reduction in the corporate tax rates down to 18% as from the 2016 tax year and thereafter. The said change reduced the deferred tax balance alongside recording of a one-off tax expense of NIS 32 million in 2009.
- H.** Changes in the rate of "Payroll tax" and "Profit Tax"
- (1) A Value Added Tax Order (Tax rate applying to non-profit organizations and financial institutions) (Provisional directive), 2009, was published on July 1, 2009. Accordingly, in the period from July 1, 2009 and December 31, 2010, the rate of wage tax and profit tax applying to financial institutions will be 16.5% instead of 15.5% (hereinafter: "the Amendment"). According to the Amendment, the new rate of profit tax will apply to one half of the earnings for 2009. Therefore, the average rate of profit tax for 2009 has been 16%.
- (2) On December 31, 2009, a Value Added Tax Order (tax rate applying to non-profit organizations and financial institutions) (Provisional order) (Amendment), 2009, was officially published, according to which, in the period from January 1, 2011 to December 31, 2010, the rate of wage tax and profit tax applying to financial institutions will be 16% instead of 16.5%.

## 29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)

(3) On February 24, 2011, a Value Added Tax Order (tax rate applying to non-profit organizations and financial institutions) (Provisional order) (Amendment), 2010, was officially published, according to which, in the period from January 1, 2011 to December 31, 2012, the rate of wage tax and profit tax applying to financial institutions will be 16% instead of 15.5%.

The effect of the said amendments on the Bank's profits is not significant.

- I. Following the said amendments to items G-H above, the statutory tax rate applying to banking corporations stood at 36.80% in 2008 and 36.21% in 2009 and 35.34% in 2010. The statutory tax rates applying to banking corporations will be as follows: in the 2011 tax year - 34.48%, in the 2012 tax year - 33.62%, in the 2013 tax year - 32.47%, in the 2014 tax year - 31.60%, in the 2015 tax year - 30.74% and in the 2016 tax year and thereafter - 29.00%.
- J. On March 6, 2008, the Israeli Income Tax Law (Inflationary Adjustments) (Amendment No. 20) (Restriction of Period of Application) - 2008 (hereinafter: "the Amendment") was published. According to the Amendment, the Inflationary Adjustments Law is no longer applicable subsequent to the 2007 tax year, and commencing with the 2008 tax year the provisions of the law no longer applied, except for certain transitional provisions the objective of which is to avoid distortions in tax computations.  
According to the amendment, starting with the year 2008, the adjustment of income for tax purposes to a real-term measurement basis, no longer applied. In addition, depreciation on fixed assets and tax loss carryforwards are no longer linked to future changes in the CPI, such that these amounts were linked only to the CPI as of the end of the 2007 tax year and are no longer linked to CPI changes after this date.
- K. Following the decision of ICC's Board of Directors not to distribute a dividend that would cause ICC's capital ratio of ICC to fall below 15.5%, and the decision of the Board of Directors of ICC not to distribute a dividend out of profits accumulated as of December 31, 2008, the Bank reversed in 2008 the provision for taxes in the amount of NIS 23 million, in respect of its share in the retained earnings of ICC.
- L. The Bank has studied the changes that occurred in 2010 in the data used for the computation of the provision for taxes in respect of the Bank's share in earnings of the First International Bank, and accordingly reduced the provision by an amount of NIS 53 million.

**29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)**

**M. PRESENTED BELOW IS THE ADJUSTED AMOUNT OF NON-MONETARY ASSETS, THE DEPRECIATION OF WHICH WILL NOT BE RECOGNIZED AS A DEDUCTIBLE EXPENSE OR AS PART OF THE COST WHEN SOLD, AND WHICH IS DEEMED A PERMANENT DIFFERENCE IN RESPECT OF WHICH NO DEFERRED TAXES ARE RECORDED:**

	Consolidated		The Bank	
	December 31			
	2010	2009	2010	2009
	in NIS millions			
Balance at beginning of year	59	65	51	56
Non-deductible amount for the current year	(11)	(6)	(11)	(5)
<b>Balance at end of year</b>	<b>48</b>	<b>59</b>	<b>40</b>	<b>51</b>

**N. YEAR-END BALANCES OF DEFERRED TAXES RECEIVABLE AND PROVISION FOR DEFERRED TAXES:****1. Consolidated**

	Deferred tax receivable				Provision for deferred taxes			
	balance		The average tax rate		balance		The average tax rate	
	2010	2009	2010	2009	2010	2009	2010	2009
	in NIS millions		in percentage		in NIS millions		in percentage	
On specific provision for doubtful debts	141	140	31.6	31.2	-	-	-	-
On provision for vacation pay, seniority bonuses provision in respect of retirees	319	304	29.3	29.3	-	-	-	-
On excess of deposits of severance pay	-	-	-	-	94	90	28.9	29.1
On income tax carry-forward deductions	40	29	31.9	34.2	-	-	-	-
On foreign operations	221	196	35.3	36.1	-	-	-	-
On securities	14	17	33.6	30.9	-	-	-	-
On adjustment of depreciable non-monetary assets	-	-	-	-	154	140	28.7	28.6
On other monetary assets	46	52	26.0	31.1	-	-	-	-
Reserve for tax on income of Investee companies	-	-	-	-	67	120	34.5	34.2
<b>Total, net</b>	<b>781</b>	<b>738</b>	<b>31.2</b>	<b>31.6</b>	<b>315</b>	<b>350</b>	<b>29.8</b>	<b>30.4</b>

## 29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)

### N. YEAR-END BALANCES OF DEFERRED TAXES RECEIVABLE AND PROVISION FOR DEFERRED TAXES (CONTINUED):

#### 2. The Bank

	Deferred tax receivable				Provision for deferred taxes			
	balance		The average tax rate		balance		The average tax rate	
	2010	2009	2010	2009	2010	2009	2010	2009
	in NIS millions		in percentage		in NIS millions		in percentage	
On specific provision for doubtful debts	99	95	31.4	32.0	-	-	-	-
On provision for vacation pay, seniority bonuses provision in respect of retirees	273	265	29.0	29.0	-	-	-	-
On excess of deposits of severance pay	-	-	-	-	92	85	29.0	29.0
On income tax carry-forward deductions	34	29	34.5	34.2	-	-	-	-
On foreign operations	8	7	35.3	30.0	-	-	-	-
On securities	20	16	34.5	34.2	-	-	-	-
On adjustment of depreciable non-monetary assets	-	-	-	-	135	122	28.8	28.7
On other monetary assets	22	17	29.0	29.0	-	-	-	-
Reserve for tax on income of Investee companies	-	-	-	-	67	120	34.5	34.2
<b>Total, net</b>	<b>456</b>	<b>429</b>	<b>30.2</b>	<b>30.1</b>	<b>294</b>	<b>327</b>	<b>30.0</b>	<b>30.6</b>

	Consolidated		The Bank	
	December 31			
	2010	2009	2010	2009
	in NIS millions			
Deferred taxes are included:				
In "Other assets" (Note 8)	480	402	176	116
In "Other liabilities" (Note 12)	(14)	(14)	(14)	(14)
<b>Total, net</b>	<b>466</b>	<b>388</b>	<b>162</b>	<b>102</b>

