

»ISRAEL DISCOUNT BANK ANNUAL REPORT

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ISRAEL DISCOUNT BANK

SUBSIDIARIES AND AFFILIATED COMPANIES

SUBSIDIARIES

DISCOUNT BANCORP, INC.
(A BANKHOLDING COMPANY)

ISRAEL DISCOUNT CAPITAL
MARKETS & INVESTMENTS

ISRAEL DISCOUNT BANK
OF NEW YORK

TACHLIT DISCOUNT - INVESTMENT
COUNSELING & MANAGEMENT

DISCOUNT BANK
LATIN AMERICA

DISCOUNT MANAGEMENT OF
PROVIDENT FUND

MERCANTILE
DISCOUNT BANK

ILANOT DISCOUNT

ISRAEL DISCOUNT BANK
(SWIZERLAND)

ISRAEL CREDIT CARDS
DINERS CLUB ISRAEL

DISCOUNT MORTGAGE BANK

DISCOUNT LEASING

ISRAEL DISCOUNT BANK
TRUST COMPANY

AFFILIATED COMPANIES

THE FIRST INTERNATIONAL
BANK OF ISRAEL

HAREL INSURANCE INVESTMENTS



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BOARD OF DIRECTORS

ARIE MIENTKAVICH | Chairman: the Bank; Discount Bancorp, Inc.; Israel Discount Bank of New York; Mercantile Discount Bank Ltd.; Discount Management of Provident Fund Ltd.; Israel Discount Capital Markets & Investments Ltd.; The Provident Fund of the Staff of Israel Discount Bank Ltd. Director, Harel Insurance Investments Ltd.

PROF. ZVI ADAR | Member of the Faculty of Management, Tel-Aviv University. Head, Health Economics Unit, The Gertner Institute for Epidemiology and Health-Policy Research, SHEBA Medical Center. Member of Board, The Israel National Institute for Health Policy and Health Services Research (NIPH). Member, National Health Council.

GAD ARBEL | Economic Financial Adviser. External Director, Nitsba Holdings 1995 Ltd. Member, Board of Trustees, The College of Management Academic Studies NPRO. Member, The Administrative Committee, The Veteran Pension Funds. Member, Audit Committee, The Israel Management Center.

NISSIM BARUCH | Economics Consultant.

ITTAMAR GIVTON | Managing Director, Automotive Equipment Group. Director, Automotive Equipment Ltd.; Moto Parts Ltd.; Israel Automobile Corporation Ltd.; M.CH.T Autorent Ltd.; Metive Ltd.; Metropolin Public Transport Ltd.; Y.D Vehicles and Transportation Ltd.; Automotive Industries Ltd.; Advanced Vehicles C.R.M Ltd.; Metrodan Be'er Sheva Ltd. Member of Management Committee, Buxenbaum-Neta Fund (private fund).

ELIE GOLDSCHMIDT | Manager & Communications. Consultant & Mediator. Partner and Director, Goldman-Goldschmidt Ltd. Director: A.F.S.K. Industries Ltd. (External Director); Gan Shmuel Foods Ltd. (External Director); Y.A.D. Communications Ltd. Chairman, Am Oved Publishers Ltd. (Vol.).

WILLI ITZHAKI | Attorney at Law and Partner in Law Firm. Director: Assuta Medical Centers Ltd.; Rod Properties & Investments Ltd.; Real Dean Ltd.; D.I.R.I. Trust Ltd.; Moritz & Tuchler Ltd.

YAACOV LIFSHITZ | Lecturer: Ben Gurion University; Academic College Tel-Aviv-Yaffo; College of Management. Director: Elbit Systems Ltd.; Dorgaz Ltd.; KALI-Insurance Agency Ltd.; Spring-Pension Management Ltd.; Carmel Investment Group Ltd.; Tesnet Software Testing Ltd.

YEHUDA MILO | Economics Consultant. Director, Arkal Filtration Systems Ltd.; Arkal Plastic Products Ltd.; Menorah Gaon Investments Ltd.; Menorah Gaon Capital Markets Ltd.; Menorah Gaon Investment House Ltd.; Menorah Gaon Netivei Gemel Ltd.; Menorah Gaon Underwriters & Investments Ltd.; Netivot Pensia Ltd.

DR. ARIE OVADIA | Economics Consultant. University Lecturer. Chairman: The Israel Phoenix Assurance Co. Ltd.; Giron Development & Building Ltd. Director & Vice Chairman, Tadiran Communications Ltd. Director: Elite Industries Ltd.; Participation in Real Estate in Israel Ltd.; Orda Print Industries Ltd.; Israel Petrochemical Industries Ltd.; Carmel Ulpinim Ltd.; Hadar Ltd.; Mehadrin Ltd.

TSIPPI SAMET (External Director) | Chairperson, Investment Committee, Avner-Motor Vehicle Accident Victims Insurance Ltd. Director: Hazera Genetics Ltd.; Mivtahim Pension Funds Ltd.; Mivtahim Provident and Education Funds.

DAVID SCHLACHET | Managing Partner, BIOCOM Management & Investments (2002) Ltd. Director: Harel Capital Markets Ltd.; Poalim Capital Markets & Investments Ltd.; Taya Investments Co. Ltd.; United Studios Ltd.; Pharmos Ltd.; Proseed Venture Capital Fund Ltd.; Compugen Ltd.; Medson Ltd.; Taldor Computer Systems Ltd. (External Director).

TIDA SHAMIR | Attorney at Law and Partner in Tida Shamir Law Firm.

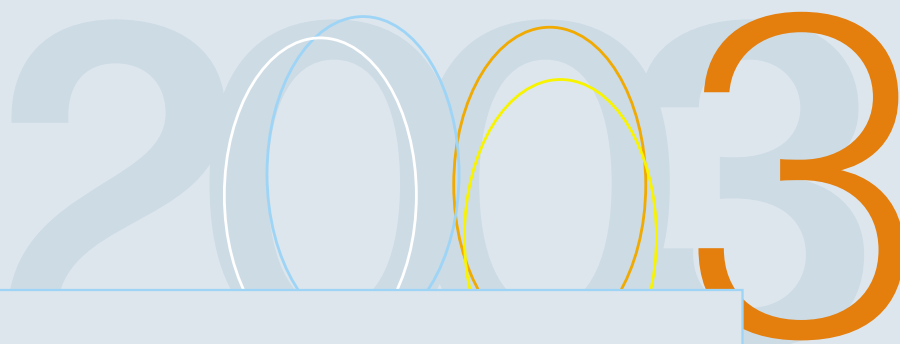
JOSEPH SINGER (External Director) | General Manager, Singer & Even Ltd. Director: Midroog Ltd; Singer & Even Finance Ltd.; Edmond de Rothschild Mutual Funds Management Ltd. (External Director); Midroog Holdings Ltd.; Singer Even & Kraizberg Holdings Ltd.

NOGA YATZIV | Corporate Secretary, The Israel Corporation, Assistant General Manager and Personnel Manager. Director: Israel Chemicals Ltd.; Analyst Exchange & Trading Services Ltd.; Sarel Supplies & Services for Medicine Ltd.; Tel-Aviv-Yafo Economic Development Authority Ltd.; The Tel-Aviv Foundation (Vol.).

MANAGEMENT

GIORA OFFER | President & Chief Executive Officer. **DR. AMNON GOLDSCHMIDT** | Senior Executive Vice President \ Finance Division \ Risk Manager. **REUVEN SPIEGEL** | Senior Executive Vice President \ Banking Division. **RONIT ABRAMSON ROKACH** | Executive Vice President \ Legal Adviser. **NISSIM ALAGEM** | Executive Vice President \ Commercial Banking Division. **LINDA BENSOSHAN** | Executive Vice President \ Asset Management Division. **JOSEPH BERESSI** | Executive Vice President \ Chief Accountant \ Accounting Group. **ISRAEL DAVID** | Executive Vice President \ Marketing & Strategic Planning Division. **NOAM HANEGBI** | Executive Vice President \ Operations & Information Systems Division. **ELI HOTER** | Executive Vice President \ Human Resources Group. **RONY HIZKIYAHU** | Executive Vice President \ Corporate Banking Division.

SHLOMO PITCHON | Senior Executive Vice President \ Internal Auditor. **MICHAEL FOKSCHANER** | Executive Vice President \ London. **RUTH MOSHKOVITZ** | Corporate Secretary.



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REPORT OF THE BOARD OF DIRECTORS TO SHAREHOLDERS

The Board of Directors, on March 29, 2004, approved and authorized for publication the consolidated financial statements of the Bank and its subsidiaries for the year ended December 31, 2003.

MAIN TRENDS IN THE ISRAELI ECONOMY IN 2003 MAIN ECONOMIC DEVELOPMENTS⁽¹⁾

The year 2003 reflects the beginning of the recovery of economic activity – a transition from the economic drawback in the past two years to stabilization and a slow growth. Developments in this year may be explained on the background of several central factors: the economic program and a line of structural reforms in the public sector, the swift termination of the US war against Iraq and the fading of uncertainty, the granting of US guarantees to Israel to the tune of US\$ 9 billion, and the gradual process of reduction in interest on Bank of Israel sources. Concurrent with these factors, the economic activity in 2003 was affected by the continued conflict with the Palestinians, for the third consecutive year.

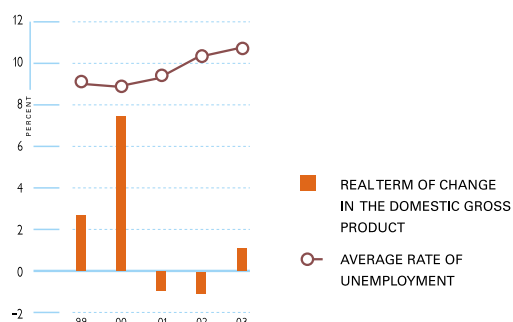
According to preliminary assessments of the Central Bureau of Statistics, the Gross Domestic Product (GDP) increased in 2003 by 1.3%, following a decrease of 0.8% in 2002. A study of the data according to six month periods shows that the rate of growth of the GDP was gradually accelerated during the year: an annual growth rate of 1.2% in the first half of 2003 compared with an annual growth rate of 1.7% in the second half of the year. The population of Israel increased in 2003 by 1.8%, accordingly the per capita GDP decreased by 0.5%, in continuation of the sharp decrease at the rate of 2.8% in 2002. The GDP, excluding start-up companies, increased in 2003 by 1.6%, compared with a standstill last year. The business product also increased by 1.6%, following a decrease of 2.8% in 2002.

The combined “state of the economy” index published by the Bank of Israel, which serves as an indicator of the level of economic activity in real terms, registered in 2003 a moderate decrease at the rate of 0.2%, compared with a sharp drop of 3% in 2002. The developments in this index during the year reflect the gradual recovery in economic activity. In the first quarter of the year, the index dropped at a sharp rate, which slowed down in the second quarter. In the last two quarters of 2003, the index changed direction and for the first time in a long period registered an increase.

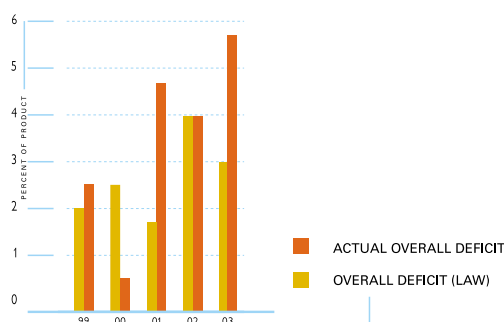
The recovery in the rate of growth this year as opposed to the drawback in the product in the past two years, results mainly from the moderate improvement in the level of demand in the economy: private consumption increased at the rate of 2.0% in 2003, following a standstill in 2002. Notwithstanding, the per capita consumption, which serves as an indication for the standard of living in the country, remained almost unchanged, following a drop of 1.9% in 2002.

(1) The data in this chapter are presented net of seasonal effects, unless otherwise indicated.

GROWTH AND UNEMPLOYMENT DEVELOPMENT IN ISRAEL



GOVERNMENT DEFICIT



The expenditure for current consumption increased in 2003 by 0.3% per capita, following a decrease of 1% in 2002. This increase reflects mainly an increase in expenditure for apparel and footwear. Acquisition per capita of durable goods reflected a decrease at the rate of 1.8%, following a sharp decrease at the rate of 10.5% last year. The export of goods and services increased in 2003 by an admirable rate of 6.2%, following a decrease of 3% in 2002 and a sharp decrease of 11.5% in 2001. The increase in export reflects mainly an increase in industrial exports at the rate of 5.7%, in addition to the significant recovery in the export of tourism services, mainly in the second half of the year. The import of goods and services registered a decrease of 1.8% in continuation of the decrease of 2.3% in 2002.

The import of investment goods (excluding vessels and airplanes) registered a decrease of 4.3% in 2003, in continuation to the decrease of 7% in 2002, while the import of raw materials (excluding diamonds and energy goods), which serves as an indicator for the future activity in the industrial sector, registered an increase of 3.5%. The trade deficit amounted in 2003 to US\$ 6.0 billion, a decrease of 13% compared with 2002. The current account in the balance of payments showed in 2003, for the first time since 1990, a surplus of nearly US\$1 billion, compared with a deficit of US\$ 1.3 billion in 2002.

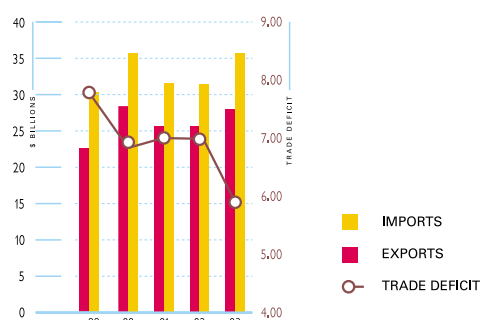
The tourist industry data for 2003 (net of seasonal effects) indicate a significant improvement in activities. The number of entries of foreign tourists amounted to 1.07 million entries, an increase of 23% as compared with 2002. Notwithstanding, this number is still lower by 11% than that of 2001 and by 55% lower than that of 2000. Occupancy in tourist hotels numbered 15 million nights in 2003, of which 78% related to Israeli tourists and the balance related to foreign tourists. The level of occupancy per night during the year by Israelis was an average of 980 thousand per month, a volume lower by 2.2% than that of the corresponding period last year. In comparison, occupancy by tourists was at an average monthly level of 270 thousands nights, an increase of 24% compared to the corresponding period last year.

The data for the real-estate industry continue to indicate a low level of activity, both on the demand side and on the supply side. In the first ten months of 2003, the construction of 24.5 thousand housing units had begun (18.6 thousand units by the private sector and the balance by the public sector) – a decrease of 13% compared with the same period last year. The inventory of new apartments offered for sale by the private sector continues to decrease, reaching the low level of 12 thousand units in November 2003, a decrease of 9% compared with the end of 2002. The recession in the building industry is affected, inter-alia, by the erosion in the available income of the public in the last three years of the recession, which resulted in the sharp decrease in the demand for new apartments, as well as by the sharp drop in the number of new immigrants to Israel, only 23 thousand in 2003, a decrease of 32% compared to 2002.

The average level of unemployment (per the manpower data review) reached in 2003 10.7% of the civilian work force compared with the rate of 10.3% in 2002. The number of foreign workers decreased in the period under review by about 30 thousand, due to stringent measures taken by the Government, compared with an increase in the number of employed Israelis, especially in the building, agriculture and restaurant and hotel sectors. The weakness in the labor market was accompanied by a significant reduction in the nominal wages in most sectors of the economy, at an average rate of 3%.

IMPORTS EXPORTS AND THE TRADE DEFICIT

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ECONOMIC DEVELOPMENTS IN THE PERIOD JANUARY – MARCH 2004

The current monthly indicators as of the beginning of 2004 signify the continued improvement in economic activity. The State of the Economy Combined Index, issued by Bank of Israel, rose also in the first two months of 2004, in continuation to the rise since September of 2003. The positive trend in activity of the economic sectors that characterized the end of 2003, continued also in the first months of 2004, registering fair increases in most sector indices: sales of retail businesses, exports, imports, industrial production, proceeds of the commercial and services sectors and tourist hotel occupancy.

The State budget registered in January – February 2004 a considerable surplus of about NIS 1 billion in the overall activity of the Government, due to a surplus of NIS 1.2 billion in Government activity abroad and a small deficit of NIS 0.2 billion in the domestic activity. The income of the State from taxation reached NIS 25 billion in those months, corresponding with the average rate of income forecast included in the State's budget.

A change of trend in the foreign currency market was registered in January – March 2004. The strengthening of the Israel currency was curbed and the NIS was devalued as against the US dollar by 2.5%. In the first quarter of 2004, activity on the foreign currency market reflected low trading levels, similarly to the last quarter of 2003. The sharp drop in the volume of activity encompassed all active segments of the foreign currency market.

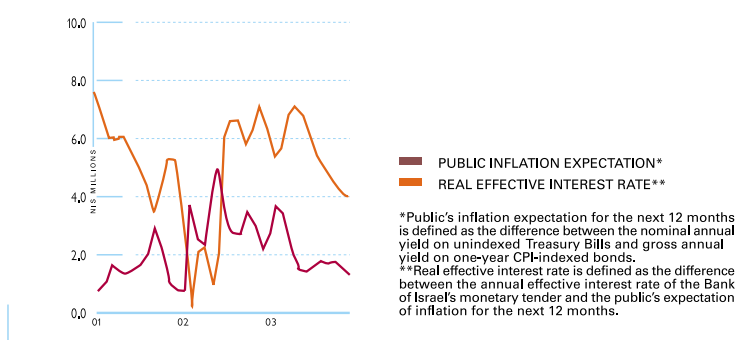
The Consumer Price Index remained unchanged in the first two months of 2004, following a decline of 0.2% in January 2004 and a rise at the same rate in February 2004. Five of the components of the CPI decreased in contrast to five other components that increased. The "basic inflation" (CPI excluding the fruit and vegetable and the housing components) increased in the first two months of 2004 by 0.2%, the wholesale price Index increased by 1.5%, while the construction inputs Index recorded a sharp increase of 2.6%. During February 2004, the Ministry of Finance declared a reduction in purchase taxes and a reduction of 1% in value added tax starting March 1, 2004. Bank of Israel reduced the interest for March 2004 by 0.2% to a level of 4.3%, representing an effective annual rate of 4.4%. As from the beginning of the year, the Bank of Israel interest was reduced by a cumulative rate of 0.9%, however the change in the real-term rate of interest was more moderate due to lower expectations for inflation, and in total the real-term interest rate embedded in Bank of Israel sources declined since the end of 2003 from 4% to about 3.5% in March 2004.

Bank of Israel has recently published several alternatives for identifying a change in economic activity. These alternatives indicate that the recession that prevailed in the Israeli economy since the end of the year 2000 has come to an end towards the year 2003.

PRICE INDICES AND CURRENCY EXCHANGE RATES

The Consumer Price Index (CPI) decreased in 2003 by an exceptional rate of 1.9%, compared with a rise in the CPI of 6.5% in 2002. The Israeli economy has never experienced a negative inflation rate, and only in 2000 a 0% inflation was registered. The changes in inflation were not evenly spread over the year. Prices in the first half of 2003 fell by a relatively moderate rate of 0.5%, while in the second half of the year they dropped sharply by 1.4%. The rate of inflation was lower by 2.9% than the lower limit of the annual inflation target, thus, for the fifth consecutive year a deviation from the inflation target determined by the Government was registered. The decline in the CPI was affected mainly by the significant appreciation of the Shekel against the US dollar during the year

PUBLIC'S INFLATION EXPECTATION* AND REAL EFFECTIVE INTEREST RATE**



and from the recession in real-term activity. The outstanding item in the CPI during 2003 was the housing index, which declined by a cumulative rate of 6.7% and contributed some 75% to the overall decline in the CPI.

The basic inflation (the general CPI net of the housing and fruit and vegetable items), declined in 2003 by 0.6%, compared with the sharp increase at the rate of 6.3% during 2002, and indicated a large production capacity surplus and the continuation of the low level of economic activity.

The industrial output wholesale price index rose in 2003 by 3.3%, compared with a rise of 6.9% in 2002. The housing construction inputs index rose in 2003 by 2.4%, compared with a sharp rise of 6.6% in 2002.

The changes in the exchange rate of the Shekel against the US dollar during 2003 are divided into two main periods: in the first period, from the beginning of the year until the middle of February, the Shekel was devalued by 4% against the dollar. The devaluation was in the main the result of a material change in the evaluations of the risk relating to the Israel economy (an increase in the risk premium), the apprehension regarding the expected deviation from the planned budgetary deficit and the uncertainty regarding the outcome of the war in Iraq as well as the continuing conflict with the Palestinians.

In the second period, from the middle of February until the end of the year, the Shekel appreciated at a sharp rate of 11%. This was the result of several factors: The end of the general elections for the Knesset and the formation of a new Government, the announcement of a new policy for the recovery of the economy and its approval by the Knesset (included therein was the reduction in the budgetary deficit), and concurrently, the approval by the US administration of an aid program for Israel (direct aid of US\$1 billion plus guarantees of US\$9 billion), the economic program and approval of the guarantees combined with the swift and successful termination of the US offensive in Iraq brought about a positive change of trend in the financial markets and a significant reduction in the risk evaluation of the Israeli economy. Foreign residents played a central role in the strengthening of the Shekel in the second period.

During 2003, the Shekel appreciated against the US dollar by a nominal rate of 7.6% (comprising a real-term appreciation of 5.8%), compared with devaluation at a nominal rate of 7.3% (comprising a real-term devaluation of 0.7%) in 2002.

During 2003, the Shekel appreciated against the currency basket by a nominal rate of 1.6% (comprising a real-term devaluation of a moderate rate of 0.3%), compared with devaluation at a nominal rate of 13% (comprising a real-term devaluation of 6.1%) in 2002.

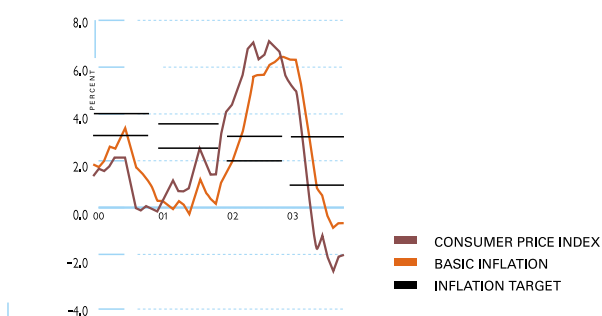
During 2003, the Shekel was devalued against the Euro by a nominal rate of 11.5% (comprising a real-term devaluation at the rate of 13.5%), compared with devaluation at a nominal rate of 27.2% (comprising a real-term devaluation of 19.5%) in 2002.

MONETARY DEVELOPMENTS AND THE MONEY MARKET

The money supply, M1 (cash and current bank accounts held by the public) increased in 2003 by a rate of 7.8%, compared with a rise of 4.9% in 2002. M2 (defined as M1 plus daily and fixed term deposits) increased in 2003 by a rate of 2.5% compared with a decrease of 5% in 2002.

The monetary interest rate of Bank of Israel at December 2003 stood at 5.2% (an effective annual rate of 5.3%), a rate lower by 3.9% than the rate prevailing at the end of 2002. The reductions in the interest rate were

INFLATION AND INFLATION TARGET



accelerated in the second half of the year, in which the interest rate was reduced consecutively every month by 0.4% to 0.5%. The reduction in the interest rate during the year was made possible due to several factors contributing to the decrease in the uncertainty in the economy: the formation of a new Government and the presentation of a new recovery program for the Israeli economy, the approval of guarantees for Israel by the US Administration, the significant decline in the risk evaluation for the Israeli economy, the significant strengthening of the Shekel against the US dollar and the convergence of the inflationary expectations for a range of one year, derived from the capital market, to the multi-annual range targeted by the Government.

The total monetary assets held by the public at the end of 2003 reached NIS 1,388 billion (current data), an increase of 12.5% compared with the end of 2002. The strengthening of the Shekel against the US dollar and the significant decline in inflation contributed, mainly in the second half of the year, to the increase in the non-CPI linked component and in the shares component, mainly on account of the foreign currency linked component. The share of the linked component in the asset portfolio of the public stood at 34% at the end of 2003, compared with 37.5% at the end of 2002, and the share of the foreign currency component decreased to 13.7% compared to 15.9% at the end of 2002. The share of the shares component increased significantly to a level of 19%, compared with 14% at the end of 2002.

The effective average return on the total applications of non-linked Shekel funds at the seven major banks decreased in December 2003 to a level of 7.6% compared with a return of 10.6% recorded in December 2002.

The effective average cost of the total sources of non-linked Shekel funds at the seven major banks decreased in December 2003 to a level of 4.2%, compared with a cost of 7.6% recorded in December 2002.

The financial margin, including management fees, in the non-linked Shekel segment at the seven major banks was at December 2003 3.65%, compared with a level of 4.1% at December 2002.

THE CAPITAL MARKET⁽²⁾

Developments in the capital market in the course of 2003 were affected mainly by the significant decline in risk evaluations for the Israeli economy, on grounds of economic developments, concurrently with the positive trends in the international capital markets.

2003 opened with falling quotations on the stock exchange in continuation to the decline in 2002. However, in the middle of February 2003 the trend took a turn and share prices recorded sharp rises of over 50%, almost consecutively, followed by considerable increases in the volume of trade.

In summing-up the year 2003, the general index of shares and convertibles increased by 55% reaching its highest level, similar to that of September 2000, prior to the breakout of the second "Intiffada".

The "TA 100" index increased in 2003 by 60%, when in the fourth quarter of the year this index increased sharply by 24%. The "TA 25" index recorded an increase of 51%, when in the fourth quarter of the year this index increased sharply by 22%. The "Tel-Tech" index was especially outstanding, recording a sharp rise of 120%, while in the fourth quarter of the year this index increased by 35%.

The average daily volume of trade on the share market, including off-market transactions, totaled in 2003 NIS 332 million, 37% higher than the average daily volume of trade in 2002. A decline in the average daily volume of trade

(2) The data regarding yields and changes in market quotations in this chapter are presented in nominal terms, unless otherwise indicated.

was recorded in the first quarter of the year amounting to only NIS 180 million. However, since then and until the end of the year an increase in the volume of trade took place.

The market value of publicly traded companies amounted at the end of 2003 to NIS 305 billion compared with NIS 199 billion at the end of 2002, an increase of 53%. The number of traded companies decreased at the end of the year to 577 companies, compared with 624 companies at the end of 2002.

The raising of capital (including public offering of shares, offers for sale, private placements and exercise of options) fell significantly in the course of the year to an amount of NIS 3.1 billion, a decline of 50% compared to 2002.

In the derivatives on the "TA 25" index market, the average daily trade volume totaled 119 thousand contracts, similar to the volume of the preceding year. In January and February of 2003 only some 80 thousand contracts were traded daily, while in May a particularly high volume was recorded and an average of 190 thousand contracts were traded daily.

Activity in the trading in dollar derivatives recorded a decline in 2003 compared to 2002, due to the low volatility of the dollar exchange rate during the year, which reduced the attractiveness of investment in such instruments. The average daily volume in 2003 amounted to 35 thousand options, compared with 46 thousand options in 2002. The bond market recorded a lively activity in 2003, reflected in a rise in prices and high volumes of trade. In summing-up 2003, the general bond index recorded a rise of 13.6%. The index of Government and other bonds linked to the CPI increased during 2003 at the rate of 10%. The short-term bonds with a redemption period of up to two years, recorded a fall in prices of 0.5%, while the remaining bonds recorded an increase in prices. Bonds with a period of redemption of between two and five years recorded an increase in prices of 5%, and prices of bonds with a period of redemption of between seven and ten years recorded a rise of 14%. Bonds with a long-term period of redemption of between ten to fifteen years recorded a price increase of 16%.

Prices of Government bonds linked to the US dollar fell during the year by 4.8%, this following a continuous increase in prices over the past six years. The non-linked bond index recorded sharp increases in prices in the course of the year, the "Shachar" bond index rising by 24% and the "Gilon" bond index rising by 14%.

Prices of short-term Government notes (MKM) increased in 2003 by 8.5%, in continuation of the 5.7% increase in 2002.

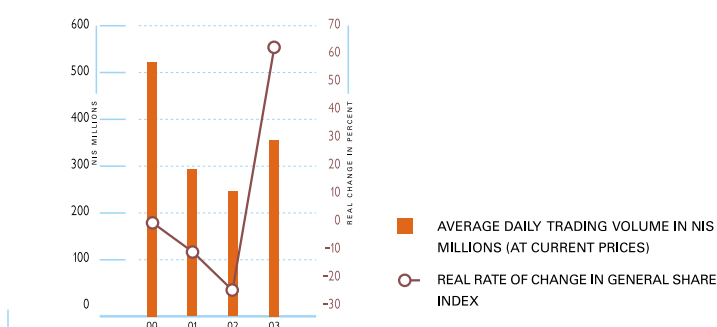
INCOME AND PROFITABILITY⁽³⁾

The Group's Net Income in 2003 totalled NIS 168 million, compared with a loss of NIS 38 million in the preceding year.

According to an instruction of the Supervisor of Banks, the net earnings of the Bank for 2003, are stated net of a provision of NIS 173 million, for impairment in value of the Bank's investment in the First International Bank of Israel Ltd. (see Note 6 to the financial statements for details of the said instruction as well as for details regarding an opinion received by the Bank, and updates thereof, according to which the recoverable value of the

(3) The data presented from this chapter onwards is in adjusted shekels on the basis of the CPI for December 2003. Pursuant to the directive concerning the discontinuation of the adjustment of financial statements to changes in the CPI as from January 1, 2004 see Note 1V to the financial statements.

STOCK MARKET





Kobi Kalmanovitz, Photoportraiture

LISTENING TO CUSTOMERS One of the most efficient ways of listening to customers is to hold a direct meeting with them. These meetings are held at the branches of the Bank, with the participation of branch, regional and Bank Management. The atmosphere is warm and friendly for the benefit of all. Customers are given the opportunity to explain, complain and praise, while the Discount staff has the opportunity of immediate feedback. At a discussion held at the Kiryat Gat branch, among the participants was the CEO of the Bank, Mr. Giora Offer.

| Eli Edri, the Kiriyat Gat branch manager, listening to Benny Gal, a farmer from Sde Moshe settlement |

Bank's investment in the First International Bank is not below the equity value of the investment as of December 31 2002, March 31 2003, June 30 2003, September 30 2003 and December 31 2003, therefore, according to generally accepted accounting principles no provision for impairment in value is required).

Disregarding the said provision, net earnings of the Bank Group for 2003 would have reached NIS 341 million. Were it not for the said provision, the Bank Group would have recorded net earnings also in the first quarter of 2003, and the fourth quarter of the year would have been the sixth consecutive quarter of the Discount Bank Group to present earnings. This following several quarters in which a loss has been recorded. Net earnings for the fourth quarter of 2003 amounted to NIS 101 million.

The income, when not considering the difference between the rise in the "actual" CPI and the rise in the "known" CPI, amounted to NIS 174 million, compared with a loss of NIS 37 million in the preceding year.

Disregarding the provision for impairment in value and disregarding the effect of the CPI differences as discussed above, net earnings for 2003 would have reached NIS 347 million, compared with a loss of NIS 29 million in the preceding year.

The Bank alone had income from ordinary operations after taxes amounting to NIS 148 million in 2003, compared with a loss from ordinary operations after taxes of NIS 365 million in the previous year.

Not considering the effect of the hedge of the investment in the Bank's overseas units and the effect of "actual/known" CPI differentials, the income in 2003 from ordinary operations after taxes amounted to NIS 86 million, compared with a loss of NIS 346 million in the previous year.

Return on shareholders' equity for 2003 was a positive rate of 3.3% compared with a negative rate of 0.7% in the preceding year.

The return on equity, disregarding the provision for impairment in value, would have reached a positive rate of 6.7% in 2003, compared with a negative rate of 0.5% in the preceding year.

The return on equity, disregarding the effect of the difference between the "actual" and the "known" CPI, would have reached a positive rate of 3.4% in 2003, compared with a negative rate of 0.7 % in the preceding year.

Net earnings per NIS 1 par value of the share capital amounted in 2003 to NIS 1.71, compared to a loss of NIS 0.39 in the preceding year.

Net earnings per NIS 1 par value of the share capital computed disregarding the provision for impairment in value, would have amounted in 2003 to NIS 3.48, compared with a loss of NIS 0.31 in the preceding year.

The following are the main factors, having a positive effect on the business results of the Group in 2003, compared with 2002:

- (a) An increase of NIS 154 million in earnings from financing operations before provision for doubtful debts, a rate of 5.8%.
- (b) A decline of NIS 48 million in the provision for doubtful debts, a rate of 5.4% which resulted mainly from the decrease in the provision for doubtful debts at the Bank.
- (c) An increase of NIS 322 million in other operating income, constituting a rate of 18.5%, mainly an increase in operating commissions of NIS 120 million, as a result of an expansion of operations, and a rise of 179 million in earnings of the employees compensation fund of the Bank.
- (d) No current tax expense in the estimated amount of NIS 64 million was recorded by the Bank in 2003, in respect

of current earnings and timing differences, due to carryforward tax losses in respect of which no deferred tax assets had been recorded in the past.

- (e) An income of NIS 43 million was recorded in 2003, in respect of the Bank's share in the profits of the First International Bank, compared with a loss of NIS 17 million in 2002, a difference of NIS 60 million.
- (f) The net cumulative effect as of the beginning of the year of changes in accounting of NIS 10 million (see note 1W).

On the other hand, the following factors offset the said positive effects:

- (a) A provision of NIS 173 million for impairment in value of the investment of the Bank in the First International Bank, in accordance with the instruction of the Supervisor of Banks (see Note 6 to the financial statements).
- (b) Net loss after tax from extraordinary operations of NIS 23 million, compared with net gain of NIS 44 million in 2002.

Effect on income (loss) resulting from the Difference between the Rise in the "actual" CPI and the Rise in the "known" CPI:

	2003	2002
	%	%
Rate of increase (decrease) in the "actual" index	(1.89)	6.50
Rate of increase (decrease) in the "known" index	(1.96)	6.69
Difference	(0.07)	0.19

In accordance with guidelines and a temporary order of the Supervisor of Banks regarding the method of calculating the effect on earnings from financing operations before provision for doubtful debts, on the provision for taxes and on the net income (loss), following is data showing the effect of the aforesaid difference (in NIS millions):

	2003	2002
Reported income (loss)	168	(38)
Effect of the difference on earnings from financing operations before provision for doubtful debts	10	9
Related tax effect*	(5)	(4)
Effect on the tax provision due to adjusting the equity on the basis of the "actual" CPI instead of the "known" CPI	1	(2)
Effect on the Bank's share in operating earnings of equity based investee companies	-	(2)
Total effect of the difference on the net income (loss)	6	1
Income (loss), net of the effect	174	(37)

* Since this is a theoretical calculation requiring inconclusive assumptions, this calculation does not take into account the Bank's decision not to record deferred tax assets in respect of current tax losses in 2002, neither was the utilization of tax losses brought into account in 2003.

Transition to reporting in nominal terms. Accounting Standard No.12 of the Israeli Accounting Standards Institute came into effect in October 2001. This Standard deals with the discontinuation of the adjustment to inflation of financial statements, which should have become effective as from January 1, 2003. In December 2002, the said Institute published Accounting Standard No.17, which postponed the implementation of Standard No.12 for one year. As from January 1, 2004 financial statements will be presented in reported amounts (see details in Note 1V. to the financial statements).

DEVELOPMENTS IN INCOME AND EXPENSES

Income from financing activities before provision for doubtful debts amounted to NIS 3,033 million in 2003, compared with NIS 2,879 million in the preceding year, an increase of 5.3%.

Income from financing activities before provision for doubtful debts was influenced by the following factors:

- (a) An increase of 7.0% in the average outstanding balance of financial assets generating financing income.
- (b) Decrease in the overall financial margin (including the effect of derivative financial instruments), which in 2003 reached a rate of 1.57%, compared with 1.63% in 2002.
- (c) Provision for impairment in value of available-for-sale bonds amounting to NIS 24 million in 2003, compared with NIS 63 million in 2002.
- (d) Realized and non-realized gains on adjustment to fair value of trading bonds, net, amounted to NIS 62 million in 2003, compared with a loss of NIS 67 million in 2002.

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							
2003				2002			
	Volume of activity* in %	Contribution to profit NIS million	in %	Volume of activity* in %	Contribution to profit NIS million	%	Changes in contribution NIS million
Israeli Currency:							
Unlinked shekels	27.8	1,197	39.5	29.1	1,170	40.6	27
CPI-linked shekels	15.4	448	14.8	16.8	307	10.7	141
Foreign Currency	56.8	1,062	35.0	54.1	1,186	41.2	(124)
	100.0	2,707	89.3	100.0	2,663	92.5	44
Options		(49)	(1.6)		(28)	(1.0)	(21)
Other derivative financial instruments (not including hedged derivatives and ALM)		72	2.4		44	1.5	28
Financing commissions		108	3.5		126	4.4	(18)
Other financing income (expenses), net		195	6.4		74	2.6	121
Total		3,033	100.0		2,879	100.0	154

* 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 the Management Review hereunder.

It should be noted that according to instructions of Bank of Israel, as from 2003, the table of financing income and expense ratios is to present the fair value of both parts of transactions in derivative financial instruments (“Gross presentation”) instead of their net set-off (“Net presentation”).

This change in the form of computation resulted in a decrease in the financial margin rate compared with that computed according to the previous form of computation in former periods, particularly in the foreign currency segment, in which the volume of transactions in derivative financial instruments is particularly large. It is clear, that the, as it were, lower ratio of financial margin relates to a much wider base of transactions, which include both the derivatives and the assets.

The comparative figures for the financial income and expense ratios, presented in the Management Review, have been restated in accordance with the new form of presentation.

Effect of Non Performing Debts. One of the factors that considerably affected the income from financing activities was the volume of non-performing debts. The balance of such debts, as at December 31, 2003, was NIS 2.9 billion, similar to that of the preceding year. (The average rate of return on credit in the different linkage segments in 2003 is between -0.41% and 12.12%).

BELOW ARE PARTICULARS ON NET INTEREST INCOME ACCORDING TO LINKAGE SEGMENTS (INCLUDING ALM):

In the non-linked shekel segment, net interest income totalled NIS 1,197 million in 2003, compared with NIS 1,170 million in the preceding year, an increase of 2.3%. Income from this segment constituted 39.5% of total net interest income in 2003, compared with 40.6% in the preceding year.

In 2003, assets exceeded liabilities in this segment by NIS 713 million, compared with 2002, where assets exceeded liabilities by NIS 523 million, contributing to the increase in earnings from financing operations in this segment.

The average balance of assets in this segment decreased in 2003 by 1.8% compared with the preceding year.

In 2003 the interest margin reached 2.45% compared with 2.57% in the previous year.

In the CPI-linked shekel segment, net interest income totalled NIS 448 million in 2003, compared with NIS 307 million in the preceding year, a rise of 45.9%. Its proportion of total net interest income in 2003 was 14.8%, compared with 10.7% in the previous year.

The average asset balance in this segment in 2003, fell by 1.6% compared with the preceding year.

The interest margin in 2003 reached the rate of 1.35%, compared with a rate of 0.73% in the preceding year.

In the foreign currency segment, which includes activities in the foreign currency-linked shekel segment, net interest income amounted to NIS 1,062 million in 2003, compared with NIS 1,186 million in the preceding year, a decline of 10.5%. Its proportion of all net interest income was 35.0% in 2003, compared with 41.2% in the preceding year.

In 2003, the average balance of assets in this segment increased by 12.1% compared with the preceding year.

The interest margin in this segment in 2003 was 1.13%, compared with 1.37% in the preceding year.

Other net financing income totalled NIS 303 million in 2003, compared with NIS 200 million in the preceding year. The increase derives mainly from realized and unrealized gains and from adjustments to fair value of trading bonds, net, in the amount of NIS 76 million.

Total interest margin in 2003 was 1.29%, compared with 1.45% in the preceding year (including the effect of hedge transactions). The interest margin, including the effect of other derivatives (in hedge transactions and ALM), reached a rate of 1.57% in 2003, compared with a rate of 1.63% in the preceding year.

Provision for doubtful debts totalled NIS 848 million in 2003, compared with a provision of NIS 896 million in the preceding year, a decrease of 5.4%. In 2003, the provision constituted 27.8% of the income from financing activities before provision for doubtful debts, compared with 31.1% of this income in the preceding year.

The decrease derives from the decline in the specific provisions for doubtful debts of the Bank, mainly relating to the trading sector.

On the other hand, an increase was recorded in the provision for doubtful debts in the construction and real estate sector and in the various industrial sectors at the Bank.

The annual provision for doubtful debts, as a ratio of credit to the public, not including off-balance sheet credit risk, was 1.04% in 2003 (0.70% - including off-balance sheet credit risk), compared with 1.11% (0.70% - including off-balance sheet credit risk) in 2002.

The balance of the provision for doubtful debts, which includes the specific provision, the general provision, the supplemental provision and the special provision, but not including provision for off-balance sheet credit risk, totalled NIS 5,040 million in 2003 (NIS 5,177 million - including provision for off-balance sheet credit risk). The balance of this provision constitutes 6.19% of the credit to the public (4.26% - including off-balance sheet credit risk), compared with a balance of the provision in the amount of NIS 4,418 million, not including provision for off-balance sheet credit risk (NIS 4,536 million - including provision off-balance sheet credit risk), constituting 5.61% of the credit to the public (3.63% - including off-balance sheet credit risk) at the end of the preceding year. The specific provision for doubtful debts amounted to NIS 844 million in 2003, compared with NIS 854 million in the preceding year, a decrease of 1.2%.

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.

The main part of the expense recorded by the Bank (in Israel) for the specific provision for doubtful debts in 2003 relates to the following industries: construction, real estate industries 35.4% in 2003, compared with 13.6% in 2002; hotel industry 5.2% in 2003, compared with 8.6% in 2002; communications and computer services 20.8% in 2003, compared with 29.4% in 2002; commercial branches 6.4% of total provision, compared with 30.1% in 2002; various industrial sectors 21.1% in 2003, compared with 11.2% in 2002.

The Bank's specific provision (in Israel) for major sectors - The Bank's specific provision for the construction and real estate sector, as a ratio of credit to the public in this sector was 1.7% in 2003, compared with 0.8% in 2002.

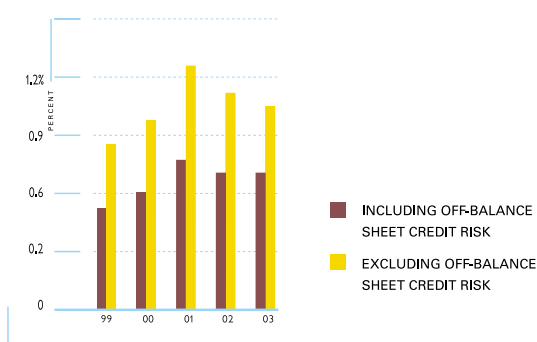
The Bank's specific provision for the hotel sector, as a ratio of credit to the public in this sector, was 1.1% in 2003, compared with 2.3% in 2002.

The Bank's specific provision for the commercial sectors, was 0.7% in 2003, compared with 3.8% in 2002.

The Bank's specific provision for the various industrial sectors, was 1.3% in 2003, compared with 0.8% in 2002.

The Bank's specific provision for the communications and computer services, was 2.8% in 2003, compared with 4.8% in 2002.

RATIO OF ANNUAL PROVISION FOR DOUBTFUL DEBTS TO TOTAL CREDIT TO THE PUBLIC



The specific provision in the Bank, in respect of all other economic sectors, as a ratio of the credit granted to such sectors, was 0.4% in 2003, compared with 0.3% in 2002.

The supplemental provision for doubtful debts of the Bank and the banking subsidiaries in Israel in 2003 totalled NIS 41 million, compared with a supplemental provision of NIS 65 million in the previous year.

The total of the said amount included, in 2003, an additional provision in respect of prior years, in the amount of NIS 13 million, compared with NIS 28 millions in 2002.

The supplemental provision for doubtful debts. The supplemental provision for doubtful debts is based on the quality of the credit portfolio in accordance with risk characteristics, as determined by the directives for proper banking procedures. In respect of these risk characteristics, the initial directive determined annual provision rates and final targeted rates for each of the risk characteristics.

In February 2002, the said directive was amended. The annual provision rates were abolished, and it was determined, effective immediately, that banks have to reach the final target of the supplemental provision with respect to problem debts in the same quarter in which a debt has been classified as problematic.

The Bank had implemented this amendment with respect to debts classified as problematic in the last quarter of 2001, and thereafter. As to the required final target of the balance of the provision relating to debts so classified up to September 30, 2001, which amounts to NIS 31 million as of December 31, 2003, the Bank obtained the approval of the Supervisor of Banks to accrue it up to 2005. Mercantile Discount Bank and Discount Mortgage Bank obtained the approval of the Supervisor to record the said provision over five consecutive quarters ending on December 31, 2002.

Directive regarding a certain loan. The Bank and Mercantile Discount Bank have granted a loan as part of a Consortium of banks. As the borrower did not abide by the terms of the loan and did not settle the periodic interest payments, The Court, at the request of the Consortium, appointed a Receiver to realize shares of "Bezeq" pledged as collateral for the loan.

At June 30, 2003, the market value of the proportionate share of the Bank and Mercantile Discount Bank in the said collateral exceeded the outstanding balance of the loan, net of existing provisions as of that date.

On July 10, 2003, the Supervisor of Banks directed that in view of the financial position of the borrower and the terms of the loan, the outstanding balance thereof should no longer be considered as credit granted.

Accordingly, the Supervisor of Banks issued on July 15, 2003, a guideline stating that the balance of the said loan as of June 30, 2003, should be treated as an "investment in shares" classified as "available-for-sale securities", based on the market value of the proportionate share of the Bank and Mercantile Discount Bank in the said collateral.

In accordance with the said guideline, the supplementary provision recorded up to June 30, 2003, in respect of this problematic loan, which until then was classified as a non-performing loan, was not cancelled and is stated in the item "Other liabilities".

The Bank and Mercantile Bank have made the classification according to the guideline, based on the market value of their share in the collateral as of June 30, 2003, which amounted to NIS 324 million. As from that date, changes in market value are taken to the capital reserve in respect of the presentation of available-for-sale securities at fair value. The excess of the market value of the collateral at December 31, 2003, over the outstanding balance of the loan (net of specific provisions) in the amount of NIS 7 million, has been taken to the capital reserve, as stated.

It should be noted, that consistent with the said guideline, the Bank has also been instructed to classify the said balance as part of the non-monetary investments of the Bank.

Spreading of the provision in respect of a certain loan. In August 2003, the Supervisor of Banks informed the Bank that in his opinion, in view of the range of possibilities existing in respect of the operations of a certain customer, who is facing financial difficulties for some time, and in view of the uncertainty regarding the arrangements which will be reached at the end of the day, that it is required to match the provision for doubtful debts to the updated assessments of the loan loss, which take into account circumstances, as considered by Bank of Israel.

The Supervisor instructed the Bank to provide for the full extent of the credit exposure regarding the loan of that borrower, as assessed by him. Notwithstanding, in view of the uncertainties, which are expected to be resolved within the next few months, the Supervisor agreed to create the required provision in equal parts over a period of up to three quarters ending at the end of 2003.

Subsequent to balance sheet date, in the light of positive developments in the field in which the borrower operates, the Supervisor of Banks suspended the request to create in the fourth quarter of 2003, a provision of NIS 60 million. The need for adjustment of the provision will be examined in the first quarter of 2004, in view of the developments in the field in which the borrower operates.

Income from financing activities after provision for doubtful debts amounted to NIS 2,185 million in 2003, compared with NIS 1,983 million in the preceding year, an increase of 10.2%.

Non-financing income in 2003 amounted to NIS 2,062 million, compared with NIS 1,740 million in the preceding year, an increase of 18.5%.

Commissions totalled NIS 1,628 million in 2003, compared with NIS 1,508 million in the preceding year, an increase of 8.0%. The increase results, mainly, from income from credit cards, income from securities transactions, handling of credit and drafting of contracts and payment order system services, which result from the expansion of activity by Bank customers.

The Group's income from credit card activity derives from both operating and financing activities.

Income from credit card operating activities amounted to NIS 465 million in 2003, compared with NIS 434 million in 2002, an increase of 7.1%. Interest income on credit to customers via credit cards amounted to NIS 74 million in 2003, compared with NIS 16 million in 2002. The increase derives from an increase of income received and from the increment deriving from negative erosion in the outstanding credit granted to credit card customers, as a result of the negative inflation rate during 2003, compared with a positive inflation rate in the course of 2002. Gains on investment in shares amounted to a loss NIS 9 million in 2003, compared with a loss of NIS 11 million in 2002. The gains (losses) in 2003 and in 2002 include dividend income of NIS 6 million and NIS 4 million respectively, received on shares of Israel Credit Cards Ltd. designated for sale.

Other income in 2003 totalled NIS 425 million, compared with NIS 243 million in the preceding year, an increase of 74.9%. This increase derives mainly from a decline in profits of severance pay funds, which amounted to NIS 179 million in 2003.

Following are the main components comprising non-financing income:

	2003	2002	2001
	%	%	%
Revenue from management fees	13.1	15.1	12.7
Payment order system services	19.4	21.6	20.1
Revenue from credit cards	22.7	24.8	27.1
Revenue from capital market activities	18.5	20.1	17.6
Profits of the severance pay fund	8.7	-	5.3
Computerized services, information and confirmations	2.1	2.3	2.4
Foreign trade activity	3.0	3.0	2.6
Margins and collection fees on loans out of deposits refundable according to collection	1.0	1.3	1.2
Other	11.5	11.8	11.0
Total	100.0	100.0	100.0

Non-financing expenses totalled NIS 3,564 million in 2003, similarly to last year.

Salaries and related expenses (including expenses for encouraging early retirement) amounted to NIS 2,241 million in 2003, compared with NIS 2,183 in the preceding year, an increase of 2.7%.

Salaries and related expenses (excluding expenses in respect of encouraging early retirement) amounted to NIS 2,161 million in 2003, compared with NIS 2,128 million in 2002, an increase of 1.6%.

In 2003, the Bank continued encouraging early retirement of employees, while directing it towards employee populations with defined characteristics, where focused efforts are being made to encourage early retirement at beneficial terms. The financial statements for 2003, include an expense of NIS 80 million in respect of early retirement (2002: NIS 55 million).

Salary and related expenses in the Bank alone (including expenses for encouraging early retirement) amounted to NIS 1,433 million in 2003, compared with NIS 1,391 million in the preceding year, an increase of 3.0%.

Disregarding expenses relating to the encouragement of early retirement, the increase in payroll expenses and related benefits in the Bank, would have been 1.3%.

The increase in payroll expenses at the Bank derives from an increase in the salary tax expense. In 2003 the salary tax expense was included in the payroll and related expenses item, while in 2002 such expenses were not included due to the Bank's loss for profit tax purposes in that year. Excluding the effect of the salary tax expense, the Bank would have been recorded a decrease in payroll and related expenses, excluding the expense relating to the encouragement of early retirement, of 4.9%.

Salary expenses, excluding related expenses, in the Bank alone, amounted to NIS 912 million in 2003, compared with NIS 918 million in the preceding year, a decrease of 0.7%.

Salary related expenses in the Bank alone, amounted in 2003 to NIS 441 million, compared with NIS 418 million in 2002, an increase of 5.5%.

See the section on “Human Resources” below, for details of employee retirement in 2000-2003.

Depreciation and maintenance of building and equipment totalled NIS 635 million in 2003, compared with NIS 596 million in the previous year, a rise of 6.5%. The increase resulted mainly from the increase in computer depreciation expenses.

Other expenses totalled NIS 688 million in 2003, compared with NIS 785 million in the preceding year, a decrease of 12.4%, mainly in consolidated companies of the Bank.

The ratio of non-financing income to non-financing expenses was 57.9% in 2003, compared with 48.8% in the preceding year.

Operating income before taxes totalled NIS 683 million in 2003, compared with NIS 159 million in the preceding year, an increase of 329.6%.

Provision for taxes on operating income totalled NIS 386 million in 2003, compared with NIS 207 million in the preceding year. The provision for taxes in 2002 includes the cancellation of excess provisions for income tax recorded in prior years on a conservative basis, in the amount of NIS 51 million, following the settlement of tax assessment for the respective years.

Due to carryforward tax losses, in respect of which no deferred tax assets were recorded in the past, the Bank did not record in 2003 a current tax expense in an estimated sum of NIS 64 million in respect of current earnings and timing differences, compared with the non-recording in 2002 of deferred tax assets of NIS 211 million in respect of current tax losses and net timing differences. (For details concerning the balance of tax losses and deductions carried forward as well as net timing differences in respect of which no deferred tax assets have been recorded, see Note 29D. to the financial statements).

Operating income after taxes totalled NIS 297 million in 2003, compared with a loss of NIS 48 million in the preceding year.

The Bank's share in operating income of affiliated companies after taxes totalled in NIS 117 million in 2003, compared with a loss of NIS 1 million in the preceding year.

Net operating Income totalled NIS 354 million in 2003, compared with a loss of NIS 74 million in the preceding year.

The ratio of operating income before taxes to shareholders' equity, including minority interest, was 16.1% in 2003, compared with a ratio of 3.4% in the preceding year.

The ratio of operating income after taxes to shareholders' equity, including minority interest, was 7.0% in 2003, compared with a negative ratio of 1.0% the preceding year.

The net loss on extraordinary items after tax amounted to NIS 196 million, of which an amount of NIS 173 million resulted from the provision from impairment in value of the investment in the First International Bank, made in accordance with instructions of the Supervisor of Banks. In the preceding year, a gain on extraordinary items was recorded in the amount of NIS 36 million.

The net cumulative effect as of the beginning of the year of changes in accounting method amounted in 2003 to NIS 10 million. This cumulative effect includes the cumulative effect as of the beginning of the year of the implementation of the instructions of the Supervisor of Bank with respect to financial instruments and hedge transactions, which increased earnings by NIS 27 million (see Note 1W1 to the financial statements) and on the other hand the cumulative effect as of the beginning of the year of the change in accounting according to a

directive of the Supervisor of Banks to Discount Israel Capital Markets and Investments Ltd., which reduced earnings by NIS 17 million (see Note 1W2 to the Financial statements).

Net Income in 2003 amounted to NIS 168 million, compared with a loss of NIS 38 million in the preceding year.

Return on shareholders' equity was a rate of 3.3% in 2003, compared with a negative rate of 0.7% in the preceding year.

The return on equity, disregarding the provision for impairment in value, would have reached a positive rate of 6.3% in 2003, compared with a negative rate of 0.5% in the preceding year.