**30. NET INCOME ON EXTRAORDINARY ITEMS, AFTER TAXES**

	Consolidated			The Bank		
	2010	2009	2008	2010	2009	2008
	in NIS millions					
Capital income on sale of buildings and equipment	3	1	-	3	1	-
Capital loss on sale of buildings and equipment	-	(1)	(3)	-	(1)	(3)
Provision for impairment in value of buildings <sup>(1)</sup>	-	(1)	(7)	-	(1)	(7)
Income (loss) on sale of shares of previously consolidated subsidiary	48	(17)	-	-	-	-
Gain on sale of mutual funds activities	6	-	-	-	-	-
Income (loss) before taxes	57	(18)	(10)	3	(1)	(10)
Provision for taxes on profit from extraordinary items:						
Current taxes	(1)	(2)	-	(1)	(1)	-
Deferred taxes	(20)	-	-	-	-	-
Total provision for taxes	(21)	(2)	-	(1)	(1)	-
Income (loss) after taxes	36	(20)	(10)	2	(2)	(10)
Bank's share in income (loss) on extraordinary items after taxes of investee (in consolidated-affiliated) companies	-	-	-	34	(18)	-
<b>Income (loss) on extraordinary items, after taxes</b>	<b>36</b>	<b>(20)</b>	<b>(10)</b>	<b>36</b>	<b>(20)</b>	<b>(10)</b>

Footnote:

(1) According to the estimated recoverable value amount of the buildings.

## [INSERTS: Ebe 31.1, Ebe 31.2, Ebe 31.3]

### 31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION

#### A. GENERAL

In December 2001, the Supervisor of Banks in Israel issued directives concerning segment information reporting in a banking corporation, which determine, among other things, the disclosure requirements and the manner of presenting the financial results of segments in the financial statements.

In July 2005, the Supervisor of Banks published a "Questions and Answers" file about the disclosure of segment information. The said file stated, among other things, that the segments requiring disclosure in the Note are: Households, Private Banking, Small Businesses, Middle Market Banking, Corporate Banking, Financial Management and Other (if relevant, on a specific basis in the reporting banking corporation). The segments relating to banking products (credit cards, capital market activity, mortgage loans and construction and real estate) are to be presented in the relevant customer segments. Notwithstanding, it is required to include in the Directors' Report, in respect of each segment in a separate column, a disclosure as to the banking product. The said file also clarified that the data for the international operations segment is to be presented similarly to the segment data presentation of the operations of the Group in Israel.

The operations of the Group are divided into six principal segments, as detailed hereunder. The segments also include, as aforementioned, the relevant part relating to banking products (credit cards, capital market activity, mortgage loans and construction and real estate).

It should be noted that these segments of operation do not accord with the organizational structure, mainly due to the fact that certain operations are reflected in the various segments, such as credit card activities and the capital market activity, and not within the organizational framework in which they are being operated.

- **Retail Banking - Household Segment:** This segment includes customers of the Bank's and Mercantile Discount Bank's Banking Division (formerly: Retail Banking Division) who are private customers who are defined as customers who are either salaried employees, possess the potential for growth, or may be viewed as VIP customers (the definition excludes customers of the private banking centers). The segment also includes the customers of Mercantile Discount Bank in that Bank's household segment – private customers of Mercantile Discount Bank, whose activities are typical of those households, including credit of volume not exceeding NIS 200 thousand and deposits of a volume not exceeding NIS 500 thousand.
- **Retail Banking - Small Business Segment:** This segment includes customers of the Bank's Banking Division and customers of Mercantile Discount Bank which are defined as small companies and small businesses with borrowings of up to NIS 10 million.
- **Corporate Banking:** The segment includes mainly companies with annual turnovers of over NIS 150 million and/or total indebtedness exceeding NIS 50 million, which are customers of the Bank and of Mercantile Discount Bank. The segment also includes customers of IDB New York's corporate banking segment.
- **Middle Market banking:** This segment includes mainly companies with annual turnovers exceeding NIS 30 million and/or total indebtedness of NIS 10-50 million, which are customers of the Bank and of Mercantile Discount Bank. The segment also includes customers of IDB New York's commercial banking segment.
- **Private banking:** This segment includes as part of the Bank's customers (individuals and corporations) who receive banking services at the private banking centers. These customers are generally Israeli customers with financial wealth held with the Bank of US\$1 million and over, as well as foreign resident customers with financial wealth held at the Bank of US\$0.5 million and above. The segment also includes customers of Mercantile Discount Bank and the London branch of medium and high wealth, all the activity of the subsidiary IDB (Swiss) Bank and the private banking customer activity at IDB New York, including all the operations of the subsidiary Discount Bank Latin America.
- **Financial Management Segment** - This segment includes activities that are characterized as banking operations, but do not involve customers of the Group (except for activity with the dealing room and banking corporations). These activities are mainly comprised of for their own account operations of the Bank, Mercantile Discount Bank and IDB New York involving securities and other banks for their own

### 31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

account, as well as management of market and liquidity risks and dealing room operations, including those involving financial derivatives. This segment also includes the Bank's share in the income of FIBI and its share in the income of its affiliated companies which operate in a supporting capacity.

The segment also includes the sub-segment of non-financial corporations, which includes the Group's investment in non-financial corporations, mainly investments made by DCMI, as well as direct investments by the Bank.

### B. THE PRINCIPAL ASSUMPTIONS, ESTIMATES AND PRINCIPLES USED IN THE PREPARATION OF SEGMENT INFORMATION

The classification of the business results of the Group into the various segments of activity, as stated above, was prepared based on the principles, assumptions and estimates detailed hereunder:

#### 1) Income

**Income from financing operations before provision for doubtful debts.** The segment is credited with the margin resulting from the difference between interest on loans granted to customers of the segment and the interest paid on deposits of customers of the segment and the transfer prices.

The transfer prices reflect the marginal alternative cost of financing sources or the application thereof.

The margins are set at the date the transaction is entered into and stay in effect for the duration of the transaction free of market risks.

According to this methodology, earning or losses from financing operations resulting from changes in market conditions, are taken to the "Financial Management" segment.

Income earned on the nostro securities of the Bank and from deposits from the public are also reflected in the "Financial Management" segment.

**Provision for doubtful debts.** This is included in the segment in which the activity of the customer is reflected, in respect of which the provision has been created. In the same manner, collection in respect of a debt provided for or the decrease in the provision is also reflected in the segment in which the activity of the customer is reflected.

**Operational income.** The operational and other income, which the bank collects from customers, are reflected directly in the segment in which the activity of the customer is reflected. Some of the income derived from foreign currency operations with customers is credited to the trading desk.

#### 2) Expenses

Identifiable direct expenses are specifically and directly reflected in the related segments.

Overhead expenses (mainly head office expenses), which cannot be related to a specific segment, are charged to the segments using an estimate based on various charging formulas, most of them based on volume of operation indices and some of them based on estimates and assessments of the various units of the Bank. (For details see paragraph 4 hereunder).

Depreciation and amortization expenses are charged as part of the overhead expenses.