The return on equity, disregarding the effect of the difference between the "actual" and the "known" CPI, would have reached a positive rate of 3.4% in 2003, compared with a negative rate of 0.7% in the preceding year.

Net earnings per NIS 1 par value of the share capital amounted in 2003 to NIS 1.71, compared to a loss of NIS 0.39 in the preceding year.

Net earnings per NIS 1 par value of the share capital computed disregarding the provision for impairment in value, would have amounted in 2003 to NIS 3.48, compared to a loss of NIS 0.31 in the preceding year.

DEVELOPMENT OF ASSETS AND LIABILITIES

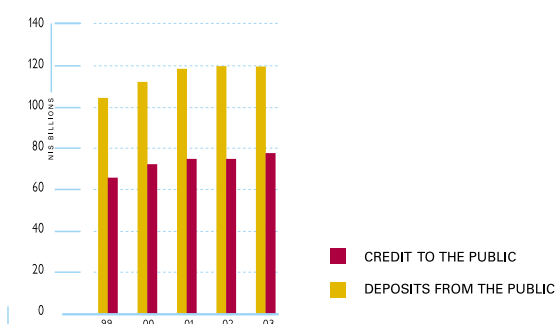
Total assets as at December 31, 2003 amounted to NIS 139,682 million, compared with NIS 137,274 million at the end of the preceding year, an increase of 1.8%.

Following are the developments in the principal balance sheet items:

Following are the developments in the principal balance sheet items:			
	December 31,		Rate of change in %
	2003	2002	
	(in NIS millions)		
Assets			
Cash and deposits with banks	16,888	18,878	(10.5)
Securities	38,774	36,581	6.0
Credit granted to the public	76,382	74,334	2.8
Credit granted to governments	367	552	(33.5)
Liabilities			
Deposits from the public	119,924	119,734	0.2
Deposits from banks	5,097	4,051	25.8
Debentures and subordinated capital notes	4,223	3,787	11.5
Shareholder's equity	5,969	5,064	17.9

Credit granted to the public as at December 31, 2003, totalled NIS 76,382 million, compared with NIS 74,334 million on December 31, 2002, an increase of 2.8%. The ratio of credit granted to the public to total assets reached 54.7% at the end of 2003, compared with 54.2% at the end of 2002.

CREDIT TO THE PUBLIC AND DEPOSITS FROM THE PUBLIC



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

	December 31, 2003		December 31, 2002		
	in NIS millions	% of total credit to public	in NIS millions	% of total credit to public	Rate of changes in %
Non-linked shekels	25,750	35.0	24,564	33.1	8.9
CPI-linked shekels	18,840	24.7	19,857	26.7	(5.1)
Foreign currency and foreign currency-linked shekels	30,792	40.3	29,913	40.2	2.9
Total	76,382	100.0	74,334	100.0	2.8

Credit in the foreign currency and foreign currency-linked shekel segment increased by 2.9%, representing an increase of US \$595 million from December 31, 2002.

Following are data as to the overall credit risk at the responsibility the Group as regards problematic borrowers⁽¹⁾ net of provision for doubtful debts (in NIS millions):

	December 31	
	2003	2002
Non-performing debts ⁽²⁾	2,872	2,925
Reorganised debts ⁽³⁾	556	539
Debts due for reorganization ⁽⁴⁾	39	80
Debts temporarily in arrears	644	714
Debts under special supervision ⁽⁵⁾	4,850	4,932
Total balance sheet credit to borrowers	8,961	9,190
Off-balance sheet credit risk regarding problematic borrowers ⁽⁶⁾	531	580
Debentures of problematic borrowers	1	31
Total overall credit risk concerning problematic borrowers	9,493	9,801
Assets received with respect to the settlement of loans	2	35

(1) Not including problem debts regarding which the collateral received is available for set-off with respect to the limitations on indebtedness of a single borrower or of a group of borrowers (Proper Banking Procedures No. 313).

(2) See Note 3D. as regards the classification as from June 30, 2003, of a debt of a certain customer as "Investment in securities" under the item "Available-for-sale securities", as instructed by the Supervisor of Banks.

(3) Credit reorganised during the current year as well as credit reorganized in prior years with waiver of income.

(4) Credit to borrowers, which per Management decision is to be reorganized, but which reorganization has not yet been implemented.

(5) Of which: debts of NIS 1,600 million, presented net of specific provision made thereof, and housing loans of NIS 207 million, in respect of which a provision according to the period of default exists (December 31, 2002: NIS 1,835 million and NIS 155 million, respectively).

(6) 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.

Most of the increase in credit risk, including problematic debt risk, relates to the hotel industry, the communications and computer services industry and to the manufacturing industry, and was partly off-set by the decrease relating to other industries.

A draft of an instruction regarding the “Measurement and disclosure of problematic debts and provision for doubtful debts in financial statements of banking corporations”. On February 11, 2004, the Supervisor of Banks delivered to the banks a preliminary draft of an instruction regarding the “Measurement and disclosure of problematic debts and provision for doubtful debts in financial statements of banking corporations”.

The principal subject of this instruction, which is intended to replace the existing instruction, is the adjustment of the set of terms and definitions customary in Israel to those accepted by the banking industry in the world, and in particular in the United States, as well as to the recommendations of the Basle International Committee on Supervision of Banks.

Banking corporations were requested to submit to the Supervisor, within two months, their comments on the draft instruction, which had been distributed, and to include preliminary assessments of the quantitative effects, if any, of the adoption of the draft instruction.

Inter-alia, the draft instruction addresses the following issues:

- The provision for doubtful debts regarding large debts will be based on the discounted value of future cash flows expected to be derived from such debts or, under certain circumstances, on the basis of the market value of the collateral at hand
- In respect of each delinquent debt (as defined in the draft instruction) the banking corporation would be entitled to recognize income only in respect of actual cash collected.
- The provision for doubtful debts in respect of consumer debts will be based on group risk coefficients in accordance with borrower characteristics.

Following receipt of the draft instruction the Bank has begun to study and analyze it, including attempts to assess its effect upon the Bank.

The preliminary draft presents a completely new model for the definition and measurement of problematic debts, which raises questions of interpretation and implementation, and many more questions will probably emerge in the process of incorporating the provisions of the new instruction into the process of treatment of problematic debts at the Bank.

These questions will probably require on the one hand, clarifications and further guidelines by the Supervisor of Banks, and on the other hand, internal processes of policy determination, both as to interpretation and implementation. Furthermore, the change of model might affect also the rules of the game and the conduct as regards the relations between the Bank and its customers, such as, possible changes in respect to customers exceeding their credit line in current and revolving loan accounts.

In addition, the existing information and measurement systems are based upon the existing model, which, as stated, is very different from the proposed model, and therefore are not able, at this stage, to provide the relevant information necessary to assess the effects of the implementation of the new model.

In view of the above, it is not possible, at this stage, to evaluate the effect of the implementation of the new model on the volume of problematic debts of the Bank and on the volume of the doubtful debt expense. Nonetheless, it is already clear that the implementation of the new instruction will increase the volume of debts,

in respect of which interest income would not be currently recognized but only upon actual collection, this as a result of their definition as delinquent debts. This relates, inter-alia, to debts defined at present as partly doubtful but income bearing, and to debts defined at present as temporarily in arrears.

The following is a review of the development of credit to the public by economic sectors:

Balance sheet credit risk for the construction and real estate sector totalled NIS 15.7 billion as at December 31, 2003, compared with NIS 14.5 billion on December 31, 2002, an increase of 8.3%, which constituted about 19.5% of the total balance sheet credit risk to the public, compared with 18.3% on December 31, 2002. Off-balance sheet credit risk for the construction and real estate sector (mostly sales guarantees and non-utilized credit lines) amounted to NIS 6.5 billion as at December 31, 2003, compared with NIS 7.4 billion on December 31, 2002, and it constituted 16.3% of the off-balance sheet credit risk, compared with 17.8% as at December 31, 2002.

Off-balance sheet credit risk for this sector, as at December 31, 2002, includes NIS 2.4 billion in respect of non-utilized credit lines.

Total credit risk for the construction and real estate sector constituted 18.4% of the total credit risk to the public as at December 31, 2003, compared with 18.1% on December 31, 2002.

Total credit risk for the industrial sectors totalled NIS 21.2 billion as at December 31, 2003, and it constituted 17.6% of the total credit risk to the public under the Group's responsibility, compared with 18.9% as at December 31, 2002. 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, 2003 totalled NIS 3.3 billion, compared with NIS 2.3 billion as at December 2002.

It should be noted, that the agreement with another bank, for the participation in the risk relating to the diamond industry, according to which the Bank has provided indemnification at the rate of 35% of the credit to this industry granted by that other bank, up to a limit of US \$325 million, and which was signed in November 1993, terminated on December 31, 2002.

Total credit risk for the commercial sector amounted to NIS 14.3 billion as at December 31, 2003, constituting 11.9% of the total credit risk to the public, compared with 11.8% the preceding year.

Total credit risk to individuals was NIS 27.6 billion as at December 31, 2003, constituting 23.0% of the total credit risk to the public, as compared with 21.5% as at December 31, 2002.

The following is a review of developments in credit to the public, including off-balance sheet credit risk by borrower size:

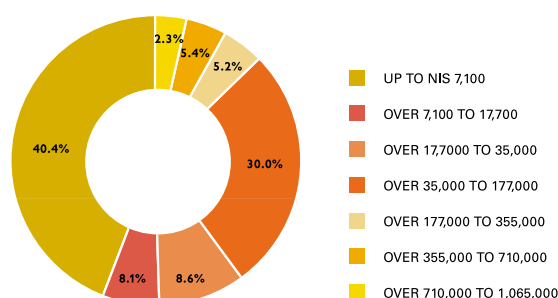
Approximately 99% of borrowers were granted credit of less than NIS 1.06 million. Credit to this group constituted 28.7% of total credit to the public as at December 31, 2003, compared with 28.2% as at December 31, 2002.

The credit bracket between NIS 1.06 million and NIS 177 million constitutes about 58.4% of all credit as at December 31, 2003, compared with 57.6% as at December 31, 2002.

The 41 largest borrowers, in the credit bracket between NIS 177 million and NIS 1,160 million, were granted credit constituting 12.9% of total credit as at December 31, 2003, compared with 43 borrowers that were granted credit constituting 14.2% of the total credit as at December 31, 2002.

CREDIT TO THE PUBLIC BY SIZE OF INDEBTNESS OF BORROWER

AS OF DECEMBER 31, 2003



Amendment of the instruction relating to limitations on indebtedness of a single borrower and of a group of borrowers. On August 20, 2003, the Supervisor of Banks issued an amendment to Proper Banking Procedure No. 313, dealing with the indebtedness of a single borrower and of a group of borrowers.

In the preamble to the instructions, the Supervisor of Banks indicated that one of the causes for credit risk relating to banking corporations is the concentration of the credit portfolio, following which limitations have been determined regarding the indebtedness of a single borrower and of a group of borrowers. The limitations set out in the instructions are to be regarded as minimal principles, while each bank has to consider and determine for its own purposes additional limitations as required. The Board of Directors of the bank, within the framework of its credit policy, has to define parameters by which the existence of significant relations between borrowers will be determined.

The main amendment in this instruction expands the term “control” to include also a controlling party in a corporation, if he owns the largest share in any of the means of control, or if there is no one other party who owns any means of control of any class at a rate that exceeds the rate of his ownership in that class of means of control.

Another principal amendment is the significant expansion of the definition “group of borrowers”:

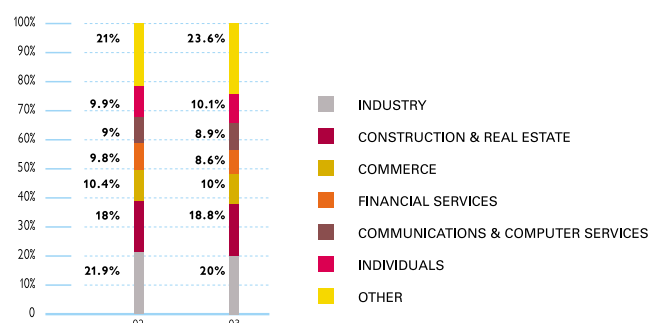
1. The borrower, whoever controls him, and whoever is controlled by them; where a corporation is being controlled by more than one person, the single group of borrowers is to include those controlling parties for whom the controlled corporation is significant (e.g., as to capital), including the controlled corporation and whoever is controlled by them.
2. Where a corporation is owned by more than one person, the single group of borrowers is to include also an owner who has no control but for whom the owned corporation is significant (e.g., as to capital), including the controlled corporation and whomever they control.
3. Borrowers being related in a way where impairment in the financial stability of one of them may affect the financial stability of the other, or where the same factors may affect the financial stability of both of them. Such a relationship exists, inter-alia, in the following cases:
 - a. Borrowers where at least one of them granted a substantial credit to the other borrower or purchased a substantial amount of his debentures;
 - b. Borrowers where at least one of them has guaranteed a substantial amount of the indebtedness of the other borrower, or where he has granted a guarantee unlimited in amount to secure the indebtedness of the other borrower;
 - c. Borrowers the indebtedness of each of them to the banking institution exceeds 5% of the capital of the banking institution, and where a substantial commercial dependence exists between them, which is not limited to a short time, including by way of securing rights;
 - d. Joint directors, joint management, and the like.

It has been determined that the amendments will come into effect not later than March 31, 2004, and that in the event that as a result of the implementation of the amendments as of March 31, 2004, the specified limitations will be exceeded, then the amount of the excess will be reduced by equal quarterly amounts over a period of two years from that date.

Certain of the amendments to the instruction are to be effective immediately: cancellation of the possibility to

CREDIT TO THE PUBLIC BY ECONOMIC SECTORS

27



take a proportionate share of the indebtedness in cases of joint control, and cancellation of the possibility to take a share of the indebtedness of a partnership.

On November 23, 2003, the Supervisor of Banks issued an amendment to the transitional provisions to the said instruction. The amended instruction determined that if the limitation of the six largest borrowers has been exceeded following the implementation of the instruction, then:

- (1) Up to December 31, 2004, the total indebtedness to the banking institution of the six largest borrowers and groups of borrowers will not exceed 150% of the capital of the banking institution.
- (2) Starting on March 31, 2005, and up to June 30, 2006, the limitation on the total indebtedness to the banking institution of the six largest borrowers and groups of borrowers will be reduced from 150% to 135% of the capital of the banking institution, at the rate of 2.5% per quarter.

The Bank is studying the said amendments and their implications. At the present stage an examination was made of the effect of the amendments that came into effect immediately, as regards the indebtedness of the ten largest single borrowers and on the indebtedness of the six largest borrower groups. It has been found that the said limitations will in certain of the cases result in an increase of the indebtedness. In addition, certain vagueness has been found in the instruction, which is now being clarified with Bank of Israel, and which if interpreted in a certain way may cause a deviation from the limitations determined in the instruction.

Together with the amended instruction, the Supervisor of Bank has informed that he is considering a further amendment to the instruction, which will be discussed by the Advisory Committee dealing with banking business, according to which banking institutions will be entitled to elect an alternative framework of limitations, according to which the banks will accept limitations on indebtedness of a group of borrowers that will not exceed 25% of the capital of the banking institution (compared with 30% otherwise). If a bank does elect the alternative limitations, then the limitation on the total indebtedness of the six largest borrowers and groups of borrowers will stand at 150% of the bank's capital (instead of 135%). The Bank has started an examination of the effects of a possible implementation of a policy for limiting the indebtedness of a group of borrowers to 25% of the capital of the Bank.

The Bank believes that implementation of the said instruction will reduce the volume of credit which banking institutions in Israel will be allowed to grant, in particular to borrowers related to the large borrower groups in the economy. However, the intensity of the limitation will be reduced in view of the issue of the amended instruction.

Credit granted to the Government - totalled NIS 367 million as at December 31, 2003, compared with 552 million as at end of 2002, a decrease of NIS 185 million (33.5%). Recent years have reflected a downward trend, which is expected to continue also in the coming years, stemming from the fact that credit to the Government that was given in the past derived mainly from the proceeds of bond issues made by the Bank's consolidated companies, which proceeds were intended for deposit with the Treasury. These issues were discontinued in 1987, and the outstanding balance is gradually being paid-off.

Securities totalled about NIS 38,774 million as at December 31, 2003, compared with NIS 36,581 million at the end of 2002, an increase of 6.0%.

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

	December 31,		Rate of change in %
	2003	2002	
	(in NIS millions)		
Non-linked shekels	10,431	6,842	52.5
CPI-linked shekels	3,513	3,869	(9.2)
Foreign currency and foreign currency-linked shekels	23,872	25,343	(5.8)
Shares - non-monetary items	958	527	81.6
Total	38,774	36,581	6.0

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, 2003			December 31, 2002		
	Net adjusted cost	Fair value	Book value	Net adjusted cost	Fair value	Book value
	In NIS millions					
Bonds						
Held-to-maturity	45	46	45	42	43	42
Available-for-sale	35,884	36,171	36,171	35,799	35,708	35,708
Trading	1,543	1,600	1,600	310	303	303
Shares						
Available-for-sale	872	898	898	511	523	523
Trading	55	60	60	11	5	5
Total Securities	38,399	38,775	38,774	36,673	36,582	36,581

Deposits from the public as at December 31, 2003, totalled NIS 119,924 million, compared with NIS 119,734 million at the end of the preceding year, an increase of 0.2%. The increase in deposits of the public non-linked NIS segment was partly offset by a decrease in deposits of the public in the CPI segment.

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

	December 31, 2003		December 31, 2002		
	in NIS millions	% of total deposits from public	in NIS millions	% of total deposits from public	Rate of change in %
Non-linked shekels	43,488	36.3	41,299	34.5	5.3
CPI-linked shekels	17,534	14.6	19,556	16.3	(10.3)
Foreign currency and foreign currency-linked shekels	58,902	49.1	58,879	49.2	-
Total	119,924	100.0	119,734	100.0	0.2

The ratio of total credit to the public to deposits from the public was 63.7% at the end of 2003, compared with 62.1% at the end of the previous year.

CAPITAL RESOURCES

The Bank's capital resources as at December 31, 2003, including minority interest, totalled NIS 6,453 million, compared with NIS 5,513 million at the end of the preceding year, an increase of 17.1%.

Shareholders' equity as at December 31, 2003, totalled NIS 5,969 million, compared with NIS 5,064 million at the end of the preceding year, an increase of 17.9%.

The increase in shareholders' equity in 2003, resulted inter-alia from an increase of NIS 736 million in the component representing the net adjustments to fair value of available-for-sale securities, net of the tax effect. This amount includes an increase of NIS 747 million in the said component of net adjustments in the Bank itself, mainly in respect of non-linked Government bonds of the "Shachar" and "Gillon" classes.

The ratio of shareholders' equity, including minority interest, to total assets as at December 31, 2003, stood at 4.6%, compared with 4.0% at the end of the preceding year.

Tier II Capital - According to Bank of Israel directives, Tier II Capital serves as a component of total capital for the purpose of calculating the ratio of capital to risk assets. Tier II Capital is composed of, inter alia, subordinated capital notes and the general provision for doubtful debts.

The Bank's Tier II capital totalled NIS 3,302 million as at December 31, 2003, including NIS 3,048 million of subordinated capital notes and NIS 251 million of general provision for doubtful debts.

During 2003, the Group issued certificates of deposit - subordinated capital notes totalling NIS 611 million, partly with the aim of improving its capital adequacy ratio and partly for the purpose of replacing capital notes deducted from the Tier II capital.

The extent of subordinated capital notes is limited to 50% of the primary capital. At December 31, 2003, the Bank exhausted the said limitation (December 31, 2002 – 49.1%).

In the period from January to March 2004, the Bank issued subordinated capital notes in the amount of NIS 289.5 million included in which is an issue to the public (see hereunder).

In accordance with the instructions of Bank of Israel, capital notes in the amount of NIS 158 million will be deducted from the secondary capital of the Bank in the first quarter of 2004. In the second quarter of 2004, capital noted in an amount of NIS 100 million will be removed from the second tier capital, in accordance with instructions of Bank of Israel.

Rating the liabilities of the Bank – The first rating report for the capital notes of the Bank was published on September 29, 2003. Ma'alot – The Israeli Securities Rating Company Ltd. determined an “AA-” rating for the subordinated capital notes of the Bank issued near that date. This rating will apply also to the other liabilities of the Bank, including the other subordinated capital notes and deferred deposits as well as all other deposits in the Bank.

Issue of subordinate capital notes. On March 18, 2004, Manpikim – Issue Company of Discount Bank Ltd. (“Manpikim”), completed an issue of NIS 236 million of subordinate capital notes (series “A”). The proceeds of the issue was deposited in full with the Bank, which is obligated towards the notes holders for the payment in full of the principal, interest, and linkage increments on the capital notes.

The major part of the subordinate capital notes was issued to replace capital notes issued in the past, and which according to the instruction of Bank of Israel will be removed from the second tier capital of the Bank in the course of 2004. The Bank approached the Supervisor of Banks for approval to include the said subordinate capital notes as second tier capital of the Bank.

Additional capital notes in the amount of NIS 264 million, were issued to a subsidiary of Manpikim immediately prior to the publishing of the prospectus. Such capital notes were listed for trade on the Stock Exchange, and will gradually be sold by the said subsidiary, in accordance with the needs of the Bank.

Tier III Capital – According to the directives of Bank of Israel, the Tier III capital serves as part of the capital components for the purpose of calculating the ratio of capital to risk assets, but which may be related to market risk only. During 2003, capital notes amounting to NIS 41 million, which were deducted from the Tier II capital, were defined as Tier III capital, with the approval of Bank of Israel.

Ratio of primary capital to risk assets as of December 31, 2003, reached a rate of 6.60%, compared with 6.71% at the end of the preceding year.

The ratio of capital to risk assets stood at 9.38% on December 31, 2003, compared with 9.30% at the end of 2002.

EXPANDING THE CAPITAL BASE OF THE BANK

In the years 1983 to 2000, the Bank was unable to increase its equity capital by issuing new shares. Accordingly, the increase in capital required for the purpose of complying with the capital to risk assets ratio, was based on two sources: Annual earnings, net of dividends, and from December 1996, the raising of funds by the issue of subordinated capital notes in ever increasing amounts, particularly regarding the increasing demands of Bank of Israel in this respect.

Following the declaration of the Government regarding the discontinuation of the process for the sale of the core

of control of the Bank, which had lasted for over two years, the Bank again requested the Government's representatives to consent in principle to expand the Bank's capital base.

In December 2000, the Government's representatives gave notice that the Bank was given approval in principle to raise capital by issuing shares, provided that the State's holdings in the Bank will not be diluted to a rate of less than 50%, on a full dilution basis.

As from the third quarter of 2000, losses of the Bank caused an erosion in its capital basis. This erosion and the growing use of subordinated capital notes, resulted in the Bank reaching, as from March 31, 2001, the limit concerning the maximum permitted amount of subordinated capital notes (except for certain dates on which the ratio was near the limit).

In May 2001, the Bank applied to the Accountant General at the Ministry of Finance for approval to increase the amount of capital to be raised by the Bank, by way of share issue (hereinafter: "the requested approval"). The application was based on various arguments, both as to the mode of calculation of the dilution of the Government and as to the minimum rate of holding which will satisfy the desire of the Government to maintain the ability to sell its control in the Bank, at least during a number of years following the sale of a the core of control in the Bank. Concurrently, the Bank began also examining the possibilities of expanding its capital base aside from a new share issue.

In October 2001 the Bank raised NIS 142 million by way of a private placement of the Bank's shares.

In a letter dated February 26, 2002, the Chairman of M.I. Holdings Ltd. informed the Bank that its application regarding the requested approval was brought before the Board of Directors of M.I. Holdings Ltd., in its meeting on January 1, 2002, which turned it down and also decided to recommend to the Minister of Finance not to accede to the request of the Bank and not to enable any additional dilution in the State's holdings in the Bank.

Since 2001, the Bank's Management adopted measures concerning risk assets, including measures for rationalizing fund application in view of the limitations. Thus, for example, the Bank reduced activities requiring capital allocation, in cases where such a reduction causes relatively minor business damage and a small loss of income, such as unused credit lines and credit granted at low margins.

As a result of the determined action taken in this respect, the Bank has managed to maintain a capital ratio of 9.3%, and at times even higher.

The Bank has examined many and varied possibilities for expanding its capital base, aside from a new share issue, including the sale of assets, and had reached various stages of preparation towards the implementation of such plans. As part of the review of possibilities for the expansion of its capital base, the Bank has reviewed several possible ways of selling its investment in IDB New York. In this respect, the Bank was approached by several entities including Bank Hapoalim, Leumi and the Safra Group, who expressed an interest in buying the whole or a part of this investment.

In view of the position taken by M.I. Holdings, according to which the Bank will not be permitted to improve its capital base by way of an issue of new shares, and in view of other alternatives, it seems that the alternative of a sale of the investment in IDB New York is the only one, at the present time, which could bring a significant improvement of the Bank's capital base.

In October 2002, the Bank concluded the process of selecting an investment bank to advise the Bank in everything connected with the examination of possibilities and forms for the sale of its holding in IDB New York, including

identifying potential buyers. After making a survey of several world leading investment banks, the Bank decided to engage the investment bankers Goldman Sachs & Co., with whom an agreement has been signed.

Goldman Sachs & Co. have begun preparations for executing the process of sale.

Correspondingly, in October 2002, the Bank submitted to the Accountant General a proposal for discussion in which was presented the overall picture of the possibilities available to the Bank for expanding its capital base, at the same time, updating matters that had already been presented extensively in the past to Bank of Israel and the Ministry of Finance. The principal issues were also presented to the Board of Directors of M.I. Holdings Ltd. at the beginning of December 2002.

On background of the above, discussions have been held with certain individuals in the Government and at Bank of Israel, and in accordance with decisions reached regarding such discussions, a draft paper was submitted to the Accountant General on April 20, 2003, regarding the sale of IDB New York and its ramifications.

Following a request by the Accountant General dated May 29, 2003, for clarifications and explanations with respect to the said draft paper, the Bank submitted, on July 1, 2003, an updated workpaper, in which were included, inter-alia, the requested supplements as well as additional clarifications and explanations.

In view of the protracted discussions in Israel, Goldman Sachs & Co. were instructed to slow down the pace of the sale process, and later even to bring it to a halt.

Recently, following the high-level personnel changes at the Ministry of Finance and at M.I. Holdings Ltd., the dealing with the capital base issue of the Bank has been resumed. In December 2003, the Bank submitted to the Accountant General at the Ministry of Finance and to the Chairperson of M.I. Holdings Ltd. a proposal for discussion in which were reviewed extensively the various alternatives for expanding the capital base of the Bank, including the alternative of an additional issue of capital and the alternative of the sale of IDB New York.

No reply has yet been received to the various approaches of the Bank, however, at this stage, the Bank was orally informed that an additional capital issue would not be approved prior to the conclusion of the process for the sale of the Bank.

Hence, it is not possible to estimate, at this stage, which of the assets will be sold, what percentage of the asset will be sold, and what will be the scope of the sale and its terms.

LIQUIDITY AND THE RAISING OF SOURCES IN THE BANK

GENERAL

The year 2003 was mainly characterized by the recovery of public confidence in the economic policy and in the local financial stability, after this was weakened in 2002. Concurrently, during the year, and in particular in its second half, most of the economic indicators registered a trend of improvement. These developments influenced public preferences and the way in which its financial assets were allocated to the various channels.