The model for the charging of expenses used in calculating the data includes the allocation of inter segment expenses, mainly in relation to operational services provided by the branch setup to customers related to other segments by charging all the branches' expenses to customers of these branches, even if these customers are not amongst the customers of the Retail Division. As stated above, this charge is made by way of an estimate based mainly upon indices for the volume of operations of customers of the Bank's branches.

Whereas, as stated, the system is in its development stage, and has not as yet been fully integrated at the Bank as a management control tool, certain changes are being made from time to time in the manner of determining assessments and in the way of allocating expenses, so that comparison between periods might be flawed.

**Taxes on income.** In order to exclude the effect of brought forwards tax losses in respect of which deferred tax assets had not been recorded,

## **31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)**

on the measurement of the profitability according to segments of operation, the following tax computation was made:

The provision for taxes of the various segments of operation was computed on the basis of the statutory tax rate of 35.3% (2009: 36.2%).

Segments showing a loss recorded a tax income computed also on the basis of the statutory tax rate.

The difference between the net taxes attributed to the segments of operation and the provision for taxes recorded in the income statement, is charged to the "Financial Management" segment.

### **3) Allocation of capital and computation of the return**

Shareholders' equity and subordinated capital notes, being part of the financing sources of credit, are being allocated to each segment in respect of its risk assets.

According to directives of the Supervisor of Banks, the segments of operations are credited with imputed interest on the capital allocated to them, on the basis the risk assets attributed to the segment.

The average balance of risk assets presented in the Note was computed in relation to risk assets calculated in accordance with the principles of Basel II (until December 31, 2009 - according to the principles of Basel I).

Computation of the return in each segment was made in accordance with the equity attributed, as stated, to the segment. Regarding recognition of the capital notes as upper tier I capital, the Board of Directors adopted a capital adequacy policy according to which the Bank will maintain an original primary capital adequacy ratio (excluding the compound primary capital) of 6.5%, at all times. Accordingly, as from the financial statements for 2008, the capital allocated to each segment was also increased. The capital attributed to each segment, as stated in the financial statements for 2009, had been increased into 7% in accordance with a resolution of the Board of Directors of July 2009, regarding the creation of an additional safety cushion at the rate of 0.5%.

### **4) Presentation of inter-segment income and expenses**

The accountability between the profit centers in the Bank is made by a mechanism that allocates the total amount of expenses to customers of the Bank, using various activity indices, and not by allocating the expenses to the profit centers (and the "sale" of inter-segment services).

The method for the allocation expenses used by the Bank is a multi-stage one. In the first stage the direct expenses of the branch are allocated to all the customers keeping their accounts at the branch, (customers attached to various segments). In the second stage, the expenses of designated units are allocated based on an estimate of the distribution of the service to the various headquarters, and the total expenses of the headquarters and administrations to the customers whom they serve. Finally, the costs of the general headquarter units (management, human resources, comptroller, operations and computer services, etc.) to all the customers of the Bank.

According to the system described above, each customer "bears" its own relevant expenses, which are accumulated in the various segments according to the affiliation of customers to these segments.

The format described above does not allow the determination as to what expenses of one segment were charged to another segment (referred to in the reporting format as "inter-segment activity"). The Supervisor of Banks permitted the Bank to report on the basis of the mechanism it developed for the purpose of allocating income and expenses, and in consequence thereof not to report inter-segment transfers.

**31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)****C. ACTIVITY SECTORS IN DISCOUNT BANK BUSINESS SEGMENTS**

## Reported Amounts

	For the year ended December 31, 2010								
	Households	Small Businesses	Corporate Banking	Middle Market Banking	Private Banking	Financial Management Non-Financial Companies		Other	Total Consolidated
	in NIS millions								
Income (loss) from financing activities before provision for doubtful debts									
- From external sources	1,759	1,777	760	764	(219)	(3)	(8)	4,830	
- Intersegmental	(373)	(857)	265	(108)	554	(1)	520	-	
<b>Total Income from financing activities</b>	<b>1,386</b>	<b>920</b>	<b>1,025</b>	<b>656</b>	<b>335</b>	<b>(4)</b>	<b>512</b>	<b>4,830</b>	
Operating and other income									
- From external sources	1,570	465	261	201	226	(7)	(55)	2,661	
<b>Total income</b>	<b>2,956</b>	<b>1,385</b>	<b>1,286</b>	<b>857</b>	<b>561</b>	<b>(11)</b>	<b>457</b>	<b>7,491</b>	
Provision for doubtful debts	191	214	221	182	11	-	2	821	
Operating and other expenses	2,413	902	593	524	464	4	731	5,631	
Operating Income (loss) before taxes	352	269	472	151	86	(15)	(276)	1,039	
Provision for taxes on operating income	114	95	193	37	39	(9)	(2)	572	
Operating Income (loss) before taxes	238	174	279	114	47	(6)	(274)	186	
Bank's share in operating income of affiliated companies	3	-	-	-	-	4	179	126	
Minority interest in the income of subsidiaries	(70)	-	-	-	-	-	-	(70)	
Net gain from extraordinary items, net of taxes	13	9	-	3	9	-	2	36	
<b>Net income (loss)</b>	<b>184</b>	<b>183</b>	<b>279</b>	<b>117</b>	<b>56</b>	<b>(2)</b>	<b>(93)</b>	<b>724</b>	
Return on equity (percentage)	8.8	17.3	7.3	7.5	17.4	(2.4)	(6.0)	6.9	
Average Assets	33,516	15,241	45,259	18,204	6,583	624	67,196	186,623	
Of which - Investment in Investee companies	9	(1)	-	-	-	23	1,623	1,654	
Average Liabilities	59,446	14,830	21,638	10,318	36,603	721	32,287	175,843	
Average Risk-assets	29,693	15,071	54,158	22,298	4,620	1,094	13,475	140,409	
Average assets of provident and mutual funds	27	10	230	16	187	-	2,292	2,762	
Average customers' securities	33,360	9,186	80,484	8,541	22,833	-	-	154,404	
Average other assets under management	3,614	347	182	1,361	2,187	-	-	7,691	
Margin from credits activity	858	741	872	533	116				
Margin from deposits activity	483	110	71	77	227				
other	45	69	82	46	(8)				
<b>Income (loss) from financing activities before provision for doubtful debts</b>	<b>1,386</b>	<b>920</b>	<b>1,025</b>	<b>656</b>	<b>335</b>	<b>(4)</b>	<b>512</b>	<b>4,830</b>	