Following are the main factors impacting the asset portfolio of the public in 2003:

- A gradual reduction in the Bank of Israel interest rate: in the course of 2003, the interest was reduced by a cumulative rate of 3.9% percentage points to 5.2% in December 2003. In the first half of the year the interest rate decreased moderately to a rate of 8% in June 2003. During the second half of 2003, the interest rate was reduced at a quicker pace. At the end of December 2003, the interest rate for January 2004 was reduced to a rate of 4.8%.

- A relatively sharp reduction in the inflationary environment: the CPI dropped in 2003 by 1.9%, compared with a rise of 6.5% in 2002.
- Despite the relatively sharp decline in the interest rate, the Israel currency appreciated as against the currency basket by 1.6%. It also appreciated materially against the US dollar but weakened against the Euro.
- The improvement in global economy, particularly in the United States, and in the local economy brought about relatively sharp increases in share and long-term bond prices (both non-linked and CPI linked).
- The Tax Reform, which came into effect at the beginning of 2003.

Following the above-mentioned developments, the following changes took place in the composition of the asset portfolio of the public:

- A continuous increase in the weight of investment in shares (both Israeli and foreign) in the asset portfolio, from a level of 15.4% at the end of 2002, to a level of 21.2% at the end of 2003.
- A decline in the weight of CPI linked assets (from 37.5% at the end of 2002 to 34.2% at the end of 2003), and in the weight of foreign currency linked assets (from 15.9% to 13.7%, respectively).
- Stability in the weight of non-linked assets, about 31%.
- Following the Tax Reform, a transition from saving scheme deposits to long-term deposits was recorded.
- An increase in public preference for publicly traded securities, the price of which increased during the year at a higher rate compared to bank deposits.

THE BANK

During 2003, the Bank maintained a relatively high level of liquidity, both in Israeli and in foreign currency. Throughout the year, the Bank maintained a volume of liquid assets larger than the total of its liquid liabilities. Preferences of the public and the raising of financial resources by the Bank were, inter-alia, impacted in 2003 by the trend of decline in interest rates on deposits, in parallel to the decline in the return on bonds and the relatively sharp increase in share prices. This trend was strengthened in the course of the second half of 2003, and, inter-alia, was reflected in the significant increase in the net accumulation of assets by mutual investment funds.

Another central factor that impacted the potential for the raising of financial resources by the Bank was the rating granted to deposits and subordinate capital notes raised by the Bank. The AA- rating granted to the Bank increased the potential for the raising of funds by the Bank, particularly as regards institutional investors.

The non-linked segment. At the beginning of 2003, the Bank increased the volume of deposits raised for periods of from one to two years, thus reinforcing the level of liquidity. The volume of non-linked deposits of the public with the Bank reached at the end of 2003 an amount of NIS 35.6 billion, compared with NIS 34.0 billion at the end of 2002, an increase of 4.7%.

The volume of non-linked interest bearing NIS deposits of the Bank with Bank of Israel reached at the end of 2003 an amount of NIS 3.7 billion, compared with NIS 6.8 billion at the end of 2002, a decrease of 45.6%. This decrease was mainly the result of the change in the mix of applications of the Bank in the non-linked segment.

The CPI linked segment. The volume of CPI linked financial resources amounted to NIS 12.5 billion at the end of 2003, compared with NIS 13.8 billion at the end of 2002, a decline of 9.4%. The demand by the public in 2003 for CPI linked deposits was affected by the decline in interest rates, following the decline in the return on bonds and by the sharp drop in the inflationary environment recorded during the year.



Kobi Kaimanovitz, Photoportraiture

CONTINUING TO TAKE-OFF Retiree clubs, recently established by the Bank, are designed for customers from homogenous sectors. The goal of these clubs is to offer their members initial tools for financial management. The clubs are designed for those who held salaried positions and now wish to expand their knowledge and learn "as much as" an investment consultant.

| Yehuda Lev-Ran, an EL-AL captain for 36 years, retired in May 2003. Oded Sagee, an EL-AL captain for 25 years, retired in November 2002.
They prefer Israel Discount Bank due to the personal touch |

In the background, the Visitors' Center of The Tel Aviv Stock Exchange Ltd.

The foreign currency and foreign currency linked segment. The volume of deposits of the public in or linked to foreign currency decreased in 2003 by a rate of 3.0% and reached an amount of NIS 28.7 billion at the end of the year. An increase of 4.9% was recorded in US dollar terms. The preferences of the public in this segment were affected by the low interests rates in the US and in the Euro block, by the appreciation of the Israel currency as against the dollar and the strengthening of the Euro against the dollar.

The reduction in the secondary liquidity requirements for foreign currency deposits. In July 2002, Bank of Israel notified the gradual reduction of the secondary liquidity requirements as regards foreign currency deposits. Beginning in August 2002, the liquidity requirement was reduced at the rate of 1% per month, until its final abolition at the end of May 2003. This move increased the free resources in foreign currency at the disposal of raising costs and the determination of the rating by Ma'alot Rating Company.

Liquidity ratio. In 2003, the Group continued to maintain a high liquidity ratio. The proportion of liquid assets - cash, deposits in banks for an initial period of up to 3 months, and available-for-sale and trading marketable securities - in relation to total assets, reached 37% at the end of 2003. The ratio of the said liquid assets to total deposits from the public amounted to 43% at the end of 2003.

EXPOSURE TO RISKS AND RISK MANAGEMENT

GENERAL

The Bank's activity as a financial broker engaged in all fields of financial activities involving risks taking, the principal of which are: credit risks, market risks and liquidity risks. Such risks are accompanied by financial risks resulting from operational and legal risks.

Risk management policy is intended to achieve the Bank's business targets, while evaluating the damage, which may result from exposure to such risks and limiting the losses at the various levels of risk.

This policy is based on various forecasts and assessments as to the development of various economic and capital and money markets indices.

The management of market risks is performed within the framework of Proper Banking Management Instruction No. 339, issued by Bank of Israel in respect of the management and control of financial risks.

The Finance Division, with its risk evaluation department, is responsible for risk management.

A committee was established at the end of 2000, headed by the risk managers of the Bank. The committee's members are the following members of Management:

Dr. Amnon Goldschmidt –	Risk manager of the Bank, market Risk Manager and chairman of the committee;
Mr. Ronnie Hezkiyahu–	Credit risk manager (replaced Dr. Ehud Kaufman at the beginning of 2004);
Mr. Noam Hanegbi –	Operational risks manager;
Mrs. Ronit Abramson-Rokach –	Legal risks manager.

DESCRIPTION OF EXPOSURE TO AND MANAGEMENT OF MARKET RISKS

Market risk – The risk to business results, to equity, to cash flows or to the value of the Bank deriving from changes in interest rates, foreign exchange rates, inflation, prices of securities, product prices, the fluctuations in these parameters and in other economic indices, which have an effect on the assets or liabilities of the Bank. Management of market risks is mainly intended to manage the economic exposure of the Bank to these risks (principally base risk, interest rates risk and options risk), not all of which are reflected in the financial statements. The extent of the exposure to which the Bank wishes to be subject and the decision parameters in this respect, are determined mainly according to evaluations made by the Bank as to the various market characteristics, while complying with the limitations set out by the Board of Directors.

(1) BASE RISK EXPOSURE

The exposure to base risk is reflected in the loss which may incur as a result of changes in inflation and in exchange rates, due to the difference between amounts of assets and liabilities, including the effect of forward transactions. This exposure is measured in each of the linkage segments: the CPI linked segment, the foreign currency and shekels linked thereto segment and the non-linked shekel segment. The measurement takes into consideration also the effect of options imbedded in the base exposure.

As part of the distribution of assets and liabilities to the various linkage bases, the Board of Directors has determined that the general free capital will include shareholders' equity, net of non-financial assets, with the addition of investments in foreign consolidated subsidiaries and certain reserves, and that it shall be considered as a liability in the CPI linked segment.

In order to limit base risks, the Board of Directors approved the policy and framework for financial activities, including the limit of exposure defined by the maximum surplus or deficit in the various linkage segments in relation to the Bank's equity⁽¹⁾: in the CPI linked segment, the maximum gap between assets and liabilities has been set at 20% of the shareholders' equity of the bank, in the non-linked segment at 25%, and in the foreign currency segment at 10% of equity.

It is the policy of the Bank to avoid significant exposure to foreign currencies other than to the US dollar. Exposure to these currencies is permitted within the limits approved by the Board of Directors of the Bank.

The policy relating to base risk exposure is being implemented, inter-alia, using derivative financial instruments, which may have a considerable effect on exposure to the various linkage bases.

The Boards of Directors of the banking subsidiaries have each determined their policies with respect to the subsidiaries' maximum exposure to base risks.

(1) In March 2004, the Board of Directors approved changes to the limits of exposure.

The following is a summary of the net linkage balances (in NIS millions):

As at December 31, 2003					
	Non-linked shekels	CPI linked shekels	Foreign currency*	Non-monetary asset	Total
Assets	35,471	17,031	30,727	7,441	90,670
Liabilities	37,536	16,226	30,878	61	84,701
Balance sheet difference	(2,065)	805	(151)	7,380	5,969
Derivatives	1,952	(256)	(1,696)	-	-
Options	514	35	(549)	-	-
Total Difference	401	584	(2,396)	7,380	5,969
As at December 31, 2002					
Assets	32,988	18,139	31,124	7,213	89,464
Liabilities	35,717	17,194	31,430	59	84,400
Balance sheet difference	(2,729)	945	(306)	7,154	5,064
Futures contracts, net	2,139	111	(2,250)	-	-
Options	(396)	10	386	-	-
Total Difference	(986)	1,066	(2,170)	7,154	5,064

* Including foreign currency-linked shekels.

The follow-up of exposure to base risks in the Bank is performed by a daily review of the economic positions of the various linkage bases (as different from the accounting positions) based on unprocessed data. The maximum exposure to base risks used to manage market risk registered by the Bank in 2003, reached NIS (988) million in the CPI linked segment, NIS 989 million in the non-linked segment, and US\$ 37 million in the foreign currency segment. This compared with an amount of NIS (676) million in the CPI linked segment, an amount of NIS 665 million in the non-linked segment and an amount of US\$ 68 million in the foreign currency segment, in 2002.

(2) INTEREST RISK EXPOSURE

Interest risk derives from the exposure to future changes in interest rates and their effect on the present value of assets and liabilities of the Bank. Such changes may adversely affect the earnings and equity of the Bank. Management of interest risk exposure is performed for each of the linkage segments separately, and is based on various assumptions as to the maturity dates of assets and liabilities.

The Board of Directors of the Bank has set out the limits for interest risk exposure for each of the linkage segments. The limits set relate to the maximum exposure effect on the Bank in a scenario of a change of 1% in the interest rate in each segment. According to these limits, and given this scenario, exposure is permitted, the effect of which in the non-linked segment is not to exceed 1% of the equity of the Bank, in the CPI linked segment not to exceed 2% of equity, and in the foreign currency segment not to exceed 0.5% of the equity of the Bank⁽²⁾.

(2) In March 2004, the Board of Directors approved changes to the limits of exposure.

The analysis of exposure of the Bank (on a stand alone basis) to economic interest rates, presents the following findings:

In the CPI linked segment – Most of the Bank's interest rate exposure results from this segment. Notwithstanding, a decline in the interest rate exposure in this segment was recorded in 2003, resulting from a decrease in assets bearing a fixed interest rate for medium and long periods, which reduced the average maturity period of assets, and also from an increase in the average maturity period of liabilities.

In determining the interest rate exposure, the Bank's policy is to include the effect of premature redemptions of savings deposits, in accordance with a model used by the Bank (see hereunder).

In the non-linked segment – The interest rate risk has increased following a growth in fund applications at fixed interest rates for medium and long periods while sources of funds were for shorter periods or at variable interest rates.

In determining the interest rate exposure, the Bank's policy is to consider a part of current account deposit balances in Israeli currency as a liability for a five-year period. This was decided after testing the performance of current account deposits in the past several years. In contrast, Schedule "D" reflects the current account balances in accordance with instructions of Bank of Israel, under "demand deposits and up to one month".

In the foreign currency segment (including foreign currency linked) – The Bank's policy is to maintain a relatively lower interest rate exposure than those in the other linkage segments. The interest rate risk in this segment declined in 2003.

Most of the activity is on the basis of variable interest rates. The reconciliation of assets to liabilities is made according to the interest adjustment dates.

The availability of varied financial instruments in international markets enables the reduction of exposure in this segment.

The following is a summary of the Bank and its consolidated subsidiaries' exposure to fluctuations in interest rates, as per the various linkage segments (in NIS millions):

	As at December 31, 2003			As at December 31, 2002		
	Non-linked shekels	CPI linked shekels	Foreign currency ⁽¹⁾	Non-linked shekels	CPI linked shekels	Foreign currency ⁽¹⁾
Total Assets	44,663	24,072	66,530	41,217	25,709	66,434
Total Liabilities	46,581	22,181	64,386	43,866	23,902	63,916
Average maturity (years):						
Assets	0.49	3.80	1.84	0.35	3.74	1.72
Liabilities	0.28	3.22	1.10	0.22	3.22	0.99
Average maturity gap	0.21	0.58	0.74	0.13	0.52	0.73
IRR gap	2.39	1.40	1.49	3.28	1.29	1.46

(1) Including foreign currency-linked shekels.

The data in the Bank's and its consolidated subsidiaries' report on their exposure to fluctuations in interest rates indicates that:

- In the non-linked shekel segment, a gap existed as at December 31, 2003, between the average maturity of liabilities and the average maturity of assets, amounting to 0.22 years, compared with an average maturity gap on December 31, 2002 of 0.13 years.
- In the CPI-linked shekel segment, the average maturity gap between assets and liabilities as at December 31, 2003, was 0.58 years (about 7 months), compared with 0.52 years (about 6 months) on December 31, 2002. Calculation of the average maturity gap includes the effect of early redemption and withdrawals at exit points of savings deposits, based on a model which serves the Bank (see hereunder).
- In the foreign currency segment, including activity in shekels linked to foreign currency, the gap between the average maturity of liabilities and average maturity of assets as at December 31, 2003, was 0.75 years, compared with a gap of 0.73 years on December 31, 2002.

The exposure to interest rates in this segment is affected also by the manner in which the Bank finances its investments abroad from the foreign currency sources of the Bank.

(3) OPTION RISKS

Option risks relate to a possible loss deriving from changes in the parameters affecting the value of options, including standard deviation.

The Board of Directors of the Bank has set out guidelines regarding the permitted activity in options, including also limit on the options activity of the Bank both as regards overall volume and as regards the maximum loss in extreme scenarios and in moderate scenarios. The scenarios relate to simultaneous changes in exchange rates and in the volatility of base assets. Furthermore, the Bank has set out limits on sensitivity indices ("GREEKS") for changes in the value of the foreign currency/shekel options portfolio, managed by the dealing room.

The limits set out for the foreign currency/shekel options activity of the Bank, include also the options imbedded in the balance sheet of the Bank. The Board of Directors determined limits as regards the volume of the foreign currency/shekel options activity, and it was also determined that no market risk is to be taken in such activity.

The activity in CPI linked options (mainly imbedded options and "over the counter" (OTC) options) is also subject to limitations determined by the Board in terms of maximum loss in extreme scenarios and in terms of volume.

(4) ACTIVITY IN DERIVATIVE FINANCIAL INSTRUMENTS

The Board of Directors has determined the mode of operation of the Bank in derivative financial instruments, volume of activity and the range of financial instruments in which the Bank may engage (whether on behalf of customers or for the bank itself). The transactions of the Bank 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 customers of the Bank, who provide security in accordance with the Bank's procedures.

Such transactions are being made either on behalf of customers or for the Bank itself, both for hedging and for other purposes. The dealing room is making the transactions, inter-alia, for management purposes of the Bank's assets and liabilities as well as for trading purposes. Subject to the limitations set out by the Board, limits were set out for the dealing room effecting the transactions, in order to allow the derivative financial instrument activity.

The Bank is active in a wide range of derivative financial instruments both in shekels and in foreign currency, and acts also as a market maker for some of which. A large part of the transactions are made “over the counter” (OTC) in accordance with customer needs. 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.

Following are data as to the volume of operation in derivative financial instruments (in millions of NIS):

	As of December 31, 2003
Hedging derivatives	3,774
ALM derivatives	31,504
Other derivatives	25,821
Credit derivatives and SPOT foreign currency exchange contracts.	4,757
	As of December 31 2002
At risk brokerage transactions	16,073
Hedge transactions	4,895
Other transactions:	
Interest rate	6,659
Currency	38,007

Accounting aspects. The accounting policy as to the measurement of the value of derivative financial instruments and the results thereof is stated in Note 1(m) and 20 to the financial statements.

According to the said guidelines of the Supervisor of Banks, most of the transactions in derivative financial instruments made by the Bank within the framework of the management of market risks resulting from its financial base assets (ALM) are classified as “other transactions” and not as “hedging transactions”, as in terms of the said guidelines more stringent criteria has 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 “other transactions” are computed, due to the absence of a market, according to “fair value”. Accordingly, no correlation exists between the recording of the base assets and the results they produce in accordance with accepted accounting principles and the transactions in derivative financial instruments in respect of those base assets, which are classified as “other transactions”. The effect of the above was a decrease in the earnings from financing operations by NIS 38 million in 2003, compared with a decrease of NIS 28 million in earnings from financing operations in 2002.

Details of financing income from derivative financial instruments are presented in Note 23 to the financial statements.

In January 2000, the Supervisor of Banks published instructions regarding “The accounting for derivative financial instruments and hedging activities”. The Supervisor of Banks published amendments to these instructions in

January 2001. According to a circular issued by the Supervisor of Banks on February 18, 2002, the said instructions are to be applied for the first time in respect of the quarter ending March 31, 2003.

The principal change in the accounting treatment determined in the new instructions in comparison to that applied in these financial statements relates to activities in derivative financial instruments intended for hedging purposes and to "embedded" derivative instruments, as detailed hereunder:

As from January 1, 2003, the Bank recognizes all derivatives as assets or liabilities in the balance sheet and measures them according to their fair value. The changes in the fair value of derivatives are reported in the income statement or in the shareholders' equity as "other comprehensive income", depending on the designation of the derivative instrument.

The changes in the fair value of derivatives that hedge against exposure to the change in the fair value of an asset, liability or a firm commitment, is recognized currently in the income statement, corresponding to the change in the fair value of the hedged item, which could be attributed to the risk being hedged.

The accounting treatment of the change in the fair value of derivatives that hedge against exposure to changes in the cash flows produced by an asset, liability or by an anticipated transaction, depends on the effectiveness of the hedging relations. See note 20 to the financial statements.

According to The instructions, certain financial instruments were defined as "host contracts", which include "embedded derivative instruments". Until now such financial instruments have not been treated within the framework of the accounting treatment of derivative financial instruments. "Host agreements" are financial instruments containing "embedded" derivative instruments, namely, explicit or inferred conditions affecting cash flows, in part or in whole, or affecting the value of other exchanges required under the agreement in a manner similar to a derivative instrument. According to the instructions, such a component is to be considered an "embedded derivative instrument", which has to be separated from the "host contract" and treated as a derivative instrument. Namely, it has to be measured at any time based on its fair value.

The initial application of these instructions was made by way of recording the "cumulative effect of change in accounting as of date of application of the instructions" and not by way of restatement of prior periods.

As from January 1, 2003, the Bank implements the required accounting treatment, as stated. The cumulative effect recorded in this respect in the financial statements of the Bank resulted in an increase of NIS 27 million in the income of the Bank.

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.

Credit risk involved in financial instruments. The Bank's activity in derivative financial instruments involves special risk factors including credit risks. The credit risk relating to such transactions is derived from the fact that the stated value of the transaction does not necessarily reflect the credit risk involved therein. This risk is measured according to the maximum amount of the loss, which the Bank may incur in case the other party to the transaction will not honour his obligations, net of the effect of enforceable setoff agreements.

The credit risk during the engagement period is estimated at the amount of the cost of engagement in a similar transaction, had it been set up at the reporting date with the same customer and for the remaining period of the

transaction. The Bank's policy as to the required security for customer activity in derivative financial instruments is similar to its policy in respect of other credit, except for customer activity in the Ma'of market. The required security may be of various kinds. Furthermore, the Bank may grant the customer a credit line without security, as the case may be. The Bank monitors the credit risk inherent in the activities of large customers transacting derivative instrument business.

Additional risk factors (in addition to credit risks and market risks) deriving from transactions of the Bank in derivative financial instruments, is the market liquidity risk resulting from the fact that it is not always possible to eliminate the exposure swiftly, particularly in low trading markets.

Considering the risks involved in derivative financial instruments, the Board of Directors approves a maximum financial amount for each of these instruments offered by the Bank.

(5) LIQUIDITY RISK

Liquidity risk is defined as a risk to the profitability of the Bank and its equity resulting from the inability to provide its liquidity requirements. This risk derives from the uncertainty, which may exist as to the availability of liquid sources, the possible necessity to raise funds unexpectedly and in a short time, as well as from the difficulty arising in a situation where a material realization of assets may be required at a given time and at a reasonable price. The measurement of liquidity risks is intended to provide decision makers with indicators for the identification of situations in which the level of this risk rises. Management of liquidity risks is intended to ensure that the Bank will have sufficient sources of funds to enable it to honor in due time all its obligations without having to incur material costs or losses in the process.

The form for measuring the liquidity risk was updated during 2003. The principles for the liquidity risk management are, inter-alia, as follows:

- Separation between short-term and long-term liquidity;
- Management of the liquidity risks in the shekel segment (including the CPI linked segment) and in the foreign currency and foreign currency linked segment;
- Differentiation between different types of depositors;
- Computation of the liquidity risk indices determined for each segment, examination of the changes therein and comparing them to the minimum levels fixed.

New Proper Banking Procedures instruction regarding liquidity risk management. At the end of August 2003, Bank of Israel issued Proper Banking Procedure Instruction No. 342, according to which a banking corporation will be required to determine an overall policy for liquidity risks management, including procedures, quantitative goals, limitation on the liquidity gap and a system for treatment of violations. A banking corporation will also be required to maintain a suitable information system that will enable the calculation of the liquidity situation on a daily basis.

The system will be required to allow measurement and control of the overall liquidity position in NIS and in the principal foreign currencies. The banking corporation will be required to measure and control the liquidity position on a daily non-consolidated basis, including overseas branches

To ensure that the banking corporation maintains sufficient liquid means to cover its liquidity requirements for the coming month, the new instruction requires that the liquidity gap shall be determined according to repayment periods as well as to the ratio of liquid assets to liabilities (for a period of up to one month), at not

less than 1. Alternatively, the instruction allows a banking corporation to define the said liquidity ratio in a different manner, if the bank implements an internal model, which reliably assesses the liquid means at its disposal and its liquidity requirements.

The instruction will come into effect on December 31, 2004. As from the end of 2003, the Bank submits to the Supervisor of Banks a quarterly report regarding the progress of development of the internal model.

Preparation by the Bank for compliance with Instruction No. 342. The Bank performs an ongoing and organized follow-up of its liquidity positions and of indications as to changes in its liquidity risk. In this framework the Bank applies an internal monthly model, approved by Management, to assess the liquidity risk, the principles of which are as follows: (1) Determination of scenarios in respect of the level of reliance on assets as a source for liquidity and (2) Assumptions as to the possible need for liquidity as a result of the non-recycling of liabilities: withdrawals from current accounts and premature redemption of savings and other deposits.

The proposed limitations define the ratio of liquidity as the total of liquid sources divided by the total possible liquidity requirement (in extreme scenario terms and in more moderate scenario terms).

This ratio is to be maintained at over one. A drop in the ratio to below 1 indicates the need for a close examination of the liquidity situation and the adoption of measures to improve it.

The ratio is measured in respect of two periods: up to one month and up to three months. In order to assess the ratio resulting from the model that classifies the total liquid assets and the total short-term liabilities the maturity thereof is expected within a short period.

The model that has been approved by the Management of the Bank, the liquidity ratios and the relevant parameters are being reported on a current basis to the forums that manage the market risk of the Bank.

During 2003 the Bank maintained a relatively high liquidity level in Israeli as well as in foreign currency. In addition to the monthly model the Bank conducts a daily and weekly model comprising an early warning system for exceptional developments in the liquidity risk. The object of the model is to monitor various data, the fluctuations in which may indicate a change in the liquidity situation of the Bank.

(6) THE MAIN CHANGES OCCURRING IN 2003 IN RISK MANAGEMENT POLICY

There were no changes in 2003 in the market risk management policy of the Bank.

Changes at the beginning of 2004. It should be noted however that at the beginning of 2004, the Bank implemented several changes with regards to market risk management, which include:

- A change in the linkage base of the available capital
- A change in the exposure limits for linkage base and interest risks.
- Determination of the VAR limit to the overall market risk of the Bank.

MEANS OF CONTROL AND APPLICATION OF THE POLICY

(1) ATTITUDE OF THE BOARD OF DIRECTORS TO MARKET RISK MANAGEMENT ISSUES

During the year, The Board of Directors and the risk management committee of the Board discussed various issues regarding market risk, including: Group policy, limitations in VAR terms, etc.

(2) BANK MECHANISM RELATING TO MARKET RISK MANAGEMENT ISSUES

The asset and liability management committee of the Bank headed by the President & CEO, which meets once a month, addresses, reports and controls the market risk management policy of the Bank. The committee discusses the policy of the Bank relating to market and liquidity risks, subject to the limitations and guidelines set out by the Board.

The exposure to market risk position of the Bank is examined and discussed once a week within the Financial Forum headed by the Head of the Financial Division. This Forum makes decisions as to short-term exposure, which the Bank may face.

Exposure to market risks is reported in the quarterly exposure document submitted to the Board. This document relates also to the other types of exposure as well as to exposure of the principal subsidiaries of the Bank.

The Bank has established in its procedures a mechanism which requires officers taking a risk and the controlling entities to report to the Head of the Financial Division any exceptional events such as a loss which exceeds the determined limit, or a deviation from the limits set, etc. The Head of the Financial Division decides how to deal with such deviations as well as how to react to exceptional developments in the various markets. Deviations are also brought to the attention of the Board.

(3) INTERNAL CONTROL MECHANISM REGARDING THE PREVENTION OF DEVIATION FROM THE POLICY OF EXPOSURE TO MARKET RISK AND ITS MANAGEMENT

The Bank operates internal control mechanisms for the prevention of deviation from the market risk management policy.

The Middle Office Unit of the Financial Division performs a general control over the activity of the dealing room, including a measurement and independent reporting of income and compliance with determined risk limitations. Any deviation from the limits is reported to the Risk Manager.

The department for risk evaluation of the Financial Division reports on a monthly basis on the exposure position of the Bank to market risk (in VAR terms) and on deviations from the determined limits or policy.

The Risk Controller and the Internal Audit Department also perform procedures intended, inter-alia, to identify failure in the risk management process and deviations from policy.

No material deviations were recorded in 2003 in the implementation of the risk policy of the Bank.

(4) MANAGEMENT OF POSITIONS IN THE TRADING PORTFOLIO

The volume of trading of the Bank (in Israeli and in foreign currency) has grown in comparison to the volume at the end of 2002. Limitations on trading activities are defined in the framework of Board procedures. The limitations relate to portfolio size, types of risks to which the Bank may be exposed to, the permitted instruments, factors of management and control, etc.

The trading activity is conducted while measuring on a daily basis the compliance with limitations by the factor managing the portfolio and periodic control of compliance with the limitations and of the profitability by an independent controlling factor.