## 31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)

### C. ACTIVITY SECTORS IN DISCOUNT BANK BUSINESS SEGMENTS (CONTINUED)

#### Reported Amounts

	For the year ended December 31, 2009							
	Small Households	Corporate Businesses	Corporate Banking	Middle Market Banking	Private Banking	Financial Management Non-Financial Companies Other		Total Consolidated
in NIS millions								
Income (loss) from financing activities before provision for doubtful debts								
- From external sources	196	840	1,905	623	263	1	929	4,757
- Intersegmental	1,057	(22)	(808)	35	99	(3)	(358)	-
<b>Total Income from financing activities</b>	<b>1,253</b>	<b>818</b>	<b>1,097</b>	<b>658</b>	<b>362</b>	<b>(2)</b>	<b>571</b>	<b>4,757</b>
Operating and other income								
- From external sources	1,627	526	424	229	187	33	65	3,091
<b>Total Income</b>	<b>2,880</b>	<b>1,344</b>	<b>1,521</b>	<b>887</b>	<b>549</b>	<b>31</b>	<b>636</b>	<b>7,848</b>
Provision for doubtful debts	249	191	293	219	15	-	31	998
Operating and other expenses	2,242	841	703	596	444	4	656	5,486
Operating Income (loss) before taxes	389	312	525	72	90	27	(51)	1,364
Provision for taxes on operating income	114	107	192	36	58	6	(6)	507
Operating Income (loss) after tax	275	205	333	36	32	21	(45)	857
Bank's share in operating income (loss) of affiliated companies	1	-	-	-	-	(7)	164	158
Minority interest in the income of subsidiaries	(54)	(6)	(9)	(3)	-	-	(0)	(72)
Net gain from extraordinary items, net of taxes	-	-	-	-	-	(18)	(2)	(20)
<b>Net income (loss)</b>	<b>222</b>	<b>199</b>	<b>324</b>	<b>33</b>	<b>32</b>	<b>(4)</b>	<b>117</b>	<b>923</b>
Return on equity* (percentage)	12.9	26.0	8.7	2.4	15.0	(9.0)	7.7	9.8
Average Assets	31,023	14,581	48,352	19,349	6,478	749	67,501	188,033
Of which - Investment in Investee companies	10	-	-	-	-	120	1,570	1,700
Average Liabilities	*64,200	14,206	24,652	10,479	37,730	745	26,377	178,389
Average Risk-assets	26,524	11,785	*57,162	*21,328	3,277	749	*15,051	135,876
Average assets of provident and mutual funds	55	25	426	83	308	-	2,182	3,079
Average customers' securities	29,366	6,275	64,172	8,014	18,718	-	-	126,545
Average other assets under management	3,659	302	141	1,518	1,419	-	-	7,039
Margin from credit activity	763	669	938	555	115			
Margin from deposits activity	444	83	79	62	259			
other	46	66	80	41	(12)			
<b>Income (loss) from financing activities before provision for doubtful debts</b>	<b>1,253</b>	<b>818</b>	<b>1,097</b>	<b>658</b>	<b>362</b>	<b>(2)</b>	<b>571</b>	<b>4,757</b>

\* Reclassified.

**31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)****C. ACTIVITY SECTORS IN DISCOUNT BANK BUSINESS SEGMENTS (CONTINUED)**

## Reported Amounts

	For the year ended December 31, 2008							Total Consolidated
	Households	Small Businesses	Corporate Banking	Middle Market Banking	Private Banking	Financial Management Non-Financial Companies Other		
in NIS millions								
Income (loss) from financing activities before provision for doubtful debts								
- From external sources	*166	*1,155	1,736	*799	*413	(39)	*(93)	4,127
- Intersegmental	1,183	(323)	(735)	(174)	(58)	(16)	123	-
<b>Total Income from financing activities</b>	<b>1,349</b>	<b>832</b>	<b>1,001</b>	<b>625</b>	<b>345</b>	<b>(55)</b>	<b>30</b>	<b>4,127</b>
Operating and other income								
- From external sources	1,408	512	368	259	172	(32)	(114)	2,573
<b>Total Income</b>	<b>2,757</b>	<b>1,344</b>	<b>1,369</b>	<b>884</b>	<b>517</b>	<b>(87)</b>	<b>(84)</b>	<b>6,700</b>
Provision for doubtful debts	176	156	233	198	7	-	10	780
Operating and other expenses	2,198	856	740	644	407	4	499	5,348
Operating Income (loss) before taxes	383	332	396	42	103	(91)	(593)	572
Provision for taxes on operating income	*96	*112	116	(16)	26	(10)	*(155)	169
Operating Income (loss) after tax	287	220	280	58	77	(81)	(438)	403
Bank's share in operating income (loss) of affiliated companies	-	-	(1)	-	-	(115)	46	(70)
Minority interest in the income of subsidiaries	(56)	(8)	(11)	(3)	-	-	-	(78)
Net gain from extraordinary items, net of taxes	-	-	-	-	-	-	(10)	(10)
<b>Net income (loss)</b>	<b>231</b>	<b>212</b>	<b>268</b>	<b>55</b>	<b>77</b>	<b>(196)</b>	<b>(402)</b>	<b>245</b>
Return on equity (percentage)	*15.5	*27.1	8.1	3.7	*27.3	(249.3)	*(23.9)	2.7
Average Assets	*27,917	14,648	42,733	19,934	*4,646	1,206	57,952	169,036
Of which - Investment in Investee companies	9	2	2	-	-	139	1,555	1,707
Average Liabilities	*57,256	11,942	19,677	9,279	*36,713	684	24,223	159,774
Average Risk-assets	22,909	12,027	50,955	22,498	4,373	1,206	14,575	128,543
Average assets of provident and mutual funds	50	45	372	193	294	-	1,897	2,851
Average customers' securities	27,488	5,008	59,817	9,510	16,033	-	-	117,856
Average other assets under management	3,617	309	256	1,457	1,196	-	-	6,835
Margin from credit activity	648	644	748	489	89			
Margin from deposits activity	*615	*130	95	*84	*269			
other	86	58	158	52	(13)			
<b>Income (loss) from financing activities before provision for doubtful debts</b>	<b>1,349</b>	<b>832</b>	<b>1,001</b>	<b>625</b>	<b>345</b>	<b>(55)</b>	<b>30</b>	<b>4,127</b>

## 31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)

### D. INFORMATION ON GEOGRAPHICAL AREAS

	Income <sup>(1)</sup>			Net Income			Assets	
	For the year end December 31						As at December 31	
	2010	2009	2008	2010	2009	2008	2010	2009
	in NIS millions							
Israel	6,259	*6,604	5,809	607	818	266	147,731	146,097
Europe	117	*149	103	(33)	(14)	(118)	5,355	5,781
North America	951	957	670	127	109	63	29,622	33,097
Sout America	164	138	118	23	10	34	3,105	2,842
Total Overseas	1,232	1,244	891	117	105	(21)	38,082	41,720
<b>Total Consolidated</b>	<b>7,491</b>	<b>7,848</b>	<b>6,700</b>	<b>724</b>	<b>923</b>	<b>245</b>	<b>185,814</b>	<b>187,817</b>

\* Reclassified.

Footnote:

(1) Income-earnings from financing operations before provision for doubtful debts and other operating income.

## 32. EARMARKED DEPOSITS, CREDIT AND DEPOSITS FROM EAMARKED DEPOSITS

	Consolidated		The Bank	
	December 31		December 31	
	2010	2009	2010	2009
	in NIS millions			
Credit and deposits from earmarked deposits				
Credit granted to the public	436	488	155	136
<b>Total</b>	<b>436</b>	<b>488</b>	<b>155</b>	<b>136</b>
Earmarked deposits				
Deposits from the public	2	1	1	1
Deposits from banks	215	239	-	-
Deposits from the Government	180	166	154	135
<b>Total</b>	<b>397</b>	<b>406</b>	<b>155</b>	<b>136</b>

## 33. CREDIT CARD ACTIVITY

### A. Developments in the field of clearing of international electronic trading transactions and additional matters

Following the large number of returned charges in respect of the cancellation of transactions, mostly in the food additives field, that had been cleared by a subsidiary of ICC, ICC International, VISA Europe Organization imposed monetary sanctions in the amount of US\$18 million, in respect of the said returned charges that were recorded until the end of 2009.

In September 2009, VISA Europe precluded ICC International from entering into engagements with new trading houses for a period of three months ended on December 15, 2009.

In November 2009, Visa Europe Organization informed ICC International that it expects it to take stringent and vigorous measures for the treatment of the deviations and to adopt a plan to which it is committed for the reduction of risk, and this within a period of three

### 33. CREDIT CARD ACTIVITY (CONTINUED)

months beginning December 1, 2009. The VISA Europe Organization further announced that it will monitor the compliance of ICC with the requirements of the reduction plan. In the event that ICC does not fulfill its commitments and deviates from the rules of the Organization, revocation of its international clearing license might be considered and in most extreme cases even termination of its membership in the Organization.

ICC has adopted and is adopting a series of measures in order to secure compliance with the rules of VISA Europe Organization and with the risk reduction plan.

In view of the steps taken by ICC, it was informed by VISA Europe in a letter of March 15, 2010, that the improvement in adherence to the rules of the Organization had been noted, and that ICC may again enter into agreements with new trading houses. In a letter dated September 20, 2010, VISA Europe reiterated its satisfaction of the measures that had been adopted by ICC, and noted that in view of the actions being taken, the possibility of revoking the license of ICC have diminished considerably. Furthermore, VISA Europe has noted the plans of ICC for expanding its activities. Within the framework of expansion of activities in the field of international clearing, VISA Europe informed that it will monitor the renewed operations of ICC while granting a pre-approval with respect to each new trading house which ICC intends to engage with.

In an additional letter of January 17, 2011, the VISA Europe Organization reiterated its satisfaction from the measures taken by ICC, and informed ICC of the immediate removal of the restrictions imposed on its international trading activity.

In February 2010, the MasterCard Worldwide organization (hereinafter: "MasterCard") approached ICC and indicated a series of prima facie deviations from the rules of MasterCard by trading houses (mainly in respect of gambling transactions). ICC objected to the assertions included in MasterCard's approach.

On March 22, 2010, MasterCard announced that it would charge ICC, in accordance with rules of the organization, some US\$3.6 million for the aforementioned deviations. In its announcement, MasterCard expressed its appreciation of the immediate action taken by ICC upon receiving the previous notice with regard to deviations from MasterCard rules.

In a letter dated July 21, 2010, MasterCard informed ICC that it had noted the steps taken by ICC in recent months towards rectifying the deficiencies discovered in its operations. In view of the measures taken by ICC to rectify deficiencies, MasterCard agreed to withdraw its demand for various documentation and reports which ICC had been requested to submit to MasterCard, this subject to the absence of further violations.

MasterCard further informed that in view of the steps taken by ICC, it will discontinue the examinations regarding ICC's operations during the period of the previous management.

Most of the relevant trading houses were charged with the cost of the monetary sanctions, in accordance with agreements with them. Notwithstanding, the value of collateral held by ICC does not cover the full amount of the monetary sanctions as assessed above, and a certain, immaterial, exposure might arise in this respect.

ICC acted immediately towards the implementation of a reduction plan in order to comply with the requirements of the international organizations, within the framework of which the following steps were taken:

- ICC International was merged into ICC;
- Organizational changes, within the framework of which the business activity of ICC International was separated from risk management, the ICC's risk management department taking responsibility for risk management at ICC International;
- Discontinuing operations with trading houses having a high rate of cancelled charges, resulting in significant decline in clearing turnover and in the rate of cancelled charges;
- Conducting a renewed underwriting process with trading houses operating in the electronic clearing field by means of an outside company, in accordance with the requirements of the international organizations;

### 33. CREDIT CARD ACTIVITY (CONTINUED)

- Formation of work procedures with respect to clearing operations of international electronic trading transactions;
- The development of advanced monitoring mechanisms for the enforcement of compliance requirements;
- Follow-up and monitoring of the treatment of this matter by a credit committee at ICC.

Furthermore, ICC has adopted measures for compliance with rules of VISA Europe and MasterCard Worldwide, in addition to terminating engagement with a number of trading houses, which caused most of the exposure. Concurrently, ICC's board of directors decided to terminate the clearing of transactions made by trading houses engaged in content areas defined as "adults only".

A number of trading houses and groups have voiced demands with respect to the monetary sanctions imposed upon them and/or the reduction in the international electronic trade clearing operations with them, which as alleged, had caused them heavy damage. The said demands may develop into legal proceedings, within the framework of which ICC may be sued for material amounts.

Adequate provisions, based on the assessments of ICC's management, are included in the financial statements in respect of the various monetary exposures described above.

The trading houses, the engagement with which has been stopped, or in respect of which a decision to stop the engagement with them has been taken, contributed a loss of NIS 8 million in 2010 (this amount includes a loss of NIS 26 million, net of tax, directly stemming from the cessation of engagement), compared to an income of NIS 38 million for 2009 (this amount includes a loss net of tax, of NIS 19 million, resulting from the cessation of the engagement).

Several internal audits conducted at ICC International towards the end of 2009 and in the first quarter of 2010 by the internal auditor of ICC and ICC International, produced findings that indicate deficiencies in various areas, among other things, in the authorization process with respect to ICC's engagement with trading houses regarding the clearing of international electronic trading transactions. The findings indicate deficiencies regarding risk management, improper maintenance of controls and documentation, non-compliance with the rules of the international organizations and the prima facie neglect of duties arising from regulation with respect to money laundering prohibition. ICC has taken various measures to rectify the deficiencies found.

The internal auditor continues to examine various aspects related to the operations of ICC, including improper conduct by organs of ICC and suspicion in respect of various unauthorized engagements.

With the help of outside consultants, ICC's management conducted a process of drawing conclusions as regards the deficiencies found. In March 2010 the Bank's Board of Directors has decided to appoint a prominent lawyer to examine the supervision, control and the manner of taking decisions in ICC and in ICC International, in view of the deficiencies indicated by the internal auditor in his audit reports, as well as drawing conclusions from the said findings and recommending measures to the Board of Directors intended to prevent such events from recurring in the future. In September 2010, the expert submitted his opinion concerning proper corporate and group governance as well as recommendations for improvement of processes in this field. The Bank's Board of Directors has discussed the opinion and its recommendations, and instructed the Board committee on interface with subsidiaries, to discuss the opinion and to issue recommendation on the matter. The expert's recommendations regarding ICC were presented to the ICC Board of Directors in its meeting on November 25, 2010.