The activity in the trading portfolios is performed subject to a daily measurement of compliance with the set limits, made by the portfolio manager, and a monthly control of compliance with the limits and of the performance of the portfolios, made by an independent control factor.

MEASUREMENT OF MARKET RISKS

(1) MODELS USED FOR MEASURING MARKET RISKS

Premature redemptions of savings deposits model. Actual management takes into consideration estimates of the Bank as to the amount of premature redemption of savings deposits. The Bank applies a model, which estimates the rate of expected premature redemptions of savings deposits, based upon a long series of historical data, which the Bank maintains. For this purpose, all savings deposits with the Bank were divided into several groups having similar characteristics, and the computations in respect of each such group is made after exclusion of extraordinary effects, and by using a moderating factor giving a higher weight to the “decay factor”. The rates of premature redemption are computed as from the end of two years of the life of the deposit and at each exit date until the final date of redemption of the savings deposit.

Background assumptions on which the model is based:

- A relation exists between the age of the savings deposits and the rate of premature redemptions thereof.
- It is possible to estimate the rates of withdrawal based on historical data of premature withdrawals from savings deposits of different ages in recent years.
- An indemnification mechanism exists in the case of withdrawal made on a date other than the determined exit dates (“breaking a deposit”).

The internal rate of return and average maturing not including the assumption of premature redemption of savings deposits:

	December 31, 2003			December 31, 2002		
	Non-linked	CPI linked	Foreign currency ⁽¹⁾	Non-linked	CPI linked	Foreign currency ⁽¹⁾
Internal rate of return						
Assets	5.37	5.77	3.59	8.34	5.91	5.21
Liabilities	3.24	4.65	3.01	5.25	4.60	3.94
Average maturity						
Assets	0.54	3.49	0.55	0.38	3.49	0.49
Liabilities	0.27	3.64	0.53	0.22	3.65	0.51

(1) including foreign currency - linked shekels.

Creditary current accounts spread model. The Bank assumes that a significant part of the credit balances on current accounts is not expected to be withdrawn immediately. For the purpose of computing the interest exposure, the Bank considers the steady amount of these balances as a liability for periods of up to five years.

(2) THE VALUE GIVEN TO THE VALUE AT RISK (VAR)

General. According to instructions of the Supervisor of Banks regarding risk management, 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 exposure to market risk by assessing the VAR.

The VAR serves as a central indicator of the extent of exposure of the Bank to market risk. An analysis of its results

and examination of the changes therein over a period of time, enables Management to receive information regarding the level of market risk involved in all operations of the Bank.

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 the change in the fair value of assets and liabilities and the following erosion in the value of the Bank (in fair value terms).

Assumptions and parameters for computing the VAR. The VAR computation (at the Bank's level) is made, as from the last quarter of 2003, on a weekly basis, by the Iris/Riskpro system (until the end of the third quarter of 2003 the computation has been made on a monthly basis). This system assembles the financial data required for risk management and which relates to the variety of financial instruments transacted by the Bank, as well as to market data (such as indices, exchange rates and interest rates), their extent of volatility and the correlation between them.

The computation performed relates to the potential damage resulting from holding of all positions, both balance sheet and off-balance sheet positions, and from exposure to market risks in general.

The VAR model applied by the Bank is still being updated, and during 2002, progress was recorded in its implementation and in the quality of interface established for this purpose.

The VAR computations detailed hereunder were performed by the parametric method, at a security level of 99%, and for a time period of ten days.

	2003		2002	
	at year end	Yearly average	at year end	Yearly average
Estimate of VAR amount (in NIS millions)	60.9	73.5	62.8	80.1

Analysis of the VAR results shows that the main risk derives from the interest rate exposure of the Bank, in the CPI linked shekel segment, and, to a lesser extent, in the non-linked shekel segment. The weight of the VAR in relation to the shareholders' equity of the Bank as of December 31, 2003, stands at 1.0%, compared with 1.2% at the end of 2002.

Limitations of the VAR model. The results produced by the VAR model do not serve as a blocking device for possible losses that may be created in various extreme circumstances. Inter-alia, the model is limited as regards the following points:

- The model assumes that the changes in risk factors are divided normally. Accordingly, a sudden and extreme change in a risk factor cannot be forecasted by the model;
- 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;
- The use of historic data is by its nature limited to events that happened in the reported time period, which may not include particularly extreme events (to overcome this limitation, the Bank is performing an analysis of the losses under stress tests, as described hereunder);
- In computing the VAR using a clear security level of 99%, losses that might be incurred at a lower level of probability, are ignored.

(3) LOSS ANALYSIS IN EXTREME SCENARIOS (STRESS TESTS)

Stress tests serve as an important tool for examining the possible effect of events having low probability, which are not anticipated in statistic models.

Such events may be related to an economic crisis, such as war, political instability, natural disasters, and reflected in significant changes in interest rates, exchange rates, and others. Evaluation of the loss potential in such circumstances will provide the Bank with data concerning the extent of its exposure to market risks in extreme situations.

One of the objects of the risk management process is to protect the Bank against a devastating loss in the event of extreme scenarios of low probability, but which are still possible. Even though the VAR is the most suitable measurement tool for assessing market risk, it does not provide information as to losses that may occur in "abnormal" market situations, which exceed the clear level in respect of which the VAR had been computed. This explains the importance of the stress tests as a complementary measuring tool.

The Bank has established a stress test forum that examines, at least once in every quarter, extreme scenarios. The forum meets in accordance with determined procedures and its members are the Chief Economist, representatives of the ALM, risk evaluation, dealing room departments as well as the Risk Controller. The Head of the Financial Division chairs the forum. The forum reviews the results of defined scenarios and examines their effect on the portfolio of the Bank. The forum also suggests changes in scenarios and additional extreme scenarios, which should be examined.

CREDIT RISKS

The Bank's policy in granting credit to the public is intended, inter alia, to secure the quality of the credit portfolio and diversify the risks thereto.

Credit risks are diversified by, inter alia, spreading the credit portfolio over a large number of borrowers, in various economic sectors, with different segments of linkage and over different geographic regions.

The policy of dispersal of the credit portfolio over a large number of borrowers is focused on the relative weight of medium and small borrowers, including expanding the credit to non-business customers in the private banking segment such as households, VIP customers and the international private banking centres.

The Bank grants credit to its customers against various types of collateral, including liquid assets, fixed assets, and various liens and guarantees. The scope and/or the quality of the collateral is derived from the level of risk which the Bank is ready to accept when granting the credit, while putting a special emphasis on the repayment ability of the borrower. In certain cases, where circumstances justify, the Bank grants credit without collateral and/or subject to conditions of various kinds.

The policy of collateral management and determining the value for security purposes of the various types of collateral, is based on rules and principles determined as part of the Bank's procedures for granting credit.

The collateral is adapted to the type of credit it is supposed to secure, while relating to the time range, linkage base the nature of the credit and its purpose.

Determining the value of the security for collateral is derived from their quality and the ability to realize them quickly, including changes in their value as a result of slowdown or growth situations in the business sector of the borrower.

In granting credit for construction via the “project financing” method, the Bank generally relies for collateral, inter alia, on the amount of equity and on the ownership rights to the land on which the project is built.

With regard to its exposure to foreign currency credit risks, the Bank has prepared itself to minimise the risks stemming from possible fluctuations in the shekel exchange rate, inter alia, by testing the sensitivity of foreign currency borrowers to changes in exchange rates. As to borrowers who have a high exposure to changes in foreign exchange rates, the Bank takes steps, to the extent possible, to reduce the exposure by strengthening the collateral, demanding coverage and hedging transactions and by applying stricter criteria for the approval of credit denominated in foreign currency.

Credit management and the follow-up of the business condition of borrowers are performed at three different levels of activity, as detailed hereunder:

Preliminary examination and approval procedures prior to making credit decisions – The procedures of the credit committees and of the Board of Directors define the authority for approving credit at committee and loan officer levels, in a manner that will address the need for an effective response to customer needs.

In addition computer programs were developed with a view to improve and make the decision making process more efficient and to maintain proper control. Furthermore, training programs at various levels are provided for the credit department staff, in order to improve the professional level of loan officers at all levels.

The use of control tools, current analysis and reporting for follow-up and identification of credit risk - The Bank makes current use of analysis and control tools with the aim of identifying quality borrowers and locating as early as possible, borrowers who may prove problematic.

The Bank operates a system for the rating of borrowers' debts, which assesses the level of risk in the liability of various categories of borrowers based on their financial performance, scope and quality of collateral, character of their business sector, their compliance with the credit terms, and others.

The system provides ratings for most of the business and commercial borrowers, which are used by Management in the credit decision making process.

Until the end of March 2004, the Bank rated some 96% of the total indebtedness, which requires rating according to proper banking management instructions issued by the Bank of Israel concerning the rating of credit granted by banks.

The Bank is developing a new indebtedness model, as required by the Basel II Principles. This model is intended to improve the rationalization of pricing the credit from the aspect of the relation between the level of risk and the return earned thereon.

Loan review procedures – The Bank has a credit control unit reporting to the Chairman of the Board, which performs follow-up and periodic assessments of the propriety of credit management, the level of credit risk taken, including an assessment of the reliability of the debt rating and quality of the collateral.

In addition, either currently or occasionally, the internal audit department performs an examination as to the propriety of loan approval processes and their compliance with the various procedures.

Repayment and collection arrangements. In 2003, as in former years, special focus was directed towards the treatment of repayment arrangements and/or collection of problematic debts, with the view of reducing the volume of non-performing debts.

Credit risk in certain economic sectors: Following the deterioration in the security-political situation from the

last quarter of 2000, the deepening slowdown of the Israeli economy, and the changing trends in the economy and the capital markets both in Israel and in the world, influenced by the said developments. The Bank performs periodic analysis of the said developments in the various sectors of the economy, which serve to define the proper policy in the matter. Note should be made of the strengthening of means of control and follow-up over the activity of borrowers in the following economic sectors:

The communications and computer services sector: Due to the worldwide crisis in the communications sector and especially in the hi-tech field, the Bank increased control over this sector, has increased where possible the collateral required and has tightened demands where new applications for finance are concerned. In 2003, the weight of this sector in the provision for doubtful debts declined as a result of the improvement in the business position of several customers in this sector and the evaluation that 2004 will bring further improvement.

The hotel and related services sector: Due to the security situation in the country, a sharp deterioration has taken place since the last quarter of 2000, in the number of tourists and in the volume of hotel occupancy, and a number of hotels have even closed. The crisis in this sector adversely affected the operations of companies engaged in the sector and in related areas. The Bank has adopted measures to increase supervision, control and the monitoring of operations of companies belonging to this sector.

The industrial sector: The continued global recession and the slowdown of the Israel economy had an adverse effect on the activity of industrial companies, which is reflected in reduced production, sales and import of materials and in the reduction in investments. All this affected the ability of borrowers in this sector to repay their loans, thus causing an increase in the volume of problematic debts in this sector and in its share in the provision for doubtful debts of the Bank.

The construction and real estate sector: In view of the continuous slowdown in activity in this sector, which is reflected, inter-alia, in reduced demand on the one hand and in a drop in prices on the other hand, the Bank strengthened control over its customers, increased the collateral where possible and has tightened the demands when examining new applications for finance. Although the loans in question are generally loans which have already been classified as problem loans in the past, the continuous economic slowdown and erosion in the value of the collateral, were reflected in the weight given to this sector in the provisions for doubtful debts and in the non performing loans of the Bank.

Credit risk involved in derivative financial instruments: The control of credit risk involved in derivative financial instruments is effected in the Bank by computer systems designed to measure the exposure at transaction and customer levels. Principles and operating procedures were adopted for determining the required level of collateral for these transactions, including the procedures required to close off the exposure as regards the transaction and the customer.

BASEL II

In June 1999, the first draft of the new recommendations of the Basel Committee (Basel II) was published. An additional draft was published at the beginning of 2001, and since then has undergone additional changes and amendments. The goals of the Committee include: securing the stability of the financial system, a more extensive relationship to risks and development of capital requirements that will respond to the specific risk level of each bank. The innovation in Basel II recommendations focus on improving the risk measurement by banking corporations,

and in particular credit risks and operational risks and the allocation of capital in their respect. In contrast to the existing situation where capital allocation is required in respect of credit and market risks only, the Basel II recommendations require the allocation of capital also in respect of exposure to operational risks. The Basel II recommendations also allow the use of advanced models for the allocation of capital in respect of credit risk.

The recommendation is composed of three tiers:

- Tier 1 - minimum capital requirements – the aim is to expand and improve the existing framework of measurement determined in 1988.
- Tier 2 - expanding the examination process of bank supervisors – including capital adequacy of the financial institution, its management processes and risk assessment.
- Tier 3 - fair disclosure – by expanding public information as to the risks to which a bank is exposed.

The original intention was to implement the recommendations in 2004, however the timetable has been postponed several times, and at this stage is planned for 2007. It seems that now, after three quantitative surveys and several rounds of amendments, the recommendation reached a near final stage and no many further material amendments are expected.

Bank of Israel has not as yet published instructions regarding the Basel II recommendations.

However, in view of the major complexity of the subject, the Bank has begun in 2003 to study the recommendations of the Committee and the ways of their implementation. It has been determined that the risk management committee of the Bank headed by the Head of the Financial Division and the Risk Manager of the Bank, will take charge of the preparations with respect to the implementation of the recommendations.

OFF-BALANCE SHEET ACTIVITY AND CAPITAL MARKET ACTIVITY

ISRAEL DISCOUNT CAPITAL MARKETS AND INVESTMENTS LTD.

Israel Discount Capital Market and Investments Ltd. ("DCMI"), a fully owned and controlled consolidated company of the Bank, is engaged in the underwriting and management of public offerings of securities, in investment banking and also in investment in venture capital funds together with foreign institutional entities.

Total assets as at December 31, 2003 amounted to NIS 208 million, compared with NIS 225 million at the end of 2002, a decline of 7.6%.

The loss in 2003 amounted to NIS 21 million, compared with a loss of NIS 11 million in 2002.

The deterioration in the business results of Israel Discount Capital Markets and Investments Ltd. derives mainly from provisions for the impairment in value of investments, amounting to NIS 31 million.

Cumulative effect of change in accounting method. Part of the investments of DCMI in venture capital funds, where such investments do not grant a significant influence in the funds, are stated at cost. Accordingly, until now, DCMI determined the provisions for impairment in value of these investments on the basis of a valuation of the investment in the fund as a whole, and not on the basis of the value of the specific assets of such funds.

Following an audit of DCMI performed by the Supervisor of Banks, the latter instructed that that the provision for impairment in value of an investment in a venture capital fund stated at cost, should be based on the financial statements of such fund and not on a valuation of the fund as a whole. This means that if the fund itself has

included a provision in respect to one of its investments, then DCMI must accordingly record its share in this provision, regardless of whether there was or was not a decline in the valuation of the investment in the fund as a whole.

DCMI believes that the accounting treatment it had applied in the matter is the appropriate treatment in accordance with generally accepted accounting principles. DCMI has related its position to the Supervisor of Banks and has also submitted an opinion rendered by its Independent Auditors supporting its professional position. However, the Supervisor of Banks rejected the position of DCMI and instructed it to change the accounting treatment of this matter, by way of presenting the cumulative effect of this change.

Based on this instruction, DCMI, and following it the Bank, applied this change in accounting by way of stating its cumulative effect as of January 1, 2003. Implementing this instruction reduced earnings by NIS 17 million.

Return on equity in 2003 reached a negative rate of 16.9%, compared with a negative rate of 8.5% in 2002.

In 2003, Israel Discount Capital Markets and Investments Ltd. participated in the underwriting of 4 public issues of securities.

In the field of venture capital fund management, DCMI participated in a number of capital funds, including:

First Israel Mezzanine Fund (FIMI), jointly with foreign investors. The total investment in the Fund is US\$ 91 million and DCMI's share will reach US\$16 million, of which US\$ 13.3 million have been invested by December 31, 2003.

The Israel International Fund, which was established jointly by Hambros Bank of England (which was acquired by Investec) and DCMI, specializes in export-oriented projects. The Fund's investors include a group of Japanese investors headed by the Nomura Company. Total investment in the Fund is US\$ 50 million and DCMI's share will reach US\$ 8.1 million, of which US\$ 7.6 million have been invested by December 31, 2003. The Fund has completed its investments and realized holdings in some of its investments.

Vertex Venture Management (III) Capital Fund (hereinafter referred to as "the First Vertex Fund") is jointly held with the Government's Inbal Company (formerly "Yozma") and Singapore Technology, a large Singapore company connected with the Singapore Government. The size of the Fund is US\$ 35 million and DCMI's share is US\$ 5.3 million. The Fund has repaid the entire investment amount to its investors and has begun distributing profits. Following the success of the First Vertex Fund, **Vertex Israel II Venture Capital Fund** was established. The size of the Fund is US\$ 160.0 million, and DCMI's share will reach US\$15 million, of which US\$ 6.4 million had been invested by December 31, 2003.

Vitalife Fund. DCMI has initiated a Fund in life sciences. Following the completion of the initial capital raising, the Fund will reach an amount of US\$ 50.3 million, of which the share of DCMI will amount to US\$ 10 million. The investment of DCMI in the Fund as of December 31, 2003, amounted to US\$ 5.2 million.

DCMI, together with Foresight Ltd, established **Golden Gate Bridge Fund** which engages in providing interim financing for high-tech start-up companies. The size of the Fund is US\$ 6 million, and DCMI's share will reach US\$2 million, of which US\$ 1.2 million has been invested by December 31, 2003. The Golden Gate Fund was transferred to the joint management with Felanos Technologies Fund.

DCMI jointly with Bezeq and others established the **Stage One Venture Capital Fund**, which is to invest in companies engaged in the communications and information technology fields. The capital of the Fund was set at US\$50 million. DCMI's share of this amount is US\$10 million, of which US\$ 6 million had been invested by December 31, 2003.

Alon Fund. DCMI has invested in a venture capital fund of the Gaon Asset Management Group, which invests in “late stage” technology companies. The capital of the fund is US\$30 million of which the share of DCMI is US\$ 2 million.

DCMI has invested in “**Menif**” - **Financial Services Ltd** together with Mivtach Shamir Finances, Clali Investments & Properties, Walter Rosenthal Ltd and Edmond Chachek. “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 projects in consideration for receiving part of the profits. DCMI holds 19.6% of the share capital of “Menif” and has undertaken to provide guarantees for projects of up to US\$ 6 million. Up to December 31 2003, DCMI provided guarantees in a total amount of NIS 14.5 million.

DCMI holds 70% of the equity capital of **Foresight Financial and Business Counseling Co. Ltd**, engaged in economic consulting, research and investment banking, in the communications, software and Internet field.

DCMI invested US\$1 million in tecc-IS, a company traded on the London AIM Stock Exchange. tecc-IS invests in Israeli high-tech companies.

See Note 19C. 16.5.1 regarding an indictment filed against the company and against two of its former employees, as well as regarding a monetary claim submitted in respect of damage allegedly caused in the same matter.

Additional investments in funds. In addition to the investment in funds through DCMI, the Bank invests directly in FIMI Opportunity Fund. The capital of this fund is US\$ 114 million, of which the Bank's share is US\$ 22 million. As of December 31, 2003, the Bank invested US\$ 4.6 in this fund.

Furthermore, Mercantile Discount Bank is committed to an investment in five venture capital funds. As of December 31, 2003, the investments of Mercantile Discount Bank in the said funds amounted to NIS 7 million. The maximum commitment for future investments in the funds amounted at December 31, 2003, to NIS 13.5 million.

TACHLIT DISCOUNT - INVESTMENT COUNSELING & MANAGEMENT CO. LTD.

Tachlit Discount - Investment Counseling & Management Company Ltd., a fully owned and controlled consolidated company of the Bank, is engaged in managing securities portfolios for private clients, companies, non-profit organizations and institutional investors.

As at December 31, 2003, Tachlit managed 957 investment portfolios with assets totaling NIS 1,116 million, compared with 771 portfolios with assets of NIS 671 million as at December 31, 2002.

ILANOT DISCOUNT LTD.

Ilanot Discount is a subsidiary of the Bank. As of December 31, 2003 the Bank owns 55% of the equity of Ilanot Discount, while IDB Development Company Ltd. (“IDB”) and Discount Investment Company Ltd. (“DIC”) hold the balance of the equity in equal parts.

The agreement dated September 1999, between the Bank and Ilanot Batucha, according to which the Bank acquired control over Ilanot Discount. (hereinafter – “the Agreement”), provided, inter-alia, provisions regarding the obligations and rights of the parties upon the transfer of control in Ilanot Discount or in the controlling parties therein.

Since December 1999, soon following the acquisition, the value of the mutual investment trust funds managed by Ilanot-Discount has increased from NIS 3.5 billion to NIS 10.2 billion at the end of 2003, and the market share of Ilanot-Discount has increased from 9.9% to 12.3%.

Until March 2003, Clal Finances Management Ltd. (formerly Ilanot Batucha Investment House Ltd.) (hereinafter - "Clal Finances"), a company controlled by IDB and DIC, owned 45% of the equity of Ilanot discount.

On March 24, 2003, the General Meetings of Shareholders of IDB and DIC approved the sale of their holdings to its shareholders (who in turn transferred them to the present shareholders). IDB and DIC assumed all of the obligations of Clal Finances towards Ilanot Discount and the Bank, except for an obligation for indemnification, for which Clal Finances remains liable, and except for an agreement to provide services to Ilanot Discount by Clal Finances.

Ilanot Discount engages in mutual funds management 53 mutual funds were managed by Ilanot Discount at December 31, 2003.

The value of the mutual funds managed by Ilanot Discount amounted to NIS 10.2 billion at the end of 2003, compared with NIS 5.2 billion at the end of 2002. Ilanot Discount's share in the mutual funds market increased from 11.3% to 12.3% at December 31, 2003.

PROVIDENT FUNDS, SEVERANCE PAY FUNDS AND FURTHER EDUCATION FUNDS

The provident funds managed by the Bank's subsidiary Discount Management of Provident Fund Ltd. include:

- Two funds for the self-employed and for salaried employees - "Tamar" and "Geffen";
- Two funds for self-employed persons only - "Shikma" and "Toar". "Toar" is a provident fund that combines long term savings with deposit insurance;
- A general severance pay fund;
- A multi-channel provident fund, "Eshkolot";
- A multi - channel severance pay fund - "Hadas".

Total assets of these provident funds amounted to NIS 15.0 billion as at December 31, 2003, compared with NIS 13.4 billion at the end of 2002, an increase of 12.3%.

The yields in real terms achieved by the provident funds in 2003 were as follows:

"Tamar": 17.63%; "Geffen": 17.45%; "Shikma": 17.56%; "General Severance Pay Fund": 17.61%; "Toar": 19.14%.

"Hadas" provides a unique investment channel for each employer. Therefore the Fund is not able to publish information as to yield.

"Tamar" Provident Fund, the largest of all funds managed by "Discount Management of Provident Fund", achieved on the average of the three years 2001-2003, the highest return of all provident funds of the banks.

The multi-channel provident fund, "Eshkolot", recorded positive real-term yields in all its investment channels, at rates of between 8.58% and 33.10%, except for the foreign currency channel that recorded negative real-term yields of 3.94%.

At the end of 2003, the provident funds had a total of 572,000 accounts, compared with 596,000 at the end of 2002, a decrease of 4.0%.

With regard to government decisions concerning provident funds, see Note 33 to the financial statements, to which the auditors draw attention in their auditors' report.

Employees Supplementary Training Funds. “Kahal”- Employees’ Supplementary Training Fund Ltd. and “Kahal Maslulim” are jointly held by the Bank and by Bank Leumi Le-Israel B.M. (BLL).

In addition, Mercantile Discount Bank Ltd. manages seven additional provident funds directly and through a consolidated company, including severance funds and a supplementary training fund. The funds’ asset value as at December 31, 2003 was NIS 2.8 billion, an increase of 17.2% over the preceding year. At December 31, 2003, the funds numbered 112 thousand members, an increase of 1.4% over the number of members at December 31, 2002.

GROUP’S PROFITABILITY BY MAIN OPERATING SEGMENTS

ADMINISTRATIVE STRUCTURE

The Bank’s business operations were conducted in 2003 by way of four divisions: Corporate Banking Division, Banking Division, Commercial Banking Division and Finance Division.

The Corporate Banking Division is responsible for operations with large and medium size companies and for service to specific customer segments, diamond dealers, construction companies (real estate project financing) and approved enterprises.

The Banking Division is responsible for operations with VIP customers, households, consumers, small companies and businesses, non-residents and private banking and direct banking customers.

The Commercial Banking Division is responsible for operations with Middle Market customers and manages the activities of the business centers, foreign trade department, the Tel-Aviv Main Branch as well as business branches.

The Finance Division is responsible for the Bank’s financial investments and managing the Bank’s own investment portfolio and liquidity.

BUSINESS SEGMENTS

GENERAL

The Supervisor of Banks issued, in December 2001, directives concerning the reporting of segment information in banking corporations (for details see Note 31d).

As the Bank is unable, at this stage, to provide information as to operating results by business segments, only partial data, with the consent of the Supervisor of Banks, is presented hereunder:

Under these circumstances, additional data are presented in the financial statements, as follows: Details as to segment information of the Mercantile Discount Bank (see Note 31 D to the financial statements) and details as to segment information of the Discount Mortgage Bank (see Note 31 E to the financial statements).

The Bank is preparing to present data as to its operating results by segments of operation as from the first quarter of 2004.

A. BUSINESS SEGMENTS OF THE BANK’S OPERATIONS

Following are certain data concerning the Business segments of the Bank. It should be noted that these segments do not match with the organizational structure of the Bank, both because certain operations are presented separately, such as the construction and real estate segment, and because of the fact that the Middle Market

Banking Division was established and began operations only at the beginning of 2002.

Corporate banking: This segment includes customers of the corporate division business center and large corporate customers of the banking division, except for real estate and construction customers and customers of the Private International Banking Centers. This segment includes large corporations, mainly corporations with annual turnover of over NIS 150 million and/or total indebtedness of at least NIS 40 million.

Middle Market banking: This segment includes customers of the business centers, customers of the Tel-Aviv Main Branch and customers of the Diamond Exchange Branch, as well as medium size corporate customers of the Banking Division (except for real estate and construction customers and customers of the Private International Banking Centers). This segment includes mainly corporations having an annual turnover of between NIS 15 million and NIS 150 million, and/or total indebtedness of between NIS 4 million and NIS 40 million.

Retail banking: This segment includes small corporate customers of the Banking Division, VIP customers, small and private businesses (except for real estate and construction customers and customers of the Private International Banking Centers). This segment includes mainly corporations and businesses with a total indebtedness of up to NIS 4 million.

Private banking: This segment includes customers of the banking division, foreign residents and Private International Banking Centers customers (except for real estate and construction customers).

Construction and real estate: Customers of the various divisions, which are classified as belonging to the construction and real estate industry.

Average balances in December						
(in NIS millions)						
	2003			2002		
	credit to the public	of which credit cards	deposits of the public	credit to the public*	of which credit cards	deposits of the public
The segment						
Corporate banking	15,790	7	3,757	17,436	7	3,330
Middle Market banking	7,141	-	6,727	6,420	-	5,939
Retail banking	7,388	520	51,517	7,109	468	47,168
Private banking	614	-	10,004	945	-	17,232
Construction and real estate	11,642	-	1,530	10,687	-	1,034
Total	42,575	527	73,535	42,597	475	74,703

* Reclassified



Kotli Kamenitz, Photoprinture

PAINTING EXHIBITION The third largest collection of Israeli art in the country is the result of Israel Discount Bank's encouragement of artistic endeavors in Israel. The artwork collected by the Recanati Family since the 60's adorns the offices of the Bank and its branches in Israel and overseas. Some 300 works of art were selected in cooperation with the Tel-Aviv Museum and shown in an exhibition "Israeli Art - A Selection from the Collection of Israel Discount Bank".

| Kutty Navon, a customer of the Bank and owner of the "Meitzag Gallery" is transporting Yohanan Simon's painting "Sabbath in the Kibbutz" |

B. BUSINESS SEGMENTS OF THE DISCOUNT GROUP OPERATIONS

Following are certain data concerning the following business segments of the Discount Group, credit cards, capital market and non-banking companies:

	For the year ended					
	December 31, 2003			December 31, 2002		
	Credit cards	Capital market activity	Non-banking activity	Credit Cards	Capital market activity	Non-banking activity
Total income	462	197	25	405	189	11
Total expenses	337	174	21	370	179	18
Net earnings	25	10	55	7	2	12

Footnotes:

- (1) The reflected credit card segment is taken from the consolidated financial statements of ICC. In addition, the Bank earned income from credit cards (as reflected in Note 24), most of which is recorded as an expense in the financial statements of ICC. It also granted credit to credit card holders, the amount of which is detailed in A above. These items were not included in this segment information. As at this stage, the Bank does not have data concerning the cost to the Bank of such operations in this segment as well as concerning the assets and liabilities.
- (2) Capital market activity – includes the activities of Ilanot Discount, Tachlit and the Discount Management of Provident Fund, as reflected in their financial statements. The above presented data do not include data concerning the capital market activity of certain subsidiaries of Mercantile Discount Bank. For detail regarding this operation, see Note 31 D to the financial statements.
In addition, the Bank and its banking subsidiaries earned commissions from securities operations, as stated in Note 24. This data is not included in this segment information. As at this stage, the Bank does not have data concerning the cost to the Bank of such operations in this segment as well as concerning the assets and liabilities.
- (3) Non-banking activity – this segment includes the non-banking investments made by the Bank, the principal of which is the investment in Harel. In addition, it includes data concerning Israel Discount Capital Markets & Investments.

Housing loans activity of the Group – The Discount Bank Group activity in the housing loan field is mainly conducted by Discount Mortgage Bank Ltd. as well as by Mercantile Discount Bank Ltd. For details regarding the mortgage loan activity of Mercantile Discount Bank see Note 31 D to the financial statements. For details regarding segment information of the Discount Mortgage Bank (see Note 31 E to the financial statements).

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, 2003, amounted to NIS 5.6 billion, compared with NIS 5.9 billion on December 31, 2002. Following is the distribution of net income (loss) by main operating segments (in NIS millions):

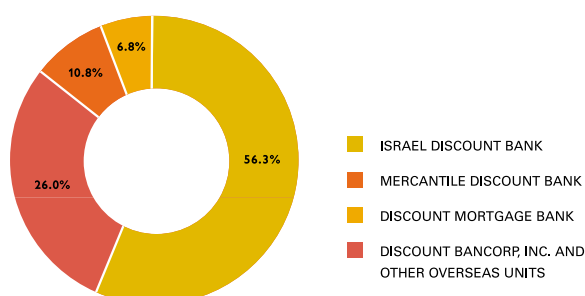
	Contribution to Group's results		Contribution disregarding the effects of coverage of investment(*)	
	2003	2002	2003	2002
Banking Activity:				
Commercial banks:				
In Israel - the Bank (including branches overseas)	148	(366)	79	(348)
- Consolidated company	86	58	86	58
- Affiliated company	(130)	(17)	(130)	(17)
Overseas - Bank offices	(31)	215	38	197
Mortgage Bank	18	24	18	24
Other Activities:				
Credit cards	24	8	24	8
Other financial services	76	5	76	5
Total operating gain (loss)	191	(74)	191	(74)
Income (loss) from extraordinary operations	(23)	36	(23)	36
Net gain (loss)	168	(38)	168	(38)

(*) The Bank in Israel created a surplus of liabilities in foreign currency, constituting coverage for the Bank's investment in Discount Bancorp, Inc., and as from May 2001 also in Israel Discount Bank (Switzerland), with the aim of preventing exposure to fluctuations in the exchange rate of the shekel against the US dollar and the Swiss Franc.

In the Statement of Income of the Bank 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 2003, the shekel was appreciated in real terms as against the US dollar by 5.8%, compared with a devaluation of 0.7% in 2002. In 2003, the shekel was devalued in real terms against the Swiss Franc by 5.9%, compared with a devaluation of 21.7% in 2002. The said devaluation/appreciation resulted in an increase in the Bank's net operating income after tax in Israel by NIS 69 million, compared with a decrease of NIS 18 million in net operating income in 2002. Concurrently, there was a decrease/increase in the positive contribution by overseas extensions to the results of the Bank.

BREAKDOWN OF ASSETS WITHIN THE GROUP



MAIN INVESTEE COMPANIES

At the end of 2003, 18.7% of all assets in the consolidated balance sheet were assets of the Bank and of consolidated companies in Israel, and 25.7% were assets of overseas consolidated companies and branches. The contribution to the net results by the consolidated companies in Israel totaled NIS 116 million in 2003 (2002: NIS 77 million). The contribution to the net results by overseas consolidated companies totaled NIS 31 million in 2003 (2002: NIS 215 million), and the contribution to the net results by affiliated companies totaled NIS 121 million in 2003 (2002: NIS 1 million).

The total contribution by both domestic and overseas investee companies to the net results of the Bank amounted to NIS 206 million in 2003, compared with NIS 293 million in 2002.

Disregarding the effect of the differential between the rate of increase in the "actual" CPI and the rate of increase in the "known" CPI, as well as 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 net results of the Bank in 2003, would have been NIS 275 million, compared with NIS 274 million in 2002.

DISCOUNT BANCORP, INC.

Discount Bancorp, Inc. ("Bancorp") is fully owned by the Bank. Bancorp holds full ownership and control of Israel Discount Bank of New York (IDB New York).

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 prior written consent thereto. A caveat to this effect appears on the share certificate of IDB New York.

Total assets at the end of 2003 amounted to US\$ 7,714 million, compared with US\$ 7,084 million at the end of the preceding year, a rise of 8.9%.

Total credit at the end of 2003 was US\$ 2,214 million, compared with US\$1,845 million at the end of the preceding year, an increase of 20.0%.

Total deposits stood at US\$ 4,587 million as at the end of 2003 compared with US\$4,383 million at the end of the preceding year, an increase of 4.7%.

Shareholder's equity totaled US\$ 524 million at the end of 2003, compared with US\$ 553 million at the end of the preceding year, a decrease of 5.2%.

Bancorp did not distribute dividends in 2002. At the beginning of 2003, Bancorp distributed a dividend of US\$ 45 million out of the earnings of 2002. In September 2003, Bancorp distributed a dividend of US\$ 15 million, and in March 2004, Bancorp distributed an additional dividend in the same amount.

The ratio of capital to risk assets was 13.6% as at December 31, 2003, compared with 15.3% at December 31, 2002.

Net income in 2003 totaled US\$ 42 million, compared with US\$ 55 million in the preceding year, a drop of 20.8%.

Return on equity was 7.6% in 2003, compared with 10.8% in 2002.

The contribution of the Bank's investment in Bancorp to the net results of the Bank was a loss of NIS 25 million in 2003 (after deducting a provision for additional tax of NIS 86 million that applies to the Bank in Israel), compared with NIS 212 million in 2002 (after deducting provision for additional tax of NIS 27 million that applies to the Bank in Israel).

The said contribution is comprised of Bancorp's net income in 2003 (after deducting the provision for tax as aforesaid) of NIS 97 million with the addition of real term exchange rate differentials on the investment of NIS 122 million, compared with net income of NIS 204 million (after deducting a provision for tax as aforesaid) and with the addition of real term exchange rate differentials on the investment of NIS 8 million in 2002.

Together with exchange rate differentials on the said investment, the Bank in Israel recorded financing expenses in 2003 and financing expenses in the preceding year, in respect of the surplus foreign currency liabilities that the Bank created as coverage for the investment in Bancorp.

IDB New York continues to be the largest Israeli bank operating overseas.

DISCOUNT BANK (LATIN AMERICA) – DEVELOPMENTS IN THE FINANCIAL SYSTEM IN URUGUAY:

Discount Bancorp Inc. has full ownership and control of Discount Bank (Latin America) (hereinafter – “DBLA”), which operates as a commercial bank in Montevideo, Uruguay.

As from February 2002, the economy of Uruguay began to deteriorate, resulting in the downgrading of this country by the international credit rating companies, and in the withdrawal by the public of deposits with banks. This deterioration reached its peak towards the end of July 2002, when the banking system in the country ceased to operate for several days.

With the support of international factors, such as the World Bank and the International Monetary Fund, and by putting into effect an emergency economic program devised by the Government of Uruguay, the country's banking system resumed operations on August 5, 2002. On February 11, 2003, the credit rating company Standard & Poor's reduced the long-term credit rating of DBLA from “B-” to “CCC”. This reduced rating is a direct result of the reduced credit rating of Uruguay in foreign and local currency, resulting from the Government debt, which reached a level similar to that of the country's Gross Domestic Product.

In view of the heavy debts of the Government and in order to increase the economic stability of the country, the government of Uruguay decided to carry out in May 2003 a debt rescheduling arrangement (conversion of about one half of the foreign currency debt and its rescheduling for five additional years).

Based thereon, the rating company Standard & Poor's decided on June 2, 2003, to raise back the long-term rating of the bank to “B-”, in local and foreign currency.

Indicators in recent months note an improvement in the economic condition of Uruguay. This improvement is explained mainly by the success of the debt rescheduling arrangement as well as by the implementation of a prudent macro-economic policy, while executing structural reforms in the country.

The improvement in the economic condition of the country is reflected also in the activity of the banking industry, which is showing the beginning of positive trends also at Discount Latin America.

MERCANTILE DISCOUNT BANK LTD.

Mercantile Discount Bank Ltd. (“Mercantile Discount”) is a wholly-owned subsidiary of the Bank.

At the end of 2003, Mercantile Discount Bank operated through 63 branches.

Total assets at the end of 2003 amounted to NIS 15,067 million, compared with NIS 14,884 million at the end of 2002, a rise of 1.2%.

Total credit granted to the public at the end of 2003 was NIS 12,293 million, compared with NIS 12,174 million at the end of 2002, a rise of 1.0%.

Total deposits from the public at the end of 2003 amounted to NIS 13,265 million, compared with NIS 13,064 million at the end of 2002, a rise of 1.5%.

Shareholder's equity at the end of 2003 amounted to NIS 898 million, compared with NIS 781 million at the end of 2002, a rise of 15.0%.

The ratio of capital to risk assets was 10.8% as at December 31, 2003, compared with 10.0% as at December 31, 2002.

In 2003, the Mercantile Discount Bank raised secondary capital of NIS 81 million, by way of the issue of subordinate capital notes. Ma'alot – The Israeli Securities Rating Company Ltd., has rated these notes as "AA-" (identical to the rating of other subordinate capital notes issued in the past by Mercantile Discount Bank). This rating relates also to the remaining liabilities of this bank.

Net income was NIS 86 million in 2003, compared with NIS 62 million in 2002, a rise of 39.1%.

The difference between the increase in the "actual" CPI and the increase in the "known" CPI had no effect on the earnings of Mercantile Discount Bank in the years 2002-2003.

The improvement in the profitability of Mercantile Discount Bank in the years 2002-2003, despite the difficult economic conditions which prevailed in those years, was achieved as a result of efficiency measures on the expense side, and the effort made in improving the structure of income of this bank. Matters, which should be noted in 2003, included:

- The increase in earnings from financing operations while diversifying the mix of the resources and applications.
- Increasing the operating earnings through the expansion of operations and of the banking services provided to customers, including the expansion of operations of the mutual trust fund management company. Similarly, the emphasis put on charging commissions in accordance with the volume of operations of the customer, has been increased.
- The tightening of control over operating costs, mainly in the payroll area.

However, the continued slowdown in economic activity in 2003, which resulted in the reduced activity of many businesses and the shutdown of others, had an adverse effect on the activity of many borrowers and on their loan repayment ability. Accordingly, the high level of the provision for doubtful debts remained also in 2003.

The significant improvement in the business results of the Mercantile Discount Bank was mainly the result of the following factors: an increase in earnings from financing operations, a decrease in the provision for doubtful debts, an increase in operating and other earnings and a decrease in the effective tax rate. The improvement was partly mitigated by an increase in operating and other expenses.

Mercantile Discount's contribution to the Bank's net results in 2003 amounted to NIS 86 million, compared with a contribution of NIS 58 million in 2002.

Return on shareholders' equity in 2003 was 11.0%, compared with 8.3% in 2002.

Details of the Government's decision regarding the separation of Mercantile Discount Bank, the plans for sale, as well as the possible effect on the Bank following this separation, are given below in the section "Government Decisions Regarding the Banking System" and in Note 33 to the financial statements, to which attention is drawn by the auditors in their auditors' report.

See Note 19C to the financial statements, articles: 15.1.4, 15.2.1, 15.2.2, 15.2.3, 15.2.4 and 16.2 as regards requests for approval of actions as class action suits against Mercantile Discount Bank in the matter of clearing

operations of payment orders (a request that had been rejected and an appeal was filed against this decision), in the matter of the form of recording post dated checks (a request which had been approved and an appeal was filed against the approval decision), in the matter of charging excess interest (a request that had been rejected and an appeal was filed against this decision), in the matter of a share hiking affair, in the matter of collecting excess stamp duty and in the matter of closing down a certain branch office.

DISCOUNT MORTGAGE BANK LTD.

Discount Mortgage Bank is a subsidiary of the Bank. As of December 31, 2003, the Bank held 65.1% of its equity and of its voting rights.

Discount Mortgage Bank operates by way of three branches (in Tel-Aviv, Jerusalem and Haifa), 36 counters spread all over the country and a telephone center that enables applicants to receive an immediate approval in principle for a loan.

Total assets at the end of 2003 amounted to NIS 9,534 million, compared with NIS 9,450 million at the end of 2002, an increase of 0.7%.

Total credit granted to the public amounted at the end of 2003 to NIS 9,377 million, compared with NIS 9,314 million at the end of 2002, a rise of 0.9%.

Shareholder's equity amounted to NIS 818 million at the end of 2003, compared with NIS 791 million at the end of 2002, a rise of 3.4%.

Net income totaled NIS 27 million in 2003, compared with NIS 42 million in 2002, a decrease of 35.0%.

The difference between the rate of increase in the "actual" and the rate of increase in the "known" CPI, had no effect on the net earnings of Discount Mortgage Bank in 2002 and in 2003.

In comparing net earnings for 2003 with those of 2002, the following factors have to be considered:

- The provision for doubtful debts in 2002 included a supplementary provision for doubtful debts of NIS 4 million (see Note 1I).
- The specific provision for doubtful debts amounted to NIS 70 million in 2003, compared with NIS 44 million in 2002, an increase of 58.8%.
- Operating earnings in 2002 included income from life assurance business of NIS 5 million, which derived from settlement of accounts reached with insurance companies in respect of the updating of life assurance claims.

Return on shareholders' equity in 2003 was 3.4%, compared with 5.6% in 2002.

The ratio of capital to risk assets was 11.6% as at December 31, 2003, compared to 11.9% as at December 2002. The Bank's share in the net income of Discount Mortgage Bank in 2003 totaled NIS 18 million, compared with NIS 27 million in 2002.

See Notes 19C 16.4 and 19C 17 to the financial statements for details of the uncertainties relating to the Discount Mortgage Bank Ltd., to which the auditors have drawn attention in their report on the financial statements, regarding the following matters: A plea to the Supreme Court in the matter of insurance brokerage by mortgage banks; The collection of fees for life assurance policies of borrowers; Supervision of Insurance Business (Special Agent License – Provisional Regulation), 2001, draft law; The regulation of the continued activities of mortgage banks in the property insurance and borrowers' life assurance business while providing housing loans; Several

requests to the Courts to approve actions against mortgage banks, including Discount Mortgage Bank, as class action suits in the matter of charging commission in respect of life assurance and property insurance of borrowers, in the matter of insuring property for amounts exceeding its reinstatement value and in the matter of collecting excess stamp duty.

FIRST INTERNATIONAL BANK OF ISRAEL LTD.

The First International Bank of Israel Ltd. is an affiliated company of the Bank. As of December 31, 2003, the Bank held 26.4% of its share capital and 11.1% of its voting rights.

The Bank's share in the net income of the First International Bank in 2003 totaled NIS 42 million, compared with a loss of NIS 17 million in 2002.

The contribution of the First International Bank to the net results disregarding the efforts of the differential between the increase in the "actual" CPI and the "known" CPI amounted to a loss of NIS 42 million in 2003, compared with net income of NIS 19 million in 2002.

Return on shareholders equity in 2003 was a positive rate of 4.8%, compared with a negative rate of 1.9% in 2002.

The ratio of capital to risk assets stood at 10.6% on December 31, 2003, compared with 9.8% at the end of 2002.

Change in control. On April 27, 2003, FIBI Holdings Ltd. (hereinafter – "FIBI") and the First International Bank Group reported that the controlling owners of FIBI and the First International Bank Group informed of an agreement reached for the sale of the control in FIBI, which holds a 48.3% interest in the equity and 67.2% in the voting rights of the First International Bank, according to which Pallimon BV will sell the FIBI shares it holds, which grant an interest of 51.89% in the equity and 70.59% in the voting rights of FIBI, to Binno Holdings Ltd. (hereinafter – "Binno") and the Lieberman Group, made up of the Michael and Helen Ables family and the Lee Lieberman family (LGC Investment Group), in consideration of US\$ 90 million.

Provision for impairment in value. See note 6 to the financial statements for details of an opinion received by the Bank regarding the value of its Investment in the First International Bank, according to which the recoverable value of this investment does not fall below the equity value of this investment, therefore, according to generally accepted accounting principles no provision for impairment in the value of this investment is required; and for details of the provision for impairment in value that has been recorded in accordance with an instruction of the Supervisor of Banks.

ISRAEL CREDIT CARDS LTD

Israel Credit Cards Ltd. ("ICC") is a subsidiary of the Bank. As of December 31, 2003, the Bank owned 51% of the equity and 63% of the voting rights in ICC and in Dinars. The remaining shares are held by strategic partners: The First International Bank, Fishman Networks, and Harel (for details as to the acquisition of the control in ICC, see Note 34A. to the financial statements). Included in the Bank's shareholding are shares acquired with the intention of resale, the balance of which at December 31, 2003 was 16% in ICC and 7% in Dinars. These shares are stated in the financial statements as available-for-sale securities.

Total assets amounted at the end of 2003 to NIS 1,504 million, compared with NIS 903 million at the end of 2002, an increase of 66.6%.

Total capital resources amounted at the end of 2003 to NIS 232 million, compared with NIS 197 million at the end of 2002, an increase of 17.8%.

Total income amounted in 2003 to NIS 462 million, compared with NIS 404 million in 2002, an increase of 14.4%.

Net earnings amounted in 2003 to NIS 73 million, compared with NIS 19 million in 2002, an increase of 284.2%.

Return on equity reached 37% in 2003, compared with 10.2% in 2002.

The share of the Bank in the net earnings of ICC in 2003 amounted to NIS 26 million, compared with NIS 8 million in 2002.

ICC issues and operates "VISA", "Diners" and "MasterCard" credit cards.

In December 2003, ICC acquired 100% of the equity interest in Iatzil Finance Ltd., engaged in the clearing of credit card transactions of business entities.

For details regarding changes in the arrangements concerning credit cards in Israel, see Note 34B. to the financial statements. For details concerning pleas for approval of actions as class action suits regarding limitation of responsibility fees, concerning commissions of business houses (an action approved as a class action suit, against which several appeals have been lodged), and concerning commission relating to payments made abroad, see Note 19C. paragraphs 16.3.1, 16.3.2 and 16.3.3 to the financial statements, to which the Auditors draw attention in their report on the financial statements. For details concerning indemnities granted by Leumi Holdings to the Bank in respect of certain legal actions, see Note 34B. to the financial statements.

HAREL INSURANCE INVESTMENTS LTD.

Harel Insurance Investments Ltd. (hereinafter – "Harel") is an affiliate of the Bank. At December 31, 2003 the Bank held a 20% interest in the equity and in the voting rights of Harel.

Harel is a holding company that primarily engages in the various insurance areas and in additional areas, such as the capital market, real estate and communications. The acquisition of the means of controlling in Harel was accomplished on December 2001, as a strategic investment that will diversify the Bank's sources of income.

Net earnings in 2003 amounted to NIS 401 million, compared with net earnings of NIS 133 million in 2002, an increase of 202.3%.

The return on equity in 2003 was 37.1%, compared with 13.3% in 2002.

The contribution of Harel to the net earnings of the Bank amounted in 2003 to NIS 73 million, compared with NIS 19 million in 2002.

With regard to motions for approval of actions against Harel and its consolidated subsidiary, Harel – Insurance, as class action suits, see Note 19C. 18 to the financial statements, to which the auditors drew attention in their opinion on the financial statements.

HUMAN RESOURCES

The average monthly number of employees, based on full-time positions, in the Bank in Israel (not including overseas branches) was reduced from 5,298 in 2002 to 5,264 in 2003, a decrease of 34 of the average monthly number of employees, 0.6%. The Bank had 4,111 tenured employees at the end of 2003, compared with 4,221 tenured employees at the end of 2002, a net decrease of 110 employees. The total number of the Bank's employees at the end of 2003 was 5,180, compared with 5,321 employees at the end of 2002, a decrease of 141 employees. There was a total of 5,264 employees in full-time positions in the Bank in Israel at the end of 2003, compared with 5,274 at the end of 2002, a decline of 0.2%.

The average direct cost per employee position in the Bank in Israel in 2003 was NIS 171 thousand, compared with NIS 168 thousand in 2002, an increase of 1.8%.

The total average cost per employee position in the Bank in Israel, not including voluntary early retirement expenses, in 2003, was NIS 254 thousand, compared with NIS 247 thousand in 2002, an increase of 2.8%. The increase in the total cost per employee position results mainly from the increase in direct salary as detailed above and from the increase in the salary tax expense in 2003, as compared to 2002, in which a salary tax expense was not included as a result of the loss of the Bank for profit tax purposes in that year.

The total average cost in 2003, per employee position in the Bank in Israel, net of voluntary retirement expenses and net of the change in the payroll tax expense, amounted to NIS 254 thousand, compared with NIS 263 thousand in 2002, a decrease of 3.4%.

The average monthly number of employees in full-time positions in the Group, both in Israel and abroad, at the end of 2003, was 8,562, compared with 8,674 at the end of 2002, a decline of 1.3%.

There were 8,551 full-time positions in the Group at the end of 2003, compared with 8,639 at the end of 2002, a decline of 1.0%.

The average cost per employee in the Group in Israel and abroad in 2003 was NIS 262 thousand, compared with NIS 252 thousand in 2002, an increase of 4.0%.

The average overall payroll cost per employee of the Group in Israel and abroad, excluding the change in the salary tax expense, amounted in 2003 to NIS 262 thousand, similarly to 2002.

The labor force of the Group and the Bank, in terms of full-time positions, appears below:

	As of December 31		Monthly average in	
	2003	2002	2003	2002
The Bank in Israel	5,264	5,274	5,264	5,298
Domestic subsidiaries	2,382	2,474	2,399	2,471
Group total in Israel	7,646	7,748	7,663	7,769
Overseas branches	31	31	29	31
Overseas subsidiaries	874	860	870	874
Group total overseas	905	891	899	905
Group total overseas and Israel	8,551	8,639	8,562	8,674

RETIREMENT OF EMPLOYEES

In the years 2000-2003, the Bank encouraged early retirement of employees, focusing upon an employee population having defined characteristics, in respect of which a focused effort was made to encourage their early retirement at beneficial terms.

182 employees retired during 2003, of which 142 employees took early retirement. During 2002, 137 employees retired from the Bank, of which 96 took early retirement. During 2001, 250 employees retired from the Bank, of which 170 took early retirement. During 2000, 313 employees retired from the Bank, of which 215 took early retirement. In total, 882 employees retired from the Bank in the period 2000-2003, of which 623 were under the early retirement plan.

Among those who retired in 2003 were 47 managers (26% of all retirees in this year), compared with 41 managers in 2002 (30% of all retirees in the year).

DEVELOPMENT OF HUMAN RESOURCES

Employee development and the treatment of the human resource were defined as one the super targets of the Bank's Management for 2003.

Derived from the managerial concept adopted by the Bank and the profile definition of the desirable manager, and following the creation of the suitable infrastructure in 2002, a development program was formed and implemented in 2003, focusing on three central levels:

- Personal level (hierarchic courses)
- Organic level
- System level

At the personal level, an advanced development framework was developed, focusing on the executive avenue. The central guiding principle in this respect is the formation of two classes of qualification: Qualification for the position and qualification within the position. In this framework, a management reserve course was implemented where some 60 employees have graduated; a reserve course for branch management was planned; ten qualification courses for acting deputy managers were completed; groups for the qualification of investment consultants were trained.

The organic level is a multi-disciplinary approach, which combines professionals from various disciplines (organizational, managerial, service and tutorial) in order to form a customized development program for a particular organic unit. According to this approach, assistance is provided to the unit manager in forming the vision (the desired situation), in diagnosing the position of the unit (the existing situation) and in forming unique operative development programs to bridge the gap between the desired and existing situations.

The system level provides a managerial toolbox for the empowerment of managers by the cross-organization method. In the course of 2003 the following projects were implemented within this framework: the conduct of team discussions project; the process of digesting consequence project; advice to managers entering a new position; support in absorbing the retail strategy; instituting the culture of conducting personal feed-back discussions; the founding of "Managers Club" for enrichment of managers in various fields of management, and more.

Also in 2003, the Bank continues to encourage the staff to acquire higher education, which included the

participation in tuition fees for 209 employees. 64 employees completed their studies for a Bachelor Degree in 2003, and 14 employees completed their studies for a Master Degree.

ABSORPTION OF THE SERVICE CULTURE IN THE BANK

The service field at the Bank was defined as a super target in the strategy of the Bank.

This decision was at the base of cross-organization action programs for the enhancement and improvement of service, which became a significant landmark in the organization. From this point onwards a revolution in the service culture of Discount Bank has taken place, which can be identified in nearly every area of banking operations and in the fabric of internal organization working relations. The activity is reflected in the empowerment of the customer's experience in each of his meeting points with the Bank on the one hand, and in the extensive efforts made in improving the intra-organization service circles, on the other hand.

Already at the stage of classification and recruitment, tests were built-in, which identify clearly the high level of service consciousness, as a necessary acceptance condition.

The "contribution" and personal obligation of each employee to the success of the service improvement process, is reflected in the annual personal evaluation forms and in the professional feed-back discussions. Inter-alia, these also serve as a basis for the selective advance in salary considerations.

Also in the position development – both professional and hierarchical – the significance of the service consciousness is outstanding and constitutes an advancing or "rejecting" factor in appointment decisions to the managerial level and the fulfillment of executive duties, such as a branch manager or department manager, and above that in particular.

Even more so, all the management qualification courses and all frameworks for managers development, are designed to deal with the formation of the image of a business/professional manager as the service manager.