**Capital adequacy and corrective measures.** In a letter dated June 16, 2010, the Supervisor of Banks informed the Bank and ICC that following the materialization of risk events of recent months, ICC is requested to take immediate action in order to comply with capital adequacy requirements and to adopt corrective measures, as detailed hereunder:

- Capital adequacy - Attaining a capital ratio of no less than 15% as from the end of 2010;
- Diners Club - Determination of capital targets higher than the minimum capital ratio of 9%;
- Process of drawing conclusions - Complete by September 30, 2010, the process of drawing conclusions, within the framework for which, a reputable lawyer has been appointed;
- Electronic trading clearing - ICC shall not significantly expand operations with trading houses until completion of the formation of an

### 33. CREDIT CARD ACTIVITY (CONTINUED)

underwriting policy consistent with the compliance requirements of the international organizations, and its approval by the authorized organs within the company, and until approval is obtained from the Supervisor of Banks for the termination of reporting on weaknesses in internal control over financial reporting;

- Legal advisory service setup - The establishment by September 30, 2010 of a legal advisory service layout;
- Remuneration - The formation and approval by August 31, 2010, of a remuneration policy consistent with the guidelines of the Supervisor of Banks of April 2009. Until the approval of the policy and completion of the process of drawing conclusions, no bonuses shall be paid to officers of ICC and no remuneration agreements shall be signed with newly appointed officers, including incentive bonuses.

ICC prepared and is preparing to implement in full the Supervisor's requirements.

Changes in the management of ICC. On April 1, 2010, Mr. Israel David began his tenure of office as President & CEO, replacing Mr. Boaz Chechik who retired from office after serving for six and a half years.

On June 24, 2010 ICC's board of directors decided on a number of new appointments to the Management of the company, as a result of which, three members of ICC's Management have been released from office shortly: executive vice president and head of the credit and risk management department, executive vice president serving as the company's CFO and executive vice president head of the marketing and sales department.

In addition, ICC's board of directors decided on the establishment of a legal consulting layout in the company and the appointment of an internal legal counsel. Furthermore, an executive vice president and head of the international operations department has been appointed, who will coordinate the international clearing operations, which in the past was executed by ICC International.

**Significant weaknesses at ICC.** The evaluation performed by the management of ICC regarding the effectiveness of the controls over financial reporting as of December 31, 2009, revealed two significant weaknesses: (1) a significant weakness regarding the control system applying to operations in the field of clearing international electronic trade transactions; (2) a significant weakness regarding the recording of expenses, in particular marketing and advertising expenses.

In view of the improved controls and following examination of their effectiveness, ICC's Board of Directors and Management believe that the material weakness found with respect to the recording of expenses, particularly marketing and advertising expenses, no longer exists as from June 30, 2010.

In view of the improved controls and following examination of effectiveness, ICC's Board of Directors and Management believe that the material weakness in the control layout on the entity level relating to clearing operations of international electronic transactions no longer exists as from December 31, 2010.

**Merger of ICC International with ICC.** On December 22, 2009, ICC decided to transfer the international electronic trading clearing operations from ICC International to ICC. The transfer of these operations will be achieved by way of merger as defined in the Companies Law, 1999. The decision to transfer the said operations had been made within the framework of a comprehensive structural change, in which, among other things, the responsibility for monitoring and control was transferred to the organs responsible for risk management at ICC, with the aim of providing an appropriate response to the compliance demand of the international organizations, and in order to extend the supervision and control over the international electronic trading clearing operations. Consummation of the merger is subject to obtaining all approvals required by the Companies Law and subject to fulfillment of all conditions precedent specified in the merger agreement.

#### B. Holding means of control in Diners

**The establishment of the YOU customer club and the sale of the means of control in Diners.** Pursuant to an agreement dated November 29, 2005, ICC sold Dor-Alon Energy in Israel (1988) Ltd. and Blue Square Israel Ltd. (hereinafter together - "the Purchasers") shares comprising 49% of the issued and paid share capital of Diners Club Israel Ltd. (hereinafter - "Diners"). Concurrently, Diners entered into an

### 33. CREDIT CARD ACTIVITY (CONTINUED)

agreement with the Purchasers for the establishment of a customer club. The transaction was consummated on December 18, 2006.

Within the framework of the agreement, ICC received preference "A" shares that entitle it to receive that part of the profits of Diners attributed to the operations that are not related to the activity of YOU Club, and this until such time that YOU Club reaches a level of operations determined in the agreement. At this stage, the "YOU Club" activity has not reached the level specified in the agreement.

The consideration for the shares has been financed by a loan granted to the Purchasers by ICC. The shares sold are to serve as collateral for the loan, which is to be repaid at different dates over a number of years, during which the Purchasers are entitled to decide on returning the shares to ICC instead of repayment of the loan, and ICC on its part is entitled to demand the return of the shares, all in accordance with the terms stated in the agreement for the sale of the shares and therefore the sale was not recognized in the financial statements.

#### C. Arrangements between the credit card companies and between such companies and the banks

**1) Arrangements between credit card companies.** At the beginning of September 2001, ICC, The First International Bank, Israel Discount Bank, Bank Leumi Le'Israel B.M. and Leumi Card (hereinafter together - "the appellants") filed motions with the Antitrust Tribunal (hereinafter: "the Tribunal") for the approval of a binding arrangement between them, concerning the cross clearing of VISA cards, as well as motions for temporary permits, allowing them to operate in accordance with this arrangement. In the motions, the Tribunal was requested to approve the issuer commission rates, according to a mechanism, which among other things, would bring about a gradual reduction in the higher categories of the issuer's commission.

Over the years, the Tribunal has granted the Appellants provisional and temporary permits for the charging of issuer commissions at agreed rates. Concurrently, the validity of the general exemption has been extended from time to time. The Tribunal proceedings in the case have been divided in two, firstly, determination of the proper methodology for determining the issuer commission, and only afterwards the Tribunal will be required to its implementation.

On August 31, 2006, the Antitrust Tribunal handed down a ruling regarding the methodology for the determination of the Cross Clearing Commission (hereinafter: "the methodology decision"), while adopting the principal points of the Commissioner's position on the matter.

On February 1, 2007, the Appellants filed an appeal with the Supreme Court against the ruling of the Tribunal.

Concurrently with the procedures in Tribunal, negotiations have been conducted between the Commissioner and the credit card companies - ICC, LeumiCard and Isracard - regarding the agreement for the formation of a cross clearing system for VISA cards and MasterCard. In view of the said negotiations, the appellants requested the Commissioner to issue a provisional permit, enabling them to complete the negotiations prior to the expiration of the provisional arrangement between them.

On September 6, 2006, the Commissioner of the Antitrust Authority granted the request, extending the exemption granted to the existing arrangement between the parties until October 31, 2006.

**A tri-party Cross Clearing agreement.** On October 30, 2006, the Commissioner, the credit card companies and the banks owning the credit card companies entered into an agreement for the Cross Clearing of Visa and MasterCard credit cards (hereinafter: "the Agreement"). The agreement came into effect upon the granting of a provisional permit by the Antitrust Tribunal on October 31, 2006, and will expire on July 1, 2013 (hereinafter: "the period of the agreement") unless the Tribunal rules otherwise at a prior date.