The absorption of the "excellent service" as an ideological and overall approach in the day to day work will be carried out by a varied and unique training, to which are party hundreds of "activists" from within and without the Bank. For example: service seminar for the promotion of the service consciousness, according to which every service provider is also a service consumer, and to the avoidance of preliminary gaps between actual service and customer expectations, by way of analyzing the intra/extra organizational service experience "on a live broadcast"; routine meetings for the mapping and "improvement" of the service status, while using novel absorption tool such as "frontal challenge" with the customer; tightening the field-head office relations; an intelligent use of the intra-organizational communication channels for the distribution of information, messages and service tips and for the appreciation survey; the harnessing of the Bank's Management to practical contribution and to the appreciation survey in the field of service at the Bank.

The varied activity in the service field and its positioning as the uppermost preference in the Bank's strategy derives from the recognition that the creation of a cross-organization service atmosphere constitutes the means for a competitive advantage supporting the Bank's business goals.

TRAINING

In 2003 professional training of and instructions to staff received extensive and focused response on matters, which are found in the center of the work plans of the Bank. This improved the existing training methods by way



Kobi Kalmanovitz, Photoportraiture

WE TAKE HIM PERSONALLY Pinnie Buchnik, marketing director of Radio Escape99: "At the first meeting with the Bavly branch manager I defined my needs. I explained that I am a busy person who finds it difficult to get to the bank. I did not tell her that as far as I am concerned, a bank is a frightening institution. However three months later, I knew that Alice succeeded in driving away this fear of the bank. She renders me a service that cannot be surpassed. She is always available for me, and I am satisfied. Very satisfied."

| Pinnie Buchnik was recruited as a customer under the campaign for recruiting 100,000 new customers. Ms. Alice Meir is the branch manager that attends to him personally |

of remote study, decentralizing training, participation of experts on various subjects taken from the “field” to structure the training courses and lecture, the development of structured apprenticeship procedures, etc.

In order to integrate a new computer system for the entire Bank, a remote study system has been acquired, which will enable independent study through an educational computer software. The study process is implemented by the “waterfall” method, according to which a small number of the staff learns the new system and later assists in the independent study of the remaining staff in their units.

In an additional integration project, which implements the “private customer segments” strategy in the branch system, a program has been structured, which includes the completion of banking know-how, training in marketing and service, and programs assisting branch managers as leaders of the change.

The number of training days in 2003 reached 30,259, compared with 17,770 days in 2002, a remarkable increase of 70%.

A vital and central tool for intra-organization communication was launched in 2003 – the organizational Intranet, used as a platform for the distribution of information, for the transmission of all-organization messages, learning, data management and the absorption of organizational culture. Also existing are varied communication channels: “Management open line” taking place twice a year; the Discount Newsletter issued monthly; the Discount Magazine – a television magazine similar to a news broadcast intended to share knowledge and information with the employees, and to present an up-to-date picture of issues on the agenda of the Bank. The Magazine includes reports and simulations and it serves as an important layer of the new organizational culture of the Bank. The Magazine is produced at fixed intervals and is transmitted to all units and branches of the Bank.

LABOR RELATIONS

With regards to orderly labor relations and cooperation, the following agreements were signed in 2003:

In April and May 2003, final employee remuneration agreements for the years 2001 – 2002 were signed. The agreements also determined the payment of an advance on account of a pay rise for 2003. At the same time agreements concerning “Retirement terms” were also signed. According to these agreements, the “retirement terms” to which employees taking early retirement are entitled, will be reduced in the period until they reach the retirement age determined in the Bank.

An additional agreement signed with the representative committee of the managers determines a new executive position, which will be added to the line of executive positions: “Senior business banker”.

Also were signed collective agreements with respect to employment terms of computer operators at the computer services division of the Bank, and with respect to the increase in the number of dealers in the dealing room, who may be employed according to personal employment agreements. Recently, an additional agreement was signed, which entitles the Bank to employ additional staff under personal employment agreements.

Recently, on March 11, 2003, on grounds of the intention of M.I. Properties Ltd. to renew the process for the sale of the Bank, The Federation of Labor declared a labor dispute and a strike in the matter of “a demand for the signing of a new collective labor agreement to secure the rights of the employees with respect to the process of the sale of control of the Bank”.

CHANGE IN THE ORGANIZATIONAL STRUCTURE

A decision in principle was made in January 2003, with regard to a change in the organizational structure of the Bank, according to which a central function will be established for the management of customer assets under the responsibility of a member of Management.

The said member of Management has been given the responsibility for subsidiary companies engaged in the management of customer assets. At the end of May 2003, the Board of Directors decided to define this function as **Division for Customer Assets**, and that as from June 1, 2003, the securities department would be transferred from the banking division to the new division.

CUSTOMER SERVICE

The target of recruiting 100,000 new private customers was attained in 2003. This was achieved by the exceptional cooperation of the staff of the headquarter units of the Bank with the staff of the branches, while emphasizing the personal and warm service and the matching and control of the work of the headquarters staff with that of the staff of the branches. The attractive banking terms, including the payment of interest on current account credit balances, exemption from fixed ledger fees, exemption from commissions on allotment of credit, a credit line of up to three times the amount of the monthly salary income, and more, also facilitated the great success in recruiting private customers.

THE PRIVATE SECTOR

The Banking Division guides the development and application of retail banking in the bank.

The strategy formed in 2002 was implemented in 2003 with regard to the private customers sector, which defines the customer segments belonging to this sector and the differentiation in service adapted to each segment.

The principles of this strategy are based on the concept which places the customer at the forefront while the service systems, both inside and outside the branches, are adapted to the customers' needs and characteristics.

The physical and organizational infrastructure in the branches and in the different service systems was adapted to these principles. The customer receives comprehensive service at one service station, from a team, which specializes in the sector being served by it.

In order to provide such comprehensive service, the personnel of the branches are to undergo training to complete their knowledge and enhance their professionalism in a variety of subjects. In addition they are to attend service seminars and are being tutored in this area.

The differentiation between customers of the private sector is based on financial wealth, volume of activity, development potential and assessment of profitability as a function of their activity.

Four main rings of operation were determined:

VIP Banking – Customers having considerable financial wealth and/or high salaries.

Private Banking – Customers having financial wealth and/or receiving salaries;

General Banking – private customers - households.

The growing segment – students, youth, servicemen.

All activities are adapted to the characteristics of the targeted populations, emphasizing their particular needs. Special emphasis was given in 2003 to the "Private Banking" group - salaried employees. In respect of these customers the Bank has devised a unique credit line of "up to three times the monthly salary".

As part of the specialized service systems, the Bank offers to customers active in securities trading, a unique service – investment centers.

Investment centers provide consulting and trading services for investors. This service is provided to customers having securities investment portfolios of NIS 450 thousand and to customers who are particularly active in the market. Experienced consultants, licensed by the Israeli Securities Authority, man the investment centers. The centers are backed-up by an advanced communications system providing on-line service. The centers operate concurrently with the Tel-Aviv Stock Exchange trading hours. After the close of trading, service is provided by Telebank and the foreign securities dealing room.

INVESTOR CLUBS

The opening of new clubs continued in 2003 side by side with the maintenance of existing clubs. 18 clubs were opened until the end of 2003, of which 11 are fully active. In view of the rising demand, additional lady investor clubs will be opened in 2004; similarly, the opening of new gentleman investor clubs is also planned.

THE BUSINESS SECTOR

The business sector enjoys professional banking services provided by two divisions, the Business Division and the Commercial Banking Division. Both divisions intensified their expertise in the **comprehensive financial guidance**, meaning, an in-depth examination of company needs and the adaptation of creative financial solutions. Customers are granted personal, professional and quality service, which relates to all of their financial needs by offering various customized banking products in the credit, risk hedging, currency hedging, international trade, clearing of credit card transactions, finance, capital market investments among others.

Concurrently, solutions are offered for the financial requirements of the owners of customers, their executives and employees, who enjoy employee arrangements granting them the status of preferred customers.

Business managers in the **Corporate Banking Subdivision** provide financial guidance for the large companies. These managers operate by way of eight teams segmentized according to the line of business operations of the companies. These teams include a business manager, a business banker, economists and loan officers. Such teams constitute a banking address for all the financial needs of the business customer.

The Project Financing Department serves companies engaged in real estate and construction, and continually guides the progress of credit requirements in accordance with the construction progress of the projects.

The department includes also an **"Approved Enterprise"** unit, which guides customers entitled to State benefits in the financing of the acquisition of property and equipment, the establishment or expansion of industrial and tourist projects under the Law for the Encouragement of Capital Investments.

The Diamond Exchange Branch, which also operates under the Business Division of the Bank, specializes in accounts of diamond merchants as well as in all special services required by the diamond industry.

The Commercial Banking Division handles customers belonging to the medium size companies group (companies with a sales turnover of between NIS 15 million and NIS 150 million, or which have credit lines of between NIS



Kotli Kalmanovitz, Photoportraiture

INVESTING IN OURSELVES The Women Investors Club is a unique capital market study course for women, which the Bank has initiated. Some of the best investment consultants and staff of the Securities Department of the Bank instruct the participants regarding the mysteries of the capital markets, beginning with basic concepts and advancing to one's own ability to manage a profitable securities portfolio.

| Dr. Livia Theodor and Dr. Rachel Nachman, both bio-technology scientists, members of one of the 18 Women Investors Clubs located throughout the country |

In the background, the Ayelet Wall — named after Ayelet Arber-Eilat.

4 million and NIS 40 million). The division operates six business centers: Dan, Sharon, Tel-Aviv, South, Jerusalem and Haifa. The service provided by the Centers is most professional and integrative, provided by teams that include business bankers, economists and credit officers.

Customers engaged in international trade are being attended to by the Foreign Trade **Subdivision**. Each customer, according to his particular industry sector, is granted overall foreign trade services by the unit specializing in that particular industry, and handles all aspects of foreign trade: export, import, finance, forward financial instruments, electronic communication and providing relevant information regarding customers and suppliers.

The services of the **Tel-Aviv Main Branch** are also at the disposal of customers. This is a unique branch due to the large amount of assets and liabilities managed there. This branch attends to four main areas: business, including company foreign currency transactions, guarantees and development; Loans and development – loans designated for local authorities and government agencies; Foreign banks – dealing with banks in the Arab Autonomous Territories and providing custodian services to foreign entities; and the private customer sector.

Discount Leasing Ltd. – a wholly owned subsidiary of Discount Bank engaged in financial lease transactions for the Bank's branches.

The support units for the Commercial Banking Division include the division's headquarters unit, the liabilities business manager, the assets business manager and the marketing support department.

At the end of 2003, the commercial division launched a "Business Club" for selected customers. This Club is the first of its kind in the banking industry in Israel, and additional such clubs are planned to be opened in the course of 2004.

In the framework of this Club, seminars are being offered to business people for the acquisition of proficiency in financial matters, such as the capital market, financial instruments and foreign trade, and in areas interfacing business activity, such as: taxation, management, leadership, advertising, marketing, human resources management, etc. In the course of 2003, a drive was launched for intensifying the current communication with customers of both divisions. Several times a year an information package is mailed to business customers. The package includes up-to-date banking information as well as an attractive set of offers, tailored for business people and companies.

TRADING DESK

The trading desk attends to the activities in financial derivatives, shekel and foreign currency deposits, foreign currency trading, foreign securities traded on overseas stock exchanges, and overseas investments. The trading desk responds to the needs of sophisticated and competitive customers, investors, companies and institutional bodies. By means of the trading desk, customers execute transactions in complex financial products, hedging against the risk of exposure to currency and interest rate fluctuations, offering customers unique customized solutions.

Advanced technology and a computer system connected to the large financial centers in the world allow prompt, accurate and reliable service.

The reinforcement in 2003 of the marketing and sales desk by additional dealers resulted in a significant improvement in the share of the Bank in the currency conversion transactions market.

At the end of the first quarter of 2003, the Bank completed establishing the infrastructure for trading in Israeli and foreign currency interest rates. During the year, the Israeli and foreign currency interest rate trading contributed to the increase in income of the dealing room. The dealing room marketed structured products based on foreign currency interest.

PRIVATE BANKING

The private banking customers, both Israeli and foreign residents, enjoy the highest level of banking services in four private banking centers.

The private banking center, located in Asia House in Tel-Aviv, offers overall banking solutions, customized to the needs of its high net worth customers, while focusing on initiativeness and on unique and sophisticated products.

The international private banking centers in Tel-Aviv, Jerusalem and Netanya provide specialized services to foreign residents and foreign corporations, including Israelis who permanently reside abroad, while emphasizing involvement in and contribution to Jewish communities overseas.

In 2003, which was affected by the implications of the War in Iraq and the political-economic condition in Israel, the private banking centers of Discount Bank continued to position themselves as leading factors in private banking in Israel: Additional service arms were established as part of the customer focused strategy of the Bank, including a private banking center in Haifa, an investment center for foreign residents, as well as "Global personal banking" at the David Intercontinental Hotel in Tel-Aviv.

A global center also stands at the disposal of customers, being an additional channel for those interested in maximizing the benefits provided by the focused international characteristic of the bank, and in receiving banking services from the Bank's foreign subsidiaries.

THE OVERSEAS EXTENSIONS

EUROPE

In 2003, customer assets increased at the Israel Discount Bank (Switzerland), a wholly owned subsidiary of Discount Bank. Israel Discount Bank (Switzerland) located in Geneva, focuses on unique private banking, through which it succeeded to recruit customers and increase its volume of operations.

The Swiss extension responds to the needs of customers of the Group and to potential customers, both Israeli and foreign residents, providing advanced private banking services and investment management at an international financial center.

In addition, the Bank has a London branch that provides commercial and private banking services.

The Bank also operates representative offices in France (Paris) and in Germany (Berlin).

UNITED STATES

IDB New York continues to be the largest of the Israeli banks operating overseas.

This bank operates at present two branches in New York and three branches in Florida. One replaced the Discount Bank Agency, which closed down, and two branches acquired from the FDIC, which had been operated by Hamilton

Bank (the additional branch was closed down in June 2003). IDB New York operates also an additional branch in Los Angeles. IDB New York also has a banking subsidiary in Uruguay. The Bank also has representative offices in South America.

DIRECT BANKING

The year 2003 was characterized by activities in many areas, the targets of which are: improving customer service, increased profitability, efficiency and reduction in costs.

Personal service Telebank - The CTI system came on the air in 2003, which brought a significant improvement in the quality of service. Personal service, which was rated first in a survey of customers of banks conducted by "Yediot Acharonot", continues to respond to hundreds of thousands of approaches per month. The number of subscribers increased continuously, and the professional level of the bankers position the "Personal service Telebank" as a leading service in its field.

On-line Telebank - Following the introduction of the new technological system, the volume of incoming calls increased greatly and they number hundreds of thousands calls per month. Queries were added and call menus have been updated. The service is provided 24 hours a day, seven days per week, and reduces significantly the burden of telephone calls to the branches, as well as reduces the waiting time and call time for the customer.

telebank @ internet - New queries were added and the range of activity conducted on the Internet has been expanded, resulting in a significant increase in the number of entries into the website and in the number of queries and transaction conducted on the Internet.

Hundreds of thousands of surfers enter the home site of the Bank, looking for extensive information regarding the products of the Bank and its various activities. Thousands of surfers have already registered to receive the Newsletter, the monthly electronic information sheet of the Bank.

Telebank investment center - continues during this year in its activities to attract new customers and to provide quality service through qualified consultants.

MERGER OF BRANCHES

As part of the reorganization of the branch system, the Bank merged in 2003 the operations of six branches. This further to the merger of twelve branches in 2002 and eight branches in 2001.

During the process of the merger the absorbing branches were organized to receive the customers and staff of the closed down branches through reinforcement, training and adjustment of means and manpower. In most cases the premises of the absorbing branches have also been renovated.

OPENING OF NEW BRANCHES

A new branch in Rosh Ha'ain was opened in 2003 - Give'at Tal branch.

The branch, which was branded as "Discount Home", has been designed according to the concept which positions the Bank as a leader in the banking service experience, establishing a unique service standard, adjusted to the retail environment, with higher sales and a smaller number of employees. The branch matches the characteristics of the location and the young developing residents: a neighborhood and family branch servicing private customers



Kobi Kalmanowitz, Photoportraiture

AT HOME AT DISCOUNT The Givat Tal Branch in Rosh Ha'ayin is the first in a series of branches expressing the new branch concept for the private customer. The neighborhood/family atmosphere of the branch and the array of services and products offered by it are tailor made for the local population. The branch offers services to customers at unusual hours, a children's corner, an internet station and more.

| The Perry family, Netta, Guy, Inbar, Ben and baby Eilon (left at home) are one of the first customers of the Givat Tal branch |

only with a focus on direct and self service means (a technological area in the forefront of the branch) and unusual operating hours (10:00 to 22:00).

The size of the branch is about one third of the size of a regular branch, and it is operated by about one half of the regular number of branch staff.

"Discount Home" is the first of a series of planned branches, to be established in accordance with the requirements of the community it is intended to service.

At the end of 2003, there were 131 branch offices of the Bank.

CONVERSION OF THE CENTRAL COMPUTER SYSTEM

The Bank has formed a workplan concerning the execution of the project; the main part thereof is the renovation of the central computer infrastructure of the Bank, while replacing the existing operating system and transition to the IBM operating system. In this respect, the Bank has completed the process of identifying a "software package" that would replace, subject to the necessary modifications, most of the existing banking software.

On October 31, 2001, the Bank signed an agreement with Accenture Ltd. (an Israeli company) and with Alnova Technologies Corporations S.L., both of the international Accenture Group, for the purchase of a "Core Banking" system and services to modify the system to the needs of the Bank and for the absorption thereof by the Bank.

The first stage in the development of the purchased system was the definition of the processes required for the modification of the system (PDP). In this framework and in the detailed testing of the different modules, the required modifications to the software, the order of development, and the solutions to for the transitional period (co-existence) were defined, a workplan was established, including principle milestones, and a budgetary framework for their execution was defined. The Bank and Accenture completed the work at the PDP stage. The Bank's Management and the Board of Directors approved the results of the PDP stage as well as the workplan and the budgetary framework. The original budgetary framework for the coming year amounted to us\$ 116 million, not including VAT.

At this stage, the Bank and Accenture have commenced the execution of the project.

Release of the software for operation at the Bank, is planned at several stages over a number of years, the first stage being defined as the pioneer stage, at the end of which conclusions would be drawn regarding the manner of execution of the project and the workplan would be updated accordingly. At the end of October 2003, the first stage of the system was installed at all branches of the Bank and is being successfully operated. Following certain difficulties, which arose during the execution of the first stage (which as stated had been defined as a pioneer stage and was successfully completed), and which caused a delay of five months in the completion thereof, a process of drawing conclusions was undergone at the end of 2003. Following this process, changes were made to the setup of the Bank for the execution of the project; modifications were made to the contents of the project while expanding its contents in respect of certain issues and reducing the contents in respect of other issues. The Board of Directors approved the enlargement of the budgetary framework of the project as well as a postponement in the time schedule for completion of the project, which is now estimated to be one year. The budget of the project following the update amounts to US\$155 million, excluding VAT. This budget includes the direct costs of the project but does not include indirect costs and the cost of the effect on the current operations of the Bank caused by the execution of the project.

Until December 31, 2003, US\$57 million (excluding VAT) have been invested in this project.

SALE OF THE BANK

On June 30, 1998, M.I. Holdings Ltd., which acts on behalf of the Government of Israel in the sale of shares in the Bank held by the State, announced publicly that the Government of Israel is interested in offering for sale, by way of an off-the-floor transaction, a block of shares in the Bank, constituting between 30% and 53% of the Bank's share capital. At the end of June 2000 M.I Holdings Ltd. gave notice of the discontinuation of the said process.

On March 25, 2004, M.I. Holdings Ltd. informed the Bank as follows:

"On March 11, 2004, the Board of Directors of M.I. Holdings Ltd. completed a series of discussions on the issue of the privatization of Israel Discount Bank Ltd. and approved the outline for the sale of the Bank.

The said outline will be brought for approval of the Minister of Finance, following which M.I. Holding Ltd. will update the Bank with respect to the procedures of the sale."

GOVERNMENT DECISIONS REGARDING THE BANKING SYSTEM

The Government resolutions of February 21, 1993 and May 2, 1993, regarding the banking system set down a number of measures concerning the following: (a) the holding of shares of the banks in the arrangement after October 1993; (b) the splitting-off of banking subsidiaries; (c) the holding of means of control in non-banking corporations by banking corporations; (d) provident funds; and (e) the holding of bank shares by institutional investors controlled by banking institutions.

Following these resolutions, the Bank Shares in Arrangement (Temporary Provision) Law, 1993, the Banking (Licensing) (Amendment No. 9) Law, 1994, and the Banking (Licensing) (Amendment No. 11) Law, 1996 were enacted. Furthermore, the Provident Funds draft bill, 1996, was published and passed its first reading in the Knesset. This draft bill was withdrawn by the Minister of Finance in January 1999. In addition, on February 20, 2000, the "Summary of the Discussions of the Inter-Ministerial Team on the Banks' Control of Provident Funds and the Draft Provident Funds Law" was published.

The possible effects on the Bank of the implementation of the said Government resolutions dated February 21, 1993 and May 2, 1993, and the aforesaid legislation will be derived from both the primary and secondary legislation and from resolutions and other steps which have been taken or will be taken by the Authorities.

At this stage the Bank is unable to assess the future impact of the implementation of the Government's resolutions, and of the laws and the regulations which have been enacted and which will be enacted in consequence thereof, on the business condition of the Bank and on the results of its operations, and whether or not such implications will be of a substantial nature. In any event, the Bank believes that the implementation of the Government resolutions and the aforesaid legislation and draft legislation are likely to be prejudicial to the Bank in the future, but that the scope of the damage is impossible to assess or estimate neither in terms of substance nor in terms of quantity.

Note 33 to the financial statements gives a detailed description of the Government decisions, the legislation and the draft bill regarding provident funds, and their possible implications for the Bank. The auditors have drawn attention to this note in the auditors' report on the financial statements.

Separation of Mercantile Discount Bank Ltd: The Government resolutions specify, inter alia, that the Government and Bank of Israel would take action to separate Mercantile Discount Bank Ltd. from the Bank.

In a letter to the Chairman of the Bank, dated August 10, 1998, on the background of the tender issued in that year for the sale of the Bank, M.I. Holdings Ltd. advised that the Government decision regarding the sale of Mercantile Discount Bank, is still in force, and accordingly the matter will be reflected in the sale agreement relating to the Bank's shares.

In the opinion of the Board of Directors of the Bank, the exercise of the Minister's powers under section 28 of the "Bank Shares Arrangement" (Temporary Provision) Law 1993, regarding the sale of the shares held by the Bank in Mercantile Discount Bank is likely to be detrimental to the best interests of the Bank.

The anticipated detriment to the interests of the Bank from its separation from Mercantile Discount Bank stems mainly from the difficulties in obtaining an appropriate price under the constraints attendant on a forced sale, as well as the detriment caused by the non-utilization of possible advantages due to size of the banking group and its position in the banking system.

The extent of the damage likely to be caused to the Bank is dependent on, among other things, the sale plan which will be approved at a shareholder's meeting, on the time constraints set for executing the sale, the steps which will be taken until the sale and the tax implications. The Bank believes that the consideration it will receive from the sale of its shares in Mercantile Discount Bank in accordance with the "sale plan" (see Note 33 to the financial statements) will not be less than the equity value of the investment in the shares. However, the numerous factors on which any evaluation is likely to be based, and the uncertainty with regard to the degree such factors will apply, as well as the fact that the decisions on this matter will be made by governmental authorities and the Committee for Shares of Israel Discount Bank, lead to a situation that the Bank's assessment that the consideration which will be obtained from the sale of Mercantile Discount Bank shares will not be lower than the equity value of the shares, is by no means certain. Similarly, all factors mentioned above do not enable the Bank to reach an estimate of the damage likely to be caused to the Bank.

The Bank cannot assess the possible effects of the transfer of control in Mercantile Discount Bank to another entity, either on the Bank or on Mercantile Discount Bank. Moreover, the Bank is unable to determine what its status will be and what influence it will have as a minority shareholder in Mercantile Discount Bank after the transfer of control, as described above.

Consequently, the Bank believes that the implementation of the decision of splitting-off Mercantile Discount Bank is liable to be detrimental to the Bank. The extent of the damage, however, cannot be assessed or estimated.

Provident Funds: On January 8, 1996 a draft bill of provident funds, intended to implement Government resolutions regarding provident funds, was published and has passed its first reading in the Knesset. The draft bill intended to regularize the modes of approval, management and supervision of provident funds. The draft bill included provisions intended to reduce the conflict of interest between the fund and those who control and/or manage it, as well as increasing the number of entities who may manage provident funds in the capital market. In January 1999 the Ministry of Finance decided to withdraw this draft bill.

An inter-ministerial team, headed by the Director General of the Ministry of Finance – Prof. Avi Ben-Bassat – which was appointed by Government resolution dated September 22, 1999, issued on February 20, 2000, the "Conclusions of discussions regarding the control by banks over provident funds and the provident fund draft bill".

The team was requested to submit recommendations regarding provident funds, with a view to reduce centralization in the capital market and reduce the potential of a conflict of interests between parties operating in this field, as well as to examine and propose ways of increasing fair competition and trading on the capital market. The principal recommendations of the team are: (1) A bank or any other entity operating in the capital market shall not control or have an interest in companies managing provident funds, the total assets of which exceed 10% of the total assets of all provident funds in the market. It was accordingly recommended that the holders of such controlling interests shall, within five years, adjust their holdings in companies managing provident funds to conform to the new provisions; (2) At least 40% of the Directors and all members of the investment committee of a fund management company in which a bank has a controlling or other interest, shall be outside Directors; (3) Special provisions shall be set-out to prevent the conflict of interests between the duties of the management company as a trustee for the assets of fund members and its possible interests resulting from its relations with a bank, so that the funds will have to adopt competitive and egalitarian proceedings for the provision of services; (4) The minimum equity capital of a management company shall be determined as a ratio of funds which are being managed by the company. The possibility is to be examined, of requiring, in the appropriate cases, insurance in addition to the minimum capital requirement or as an alternative.

The above recommendations have not yet been accepted by the Government and/or embodied in a draft bill. There is no certainty that the Government will adopt these recommendations as a whole or in part, or that they will not be materially changed during the various stages of legislation.

However, on October 1, 2002, the Income Tax Regulations (Principles for Approval of Provident Funds) (Amendment No.2) – 2002, came into effect. These Regulations determine, inter-alia, special provisions for the prevention of conflict of interests in the activities of a provident fund because of its relations with a bank, including special provisions concerning the membership of the investment committee when discussing and approving transactions to which a banking group is a party.

In addition, a private law proposal was tabled before the Knesset in January 2004, which precludes the ownership of a provident fund by a banking corporation. The Knesset, with the support of the Government, approved the Law Proposal in a preliminary reading held in March 2004.

At this stage, the Bank is not able to evaluate the future implications of the above or of additional legislation initiatives regarding provident funds, if any, on the Bank's financial position and results of operations, and whether such implications will be material. The Bank believes that implementation of Government resolutions and of legislation initiatives based upon the recommendations described above, including the recommendations of the said team, may be detrimental to the Bank in the future and may require the Bank to reduce its holdings of provident funds. However the extent of such future damage cannot be quantitatively or substantively evaluated or assessed.

For further details see Note 33 to the financial statements.