The Agreement specifies, among other things, the rates of the Cross Clearing commissions and the structure of the categories of the Cross Clearing commissions applying to the credit card companies during the effective period. The Agreement outlines a gradual decrease in the rates of the Cross Clearing commissions down to a rate of 0.875% starting on July 1, 2012, alongside the reduction in the number of categories over the effective period.

The Agreement specifies general guidelines that, among other things, prohibit the inter-dependence between various types of credit cards being cleared by a trader with each of the credit card companies. The guidelines also prohibit the deterioration in the terms of clearing following a reduction in the number of credit card types being cleared by a particular trader.

### 33. CREDIT CARD ACTIVITY (CONTINUED)

The Agreement specifies further rules that, among other things, do not permit banks that control credit card companies, to link between the services provided to the trader and the terms of engagement with the clearing agent. Further rules prohibit banks from discriminating between customers of a bank holding a credit card issued by that bank and other customers of that bank who do not hold credit cards issued by it.

Within the framework of the agreement, certain provisions were determined according to which, under certain circumstances, the Commissioner would withdraw the declaration of IsraCard as a monopoly with regards to the clearing of IsraCard and MasterCard credit cards, forcing IsraCard to determine under certain circumstances identical commission rates for a trader that clears with it transactions with IsraCard and MasterCard, and an undertaking of the parties to apply to the Tribunal for approval of a cross clearing commission for the period following the termination of the arrangement, in case they would request the continuation of the cross clearing.

The Agreement further provides that until May 30, 2007, a joint interface would be established and operated to enable the three credit card companies to effect the clearing of VISA and MasterCard credit card transactions. The joint interface went into operation in the beginning of June 2007.

Following the signing of the new Agreement, IsraCard joined the local agreement for cross clearing existing between ICC and LeumiCard with respect to the VISA brand. Since June 2007, ICC also started the clearing of MasterCard in accordance with the tri-party cross clearing agreement.

The arrangement has been submitted for approval of the Antitrust Tribunal, and five opposing motions have been submitted to the Tribunal in this respect. On October 31, 2006 the Antitrust Tribunal issued a provisional permit for the agreement.

This permit has been extended by the Tribunal from time to time, most recently until August 15, 2011.

**Appointment of an expert.** According to the methodology ruling, the Tribunal decided that in order to examine whether the tripartite agreement brought for approval is compatible with public interest, an expert is to be appointed to examine the rate of issuer commission, issuer commission categories and the rate of its amortization. The Tribunal has decided that the expert shall perform the examination in accordance with the methodology determined in previous proceedings (see above), the expert being appointed and supervised by the Antitrust Authority. The expert rendered an opinion on January 4, 2009 (within the framework of an interim report). The parties including ICC have, at this stage, waived the interrogation of the expert and the submission of the claim sum-up briefs, and the Tribunal has been asked to instruct the expert to continue his work to the second stage, until submission of his final opinion.

In view of the fact that the expert has been appointed Chairman of the Board of Discount Bank and in accordance with the decisions of the Court dated August 13, and November 1, 2010, the Chief Economist of the Securities Authority ("Chief Economist") has been appointed Expert and has been directed to submit a final opinion by February 15, 2011. The Chief Economist has collected information and data for the purpose of forming his opinion. On December 26, 2010, the Chief Economist presented to ICC the preliminary findings relating to it, and a meeting is to be held in this respect in which ICC will present its comments on the said preliminary findings.

On January 13, 2011, the Court decided, at the request of the appellant in the appeal process, that the final opinion shall be submitted until March 15, 2011. Further to the appointment of the Chief Economist as acting Commissioner, the Court decided on March 1, 2011, that considering the period of time during which the Chief Economist is supposed to serve as acting Commissioner, he shall not deal during this period with the final opinion that he has to submit, and that at the end of three weeks he will provide an updated notice in the matter. To the best of the Bank's knowledge, such updated notice has not as yet been delivered.

**Appeal against the decision on the methodology.** As stated, on February 1, 2007, the Appellants filed an appeal with the Supreme Court against the methodology decision. On December 24, 2009, the Appellants and the Commissioner filed in agreement a motion for granting the compromise agreement on the appeal the power of a Court ruling (hereinafter, respectively, "the motion" and "the compromise agreement"). According to the motion, the Appellants and the Commissioner agree to postpone the hearing of the

### 33. CREDIT CARD ACTIVITY (CONTINUED)

arguments of the Appellants regarding the methodology for determining the cross commission, as this is expressed in the decision on the methodology, until the hearing of an appeal, if submitted, against the first Tribunal ruling given with respect to a cross clearing arrangement, in any proceedings conducted at the Antitrust Tribunal, following the termination of the tripartite arrangement framework. It was further agreed that if, at the end of the day, an appeal is lodged against the methodology decision, the arguments of the parties regarding the methodology would be only those detailed in the appeal.

On December 27, 2009, the Supreme Court ruled that the compromise agreement is to have the power of a Court ruling.

The clearing revenues form a function of the clearing commission charged to traders, the cross commission between the credit card companies and the clearing turnover of ICC. In the opinion of the Bank and ICC, the decrease in the cross commission rate is expected to have an effect on the rates of clearing commissions charged to traders.

- 2) A joint issuance agreement between ICC and FIBI.** On November 20, 2007, a three year agreement for a joint issuance was signed, following which the agreement will be renewed for an additional period of three years, unless either of the parties gives a six month notice of his wish to terminate the engagement. The said agreement replaced a previous agreement of August 1, 2000.
- 3) A joint issuance agreement with Mizrahi-Tefahot Bank.** On November 18, 2008, ICC and Diners signed an agreement with Mizrahi-Tefahot Bank for the joint issuance of VISA, MasterCard and Diners Club credit cards, including Mizrahi-Tefahot branded cards, and for determining operating arrangements and providing services by ICC and/or Diners for credit cards issued by them and distributed by Mizrahi-Tefahot Bank to its customers. This agreement replaces the agreement between the parties dated July 26, 1995, as amended. The agreement is for a period of five years from date of signature. In the event that the option for the purchase of ICC shares described hereunder is exercised or redeemed, the period of the agreement will be extended to ten years from date of signature. The agreement period will be extended by additional periods of two years, unless a notice in writing is given by one party to the other, six months prior to the end of each period or additional period, of its reluctance to further extend the period of the agreement.

**The grant of an option to Mizrahi-Tefahot Bank to purchase up to 10% of ICC's share capital.** Within the framework of the joint issuance agreement described above, Mizrahi-Tefahot Bank was granted an option to purchase from ICC, by way of a share issue, up to 121,978 ordinary shares in ICC, comprising at date of the agreement, 10% of the fully diluted ordinary share capital of ICC. The amount of shares allotted may be higher in the event that prior to the exercise of the option, ICC will issue shares at a price reflecting a value lower than market value, in accordance with the formula determined in the agreement. Furthermore, the number of shares may vary respectively, in the event that ICC decides to carry out a reverse split of its ordinary shares into shares having a higher par value or to split its ordinary shares into shares having a lower par value, or decides to distribute bonus shares, all this from date of signing the agreement and until a date prior to the exercise date of the option.

The option is exercisable in one lot no later than five years from date of the agreement (or, under certain circumstances, during a slightly longer period) at any time after the average monthly amount of credit transactions made by Mizrahi-Tefahot Bank customers reaches the minimum amount stated in the agreement. The number of ordinary shares to be allotted within the framework of the exercise of the option shall be computed according to a formula determined in the agreement, which is effected by the average monthly amount of credit transactions made by Mizrahi-Tefahot Bank customers and to the increase in volume of transactions on the bank credit card market in Israel.

In consideration for the exercise of the option, Mizrahi-Tefahot Bank will pay an exercise price in accordance with a formula determined in the agreement, which reflects ICC's present company value and is effected by the net accumulated earnings of ICC in the last four calendar quarters ending prior to the date of the agreement, less the contribution to the profitability to ICC of the cards issued to customers of Mizrahi-Tefahot Bank, as well as subject to a profit multiplier of 12 and certain additional adjustments.

The option may be converted into a cash payment to Mizrahi-Tefahot Bank, if difficulties arise in the exercise of the option by way of

### 33. CREDIT CARD ACTIVITY (CONTINUED)

allotment of ICC shares, as stated, or if ICC elects to redeem the option in consideration for a payment. Redemption of the option shall be effected by a payment computed according to a formula determined in the agreement, which reflects the future company value of ICC and is subject to the net earnings of ICC (excluding nonrecurring items and capital gains/losses) in the last four calendar quarter ending prior to the date of notice of exercise and a profit multiplier of 12 (or a multiplier derived from the value of ICC on the market, if it is listed for trade prior to the date of exercise of the option, but not higher than a multiplier of 14) and net of the exercise price as stated. The amount to be paid for the redemption of the option shall not exceed an amount of between NIS 85 and NIS 100 million (such maximum amount shall be determined on the basis of the volume of the average monthly amount of credit transactions made by Mizrahi-Tefahot Bank customers in the three calendar months preceding the notice of redemption).

The agreement is subject to all regulatory requirements under any law, if such exist.

#### 4) Agreements with Union Bank

**A joint issue agreement with Union Bank.** On July 1, 2010, ICC and Diners Club signed an agreement with Union Bank of Israel Ltd. (hereinafter - "Union Bank"). The agreement is for a period of ten years and it replaces a previous agreement between the parties, which expired on that date.

Under this agreement, ICC and Diners club will issue credit cards, bank cards and combined cards to customers of Union Bank. The agreement determined operating arrangements and the granting of services by ICC and/or Diners Club for credit cards issued by them and distributed by Union Bank to its customers.

**The granting of an option to Union Bank to purchase 3% of ICC's share capital.** Within the framework of the agreement for a joint issue, as described above, Union Bank has been granted a non-transferable option to purchase from ICC 32,934 ordinary shares of NIS 0.0001 par value each in ICC, comprising at date of the agreement 3% of the issued and paid ordinary share capital of ICC, subject to adjustment events determined in the agreement, and this at date of completion of a public issue of securities of ICC, if such will materialize, and subject to the completion of the issue. The exercise price of the option reflects a discount of 25% on the gross price of the shares as determined in the prospectus for the public offer. ICC, at its own judgment, has the right to exchange the option shares for a one-time payment in an amount equal to the exercise price multiplied by the total number of the option shares as if the option has been fully exercised.

The shares arising from the exercise of the option, if at all, shall not be transferable to a competitor of ICC.

The option is in effect during the period of the agreement, subject to a series of business conditions as determined in the agreement.

The option will come into effect upon obtaining the regulatory approvals required by law, to the extent required. At this stage, the conditions precedent for the option to become effective have not yet been fulfilled.

ICC's decision to issue shares to Union Bank requires the approval of the Bank's Board of Directors

### 34. LEGISLATION INITIATIVES

Several legislation issues exist (laws, regulations and administrative instructions) which are at different stages of the enactment proceedings. Certain of these issues are liable to have an adverse effect on the the Bank's operations and its consolidated subsidiaries and their business results in the future. The Bank is not able to evaluate the scope of such effect.

### 35. EARNINGS PER SHARE

	Consolidated		
	2010	2009	2008
Basic earnings (losses) <sup>(1)</sup> Per share <sup>(1)</sup> of NIS 0.1 (in NIS)			
Net operating income	0.69	*0.95	0.26
Net income (loss) from extraordinary items, net of taxes	0.04	(0.02)	(0.01)
Net income	0.73	0.93	0.25
Weighted average of the number of shares	997,578	*993,979	*993,979

\* Restated in order to reflect the benefit component of the right's issue - see note 13 D.

Footnote:

(1) In computing the earnings per share, stock options to officers of the Bank have not been taken into account due to their antidilutive effect.

### 36. INFORMATION BASED ON NOMINAL DATA - THE BANK

	December 31,	
	2010	2009
	in NIS millions	
<b>Balance Sheet</b>		
Total assets	130,657	130,244
Total liabilities	119,802	120,671
Shareholders' equity	10,855	9,573
	For the Year Ended on December 31	
	2010	2009
	in NIS millions	
<b>Statement of Income</b>		
Net income	760	953

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Tel: 972-3-5145555

### OVERSEAS BRANCH

London, United Kingdom: 65 Curzon Street

### REPRESENTATIVE OFFICES

Paris, France: 33 Rue Galilee  
Buenos Aires, Argentina: Corrientes 447 6°  
Santiago, Chile: Av. Vitacura 2771 Of. 804

### SUBSIDIARY BANKS ABROAD

#### Israel Discount Bank of New York

website: <http://www.idbbank.com>

Main New York Office: 511 Fifth Avenue.

New York Branch: 1350 Broadway

Staten Island, NY Branch:

201 Edward Curry Avenue, Suite 204

Beverly Hills, CA Branch:

9401 Wilshire Boulevard, Suite 600

Downtown Los Angeles, CA Branch:

888 South Figueroa Street, Suite 550

Aventura, FL Branch:

Harbour Centre, 18851 NE 29th Avenue,  
Suite 600

Grand Cayman (B.W.I.) Branch:

P.O.Box 694GT, 11 Dr. Roy's Drive

International Banking Facility:

511 Fifth Avenue, New York

Representative Offices:

Tel Aviv, Israel / Santiago, Chile /

São Paulo, Rio de Janeiro, Brazil /

Lima, Peru / Mexico City, Mexico /

Montevideo, Uruguay

#### Discount Bank Latin America, Uruguay

Montevideo Head Office: Rincon 390

Branches throughout Uruguay

#### IDB (Swiss) Bank Ltd.

Geneva, Switzerland Head Office:

100 Rue du Rhone

Zurich Branch: Talacker 41

Representative Office: Tel Aviv, Israel

### SUBSIDIARIES IN ISRAEL

#### BANKING

Mercantile Discount Bank

Discount Mortgage Bank

#### CAPITAL MARKETS

Israel Discount Capital Markets & Investments

Tachlit Investment House

#### FINANCIAL

Israel Credit Cards

Diners Club Israel

Discount Leasing

Discount Manpikim

#### TRUST SERVICES

Discount Trust

Website: [www.discountbank.co.il](http://www.discountbank.co.il)