LEGISLATIVE INITIATIVES AND NEW LEGISLATION

GENERAL

Many private law proposals have been tabled recently (supported by the Government) as well as law proposals 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, separation of provident funds from the banks, etc. These law proposals and other similar ones, if passed, might have an 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.

PROHIBITION OF MONEY LAUNDERING LAW

The Prohibition of Money Laundering Law, 2000 came into force on August 17, 2000. The Law, inter alia, provides that a person knowingly effecting an operation with prohibited property, knowing that it is prohibited property, or with the object that there will be no report or to procure an incorrect report - commits a criminal offence. The Law further provides, inter alia, that a person reporting actions as aforesaid shall be exempt from liability.

The Prohibition of Money Laundering (Reporting to Police) Regulations enacted by the Minister of Internal Security, entered into force on December 22, 2000. The Governor of Bank of Israel also published an Order that stipulates the identification, reporting and record maintenance obligations by corporations. The Order came into force on February 17, 2002.

On December 24, 2001, the Prohibition of Money Laundering (financial sanction) Regulations, 2001, were published.

Further Orders were issued on December 24, 2001, specifying obligations regarding identification, reporting and record maintenance by provident funds, companies managing provident funds, investment portfolio managers, insurers and insurance brokers as well as Tel-Aviv Stock Exchange members.

On May 2, 2002 the Supervisor of Banks issued a Proper Banking Procedure Regulation concerning the prevention of money laundering, the identification of customers and maintenance of records. Amongst other things, the regulation instructs the banks to determine principles for "recognizing the customer" and a policy regarding the monitoring and handling of certain accounts, all this with the view of reducing the banks' exposure to risks relating to money laundering activities.

The Bank and certain of its subsidiaries have appointed officers responsible for the compliance with the requirements of the Law, and they prepared and are preparing the implementation of the said provisions, including the updating of customer data, verification of customer identity, determining procedures and installing appropriate computer programs. Inter-alia, in accordance with the Regulations, some 45,000 customer accounts were blocked on August 18, 2003, because they did not have the details of identity required by the relevant Regulations, so that until such details are available, customer initiated activity in these accounts is not permitted, except for the settlement of debts. Since that date, the decline in the number of these blocked accounts has been insignificant.

It should be mentioned that various amendments to the legislation concerning the prevention of money laundering, including the Law for Fighting Crime Organizations and the Law Proposal prohibiting the finance of terror activities, are in various stages of amendment and change.

It has been recently related that as part of the completion of the secondary legislation concerning the campaign against money laundering, The Supervisor of Bank formed an Order prohibiting money laundering through credit card companies, which includes specification of identification duties, reporting and maintenance of records. The draft Order is based in the order of the Governor of Bank of Israel to the banking corporations, issued already in January 2001, mutatis mutandis with the activity characteristics of credit card companies.

Audit report in the matter of the implementation of the "Money Laundering Law". Following an audit performed at the Bank and at its banking subsidiaries in Israel (Mercantile Discount Bank and Discount Mortgage Bank), as well as at the other banks in the Israeli banking industry, Bank of Israel submitted to the Bank and its said subsidiaries audits reports concerning the implementation of the "Money Laundering Law".

The audit reports note certain deficiencies, most of which were corrected by the Bank and its banking subsidiaries in Israel proximate to the date of the audit. Similarly to other banks, the Bank and the said subsidiaries were called before the "Monetary Penalty Committee" established under the said Law. The hearing of the case of the banks of the Discount Bank Group took place in February 2004. According to the Law the Committee is authorized to impose monetary fines in certain cases.

THE CREDIT DATA LAW, 2002

This Law, which was passed and promulgated on January 29, 2002, permits the communication of information by way of a credit data service, regarding the credit discipline of existing and potential customers, including private customers (differentiating from corporations) in whose case, the communication of information constitutes an invasion of privacy under the Privacy Protection Law. The object of the Law is, on the one hand, to avoid the granting of credit to those who are not fit to receive it, thus reducing the volume of uncollectible debts in the economy, and on the other hand, to avoid the demand for excessive collateral from reliable customers, whose history of honoring their obligations is indisputable. According to the Law, at least in the first stage, a license holder for credit data services, may assemble, without the customer's consent, information regarding the non-payments of debts, only from specified data sources.

The Law provides that such a license holder shall communicate the credit report only after he has assembled also positive information regarding the customer, which should be included in the said credit report. The Law obligates the banks to transmit to a credit data service licensee information both as to the non-payment of debts as well as positive data regarding the customer. The format of the report and the obligations of the banks will be determined by regulations, which have not as yet been enacted.

The Law was intended to come into effect in February 2003. On November 4, 2002, the Law was amended to defer its effective date, and on August 5, 2003, it was amended again to come into effect on January 31, 2004. On February 2, 2004, the Minister of Justice postponed by an Order the effective date of the Law to August 1, 2004. The Finance Committee approved on March 23, 2004, the required Regulations for the implementation of the Law.

CHANGES IN THE TAX SYSTEM IN ISRAEL

On June 12, 2002, the Commission for Tax Reform (the Rabinovitz Commission) appointed by the Minister of Finance, published its recommendations. On July 24, 2002 the Knesset passed the Income Tax Amendment Law (Amendment No. 132) – 2002 (hereinafter – “the Amendment”).

The Law focuses mainly on the alleviation of the tax burden on income from labor on the one hand, and on the imposition of tax on income derived from capital investments and from capital market activities on the other hand. The Law also changes the international taxation method prevailing in Israel from a “territorial” basis, in effect until now, to a “personal” basis.

Amongst other things, it was determined that a tax will be levied on interest income from deposits (including savings plans) and on capital gains from investments in securities. The principal provisions of the law in this respect include a tax at the rate of 10% on interest and capital gains from financial instruments in Israel (deposits and securities) producing a return in nominal terms, and a tax at the rate of 15% on said instruments producing a return in real terms. Special provisions were determined for the taxation of mutual funds, differentiating between three classes of funds.

As a general rule, the taxation of income from capital investments and from capital market activities began on January 1, 2003, while the alleviation of the tax imposed on income from labor will be made gradually during the years from 2003 to 2008.

The implementation of the Law required the banks and other parties active in the capital market to make changes in their reporting systems, which involved financial costs. Also these steps are expected to affect the structure of the investments portfolio of the public and the attraction of deposits of the public by the banking system.

Within the framework of the emergency plan devised by the Government for the years 2002 and 2003, as approved by the Knesset on June 5, 2002, the following acts were, inter-alia, included:

Cancellation of the ceiling of income for the purpose of National Insurance contributions and the increase in the rate of employer National insurance contributions by 1%, as from July 1, 2002. Cancellation of the maximum amounts was limited to December 31, 2003, but in fact the maximum amounts were reinstated as from July 1, 2003.

An increase from 17% to 18% in the rate of profit tax and payroll tax imposed on financial institutions under the Value Added Tax Law, as from June 15, 2002 and up to December 31, 2003. Termination date for the increase period as stated, was postponed to December 31, 2004, and later advanced to March 1, 2004.

PRINCIPLES OF CONDUCT DOCUMENT

In 1985, the Bank voluntarily agreed to an arrangement with the Attorney General of the Government and with the Commissioner of Restrictive Trade Practices (“the Commissioner”) regarding principles of conduct. This arrangement determined the areas in which banks are not permitted to act jointly on the one hand, and the areas in which banks have a legitimate interest to act among themselves on the other hand.

The arrangement also included provisions for the recording and reporting of certain meetings between representatives of various banks.

The arrangement was made within the framework of a plea bargain and as part of the proceedings for the

cancellation of an indictment against the chairmen of the boards of four banks (including the Bank).

On July 10, 2001, after receiving the reaction of the relevant banks, the Commissioner declared that *prima facie* the principles of conduct are not considered law, that they are not enforceable and that at present, they do not bind the Commissioner. He further declared that enforcement acts, regarding activities which may be considered as a restrictive trade practice, will be executed by him as from April 1, 2002, and as regards the exchange of information among banks, in as much as this will constitute a restrictive trade practice, as from November 2001. The banks were requested to provide the Commissioner with information, and to prepare for the submission of applications for the approval of restrictive trade arrangements, or for exemptions therefrom, or for a class exemption, in terms of the Restrictive Trade Practices Law.

Subsequent to providing the required information and to a further examination of the arguments of the banks, the Commissioner declared on October 28, 2001, that he reiterates his contention, according to which, certain activities "permitted" within the framework of the principles of conduct, *prima facie* constitute a restrictive trade practice.

The Bank together with the three other banks applied to the Commissioner for an exemption from a binding arrangement as regards agreements to which the Bank is a party, concerning the companies Automatic Bank Services Ltd. and Bank Clearing Center Ltd. At this stage, additional information has been requested and the Commissioner has not yet decided on the matter. In addition, the Bank, similarly to other banks, has applied for exemption from a binding arrangement as regards the authorization for debiting accounts, in respect of which additional information has also been requested.

The Commissioner has informed the Bank that no enforcement actions would be taken by him in connection with the matters in respect of which petitions for exemption had been submitted, as above, until June 1, 2002.

Authorization for debiting accounts. On June 6, 2002, the Commissioner informed the banks of his refusal to authorize them to charge and/or collect inter-bank commissions in connection with the authorization to debit accounts. In the opinion of the Commissioner, such an arrangement limits competition, and he is not convinced that it is required for the granting of this service.

The Commissioner recognized the fact that the said service provided by the banks is a vital service, both to the end customer (who gave the "payment order") and to the beneficiary (whose account is credited with amounts transferred through "payment orders").

However, and despite the fact that agreements regarding commissions have in fact been signed between each two banks separately, the Commissioner determined that these are multi-party agreements for a uniform inter-bank commission. At this stage, and since such commissions have in most cases a direct effect on the commissions collected from the beneficiaries, he regards it as detriment to competition.

The Commissioner informed the banks that they have to terminate the arrangement regarding the said inter-bank payments within 30 days from date of the decision.

Following the decision of the Commissioner, the Bank, like other banks, approached the beneficiaries requesting them to reach an agreement with it as regards the payment for the service granted by the Bank.

On July 23, 2002 the Commissioner approached the Bank, as well as other banks, clarifying, amongst other things, that, in his response to the petition for exemption, he did not determine that the arrangement itself between the banks should be terminated, but that such an arrangement should be agreed for a commission which could be

justified to him. Therefore, if such an application would be submitted, the Commissioner would study it.

On August 8, 2002, The Supervisor of Banks clarified his position that the Bank may not terminate the service of honouring authorizations for debiting accounts, despite the fact that, at this stage, the Bank does not collect a commission for this service from the beneficiary who enjoys the service.

On December 18, 2002, the Supervisor of Banks and the Commissioner determined, inter-alia, the maximum commission that may be charged in this framework, and the obligation of each two banks reaching an agreement in the matter to apply to the Commissioner for an exemption from a binding arrangement.

The Bank has approached the Supervisor of Banks for clarification regarding the manner of computation of the commissions, and in any case, is studying ways of regulating the matter. On July 7, 2003, the Supervisor of Banks informed the banks that for a period of one year inter-bank commissions for establishing new authorizations as well as for each entry will be uniform for all banks, at the rates determined by him, so long as banks have not reached an agreement between them for reduced commissions. The Supervisor further informed that during the year he will perform a study as to the appropriate level of commission.

Continued holding and joint activity of Automatic Bank Services Ltd. (ABS). On June 19, 2002 the Commissioner informed the banks that he authorizes them to operate within the framework of ABS subject to the provisions determined by him, which include a limitation on the areas of activity of ABS; the non-distribution of profits in any form or manner to the shareholders of ABS (five banks including the Bank); imposing an obligation on ABS to allow any person (and not only a bank) to connect to the access services both as an operator of automatic teller machines and as an issuer; charging identical commissions to all users; the obligation of providing full information to whoever connects to the service; a limitation on the information to be transmitted to or passed between the shareholders of ABS.

It should be further mentioned that at present the banks charge a commission of US\$ 0.20 for a cash withdrawal at the automatic teller machine. The Commissioner instructed the banks to submit within 90 days the calculation on which commission is based, and if he will not be convinced that this commission is justified, the amount of the commission will be reduced by US\$ 0.05 per withdrawal; ABS will be entitled to collect, in the case of a new connection, its direct costs with respect to this connection as well as "access fees" in respect of its investment. In the event that no agreement will be reached with respect to the access fee, such fee will be determined by an arbitrator to be appointed with the approval of the Commissioner, based on the parameters to be taken into consideration for this purpose.

The Bank has submitted a computation of the commission to the Commissioner. On September 17, 2002, the Commissioner informed the Bank that he was convinced of the reasonableness of the commission, and approved its amount for a period of two years from the date of the exemption granted under the ABS agreement.

The continued holding and joint activity of the Bank Clearing Center (BCC). On June 19, 2002, the Commissioner informed the shareholders of BCC (five banks including the Bank) of his approval of their joint holding of BCC, subject to the provisions determined by him, including limitation on the areas of operation of BCC; an obligation to allow access for any bank to the said clearing services; the non-distribution of profit or of any other payments to the shareholders; identical commissions to all users of the clearing services; the possibility of charging "access fee" for a new connection (if no agreement will be reached between the said newly connected bank and BCC, an arbitrator will be appointed, with the approval of the Commissioner, who shall determine the

amount of the access fee and the parameters to be considered in determining such fee; the obligation to present full information to the bank being connected; a limitation on the information to be passed between the shareholders of BCC.

Consortium agreements. On August 18, 2002, the Commissioner informed Bank Leumi, Bank Hapoalim and the Bank that at this stage he is not able to determine the terms for a “class exemption” regarding consortium agreements. Therefore, he does not intend to enforce the terms of the exemption for six months or until the establishment of a “class exemption”, whichever is earlier, subject to the fulfilment of the following provisions: the joining of a consortium is vital in the sense that otherwise it would not be possible to grant credit to the customer at reasonable terms; the customer agrees to the consortium; the customer shall be entitled to negotiate separately with the member banks of the consortium; and where both Bank Leumi and Bank Hapoalim are members of the consortium – the minimum amount of credit to be granted is to be greater than NIS 150 million.

On March 5, 2003, the Commissioner extended the period of effect of his said notice until December 31, 2003, determining that the said limitation on the Consortium in which Bank Hapoalim and Leumi participate, will not apply to an arrangement regarding the repayment of loans granted by them to the same customer prior to August 18, 2002.

On December 30, 2003, the Commissioner extended the validity of his above notice by one year, until December 31, 2004.

The Bank cannot evaluate at this stage the implications which the above matter might have on its operations.

Cooperation between underwriters. During December 2003 and February 2004, the Commissioner of Restrictive Trade Practices informed that cooperation between competing underwriters with respect to public issues of securities, is on the face of it, considered a binding arrangement. Concurrently, the Commissioner specified conditions, which when fulfilled, it would seem that cooperation between securities issue managers would not raise material questions of violation of fair competition, meaning that in such circumstances he also will not put into action the enforcement setup in accordance with the Restraint of Trade Law. These guidelines are in effect until December 2004. The Bank believes that the said guidelines do not adversely affect the activities of the underwriting company of the Discount Bank Group.

PROPOSAL FOR THE AMENDMENT OF THE BANKING LAW (LICENSING).

On August 4, 2002, the Government approved the recommendations of a committee headed by Mr. Ohad Marani, Director General of the Ministry of Finance, regarding, inter-alia, the regulation, supervision and control of banking institutions privatized through the capital market, and which are found in a situation where no entity, which obtained a prior approval by the Governor of Bank of Israel, holds a controlling interest therein.

In September 2002, the Ministry of Finance distributed a Memorandum of Law proposal reflecting the said recommendations including, inter-alia, limiting the means of control which one bank may hold in another bank, including by way of pledging means of control in connection with the granting of loans, the reduction in the rate of holdings in a banking institution requiring the approval of the Governor, authorizing the Governor to change or cancel permits and to issue instructions in respect of exceptional holdings, authorizing the Supervisor to grant prior approval for the appointment of directors and officers of a banking institutions, determining reporting

requirements, creating a mechanism for the appointment of directors in cases where a shareholder holding a permit has not done so. Transitory provisions have also been added, as well as a section permitting the Bank of Israel to transfer information to foreign regulatory authorities.

The banks have submitted their comments to the proposed amendment. On July 14, 2003, the Government tabled the subject Law Proposal to the Knesset, without any significant changes compared with the Memorandum which had been published. At this early stage of legislation, it is not possible to assess the effect on the Bank of the amendment, if approved at all and to the extent approved.

CRITICAL ACCOUNTING POLICIES

INSTRUCTIONS OF THE SUPERVISOR OF BANKS

On January 7, 2004, the Supervisor of Banks issued a Temporary Instruction in the matter of disclosure of accounting policies on critical issues, which will apply to financial statements of banking corporations for 2003 and thereafter. This Instruction follows an Instruction by the SEC dated December 12, 2001, regarding the same issues. The Instruction relates to two layers: the one – adoption of an accounting policy on critical matters and its application; and the other – the disclosure of such policies.

Accounting policy on critical matters is defined as a policy relating to issues, which are both most important to the description of the financial position of a corporation and are difficult, subjective and require complex assessments, due to the necessity to perform assessments as to matters that by their nature are uncertain.

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:

A. 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, including those in relation to the classification and volume of the problematic debts, as determined in the instructions of the Supervisor 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 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.

See the above section “Exposure to Risks and Risk Management” for details regarding the credit risk management at the Bank.

See the above section “Development of Assets and Liabilities” for details regarding the draft Instruction relating to “the measurement and disclosure of problematic debts and the provision for doubtful debts in the financial statements of banking corporations”.

B. 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 US Standard on contingencies – FAS 5 – which is accepted practice in Israel, and has therefore become in fact the accepted accounting principle binding in Israel. The disclosure regarding contingent liabilities is made in accordance with instructions of the Supervisor of Banks relating to the reporting to the public.

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 US 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 class actions relate 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 exist today.

Indeed, as stated, the accepted practice in Israel adopted the US Standard, however it is vital to bring into account in this respect the difference in the characteristics of the US reality in comparison to Israeli reality, and the difficulties that arise as a result.

The US 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 US 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.

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 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.

See Note 19C. to the financial statements for details of legal actions pending against the Bank and against other companies in the Group. It should be noted that changes were made in the editing and wording of that Note as compared with the form of reporting in financial statements of prior years, following guidelines and comments received from the Supervisor of Banks.

For details concerning a class action and pleas for approval of actions as class action suits lodged against the Bank in the matters of limited responsibility fees and business house commissions regarding credit cards, the mode of recording post dated checks, and in the matter of the opening of fictitious accounts and the hiking of share prices, see Notes 19C. paragraphs: 16.1, 16.3.1 and 16.3.2, to which the Auditors draw attention in their report on the financial statements.

C. 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. 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 asset and liability management department

of the Bank, 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 mainly upon the Black and Scholes Model, and is influenced by the inherent fluctuations and interest rates of the base assets. The data regarding the fluctuations in exchange rates of the Israel currency against foreign currencies are determined by the dealing room of the Bank and are controlled by the Middle Office, while comparing them with several sources of information and fluctuation data of one foreign currency against another determined according to the international money markets.

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.

D. 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.

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 Bank of Israel, based on forecasts prepared by the actuary and the experience accumulated in the Bank.

The calculation of the provision for Jubilee bonus is sensitive to each of the values and parameters mentioned above.

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.

In addition to the activities of "Lema'an – Discount Employees for the Community" project, described hereunder, the following activities were also conducted in 2003 in the culture and arts field, providing sponsorship, "Tzalash" activities in the branches and donations.

The year 2003 was characterized by the significant expansion in the areas and scope of the voluntary activities



Kobi Kalmanovitz, Photoportraiture

MUSIC WITH A SOUL O., aged 12, cultivates his musical abilities in the Neve Offer Club of the Educational Society in Jaffa. The youth clubs have been adopted by the employees of the Bank. Various associations, including the **Elem Association**, and the **Yad Sarah Association**, are supported within the framework of “**Lema’an**” - the voluntary project of the Bank established at the joint initiative of the Management of the Bank and the Employees Committee.

| Shabtai Nachmias of the payroll department, a volunteer at the Neve Offer Club |

of individuals and groups of Bank employees, customers and even the public at large. Inter-alia, an internal effort was made to convince employees to join the circle of volunteers, following which their number has doubled.

The total volume of activities in 2003, including the Lema'an Project, amounted to NIS 2,263 thousand, compared with NIS 1,700 thousand the preceding year.

The social work and involvement in the community was carried out by the Bank in the following areas:

Donations – these were directed mainly to associations, clubs, education establishments, health organizations and others, that focus on children and personal welfare.

In 2003, the Bank continued the trend of supporting children and youth in various states of distress.

“Tzalash” local activity – Activities carried on in all branches, the object of which is to tighten the bonds between the branch and the neighbouring community.

Various events took place during the year in the branches and in voluntary institutions in cooperation with the local community. Inter-alia, holidays of Israel were celebrated, works of amateur artists were exhibited, lectures were held on various subjects, etc.

Arts and Culture– These activities were conducted within the framework of the “Discount Culture and Art Activities”, which encourage and cultivate the original Israeli artistic creativity.

The apex of this activity was in December 2003, when the **“The Discount Bank Art Collection”** was opened. The art collection of the Bank is considered one of the large collections in Israel. Selected paintings of the collection were exhibited at the Tel-Aviv Museum of Art in an exhibition opened on December 8, 2003. This was a first exposure of parts of the collection, which numbers over 1,500 original quality paintings.

As part of the exhibition, customers of the Bank received invitations granting them free entry to the exhibition at determined dates. In addition, the Bank initiated activities for the benefit of art loving youth in distress areas, which were invited to visit the exhibition at no cost.

At the request of the Museum, due to the success of the exhibition and the large number of visitors, the closing date of the exhibition was postponed to April 25, 2004.

Sponsorships – granted to entities that enhance initiatives for enrichment and excellence, such as the Track and Field Association, other sports groups, etc.

The “Lema'an” Project – Discount Employees for the Community – 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 2003, the number of employees volunteering for community work doubled and now stands at 700.

In 2003, the effort was focused on voluntary activities of the following associations: “Yad Sarah” Association, “Elem” – Youth in Distress Association, children clubs and various associations that support the needy.

“Yad Sarah” Organization – Volunteers from the Bank take part in various activities of this organization, such as the installation of distress call appliances, distribution of equipment, home industry services for the old and the handicapped, etc. Particular activity is also performed at the request of “Yad Sarah” all over the country, such as administrative assistance, work at the equipment distribution depots, etc.

“Elem” Organization – Since the launching of the project, most of the voluntary activity is focused on youth information and consultation centers, the night consulting mobile units, and additional activities as requested specifically by the “Elem” branches.

The Elem Project “Someone to Run With” – This Project is designed for the rehabilitation of youth and young persons both Israeli born and new immigrants. The Bank directed to this project Russian speaking volunteers who help lonely immigrants, youth and young persons. In addition, foodstuff is supplied to the center of “someone to run with” for various activities and special events.

The night mobile units of Elem – During the year, the sum of NIS 260 thousand was granted to the Elem Association to finance the operation of the night mobile units of the Association.

Children clubs - In July 2002, the Bank commenced its cooperation with the “Israeli Spirit” organization. It was decided at the first stage to adopt children clubs of the “Association for the Advancement of Education in Jaffa”, one in the heart of Jaffa and the other in Neve Opher. These clubs operate as day hostels providing response to the needs of children in grades 6 to 11, coming from multi-problem families. The personnel of the Bank’s Human Resources Group adopted these clubs. In addition, with the opening in 2003 of a new club in the Shapira Quarter of Southern Tel-Aviv, the staff of the Operations and Logistics Division also volunteered to help in the operation of this club. As part of this voluntary work Bank employees assist the children with their homework, conduct study groups and help in the preparation of parties and other events in public holidays etc.

The WIZO treatment club in Haifa was also adopted in 2003. A group of volunteer lady employees of branches in the Haifa region arrive regularly at the club and assist the children. Recently, the Haifa club was renovated with the help of the staff of the Bank’s Building and Maintenance Departments.

Activity at the clubs was expanded in 2003, and the weekly quota of days on which Bank employee conduct voluntary work increased to three to four days per week, instead of twice a week previously.

Assistance to various associations for the support of the needy – A most fruitful cooperation between the Bank and the “Open Heart” Association commenced in July 2002, which is reflected in a variety of activities. Since then the Bank has expanded its support of associations assisting the needy, and support on a current basis is provided today to eight associations: “Open Heart” Association in Rishon Le’Zion and in Carmiel, “Food Donation Krayot”, “Breshit Association”, “Ezer Mi’Zion”, “Hassdie Naomi”, “Give a Friend a Helping Hand”, “A Helping Hand to a Friend” in Haifa, and “Assistance for Fellowmen Center” in Jerusalem.

The work of assisting the needy has become a tradition at the Bank, thus regularly twice a year, the Bank conducts a drive for collecting foodstuff and other products: the “Kimcha DePascha” drive before Passover, and the “Vesamachta bechagecha” drive before the New Year. During these drives the Bank branches and its various units turn into collection centers for products, which are donated by Bank employees and the public at large. In this way, over ten tons of foodstuff, baby food and nappies are being delivered to the various associations nationwide. These donations help these associations to increase the number of food baskets distributed to the needy and to enrich their contents.

The “Warm Winter at Discount” drive – At the beginning of winter, with the arrival of cold weather, a drive was launched for the collection of products and equipment for the winter for distribution among the needy. Also this drive turned the Bank branches and its various units into collection centers for the donation of winter items like: warm clothing, blankets, heating appliances etc.

The drive was backed by television and radio broadcasts, and a major part of the suppliers who assisted the Bank in this operation did so voluntarily. These number: Keshet, Telad, Channel 10, Channel 24, SPM, SPA, Roll Production Company, TBWA Joshua Advertising Agency, etc.

4,000 large carton boxes were collected, which were divided between 12 associations the country over and between the welfare departments of a number of local authorities. Inter-alia, exciting donations were received from businessmen customers of the Bank, who donated new items to this operation. Among the associations which participated in this project "Open Heart", Bereshit Association", "Give a Friend a Helping Hand", "A Helping Hand to a Friend" and "The Power to Help" were particularly noticeable.

"The March of the Living" – In April 2003, a delegation of Discount Bank employee participated for the first 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, headed by the Chairman of the Board and by the Chairman of the Employee Union of the Bank numbered 120 bank and subsidiary companies employees. This started a tradition of participation of a Discount Group delegation in the "March of the Living", the Bank and the Employee Union participating in the cost thereof. The delegation planned to participate in the "March of the Living" in 2004 will number 160 employees of the Bank, Mercantile Discount Bank and additional subsidiaries. In addition 35 young persons from development towns will join the delegation, the Bank and the Employees Union bearing the cost of their travel to Poland.

AUDITORS' REMUNERATION^{(1) (2)}

The Bank's auditors are Ziv Haft and Somekh Chaikin - joint auditors. Below are particulars of the remuneration that was paid to the auditors (in NIS thousands):

	Consolidated		The Bank	
	For the year ended December 31			
	2003	2002	2003	**2002
For Auditing⁽³⁾:				
To the joint auditors ⁽⁵⁾	6,867	*6,201	3,695	*3,233
To other auditors	3,322	3,949	-	-
Total	10,189	10,150	3,659	3,233
For Other Services:				
Audit related services ⁽⁴⁾ :				
To the joint auditors	450	**226	251	135
To other auditors	-	115	62	115
Taxation Services⁽⁵⁾:				
To the joint auditors	1,570	*935	886	*605
To other auditors				
Other Services:	1,660	-	-	-
To the joint auditors	436	*901	287	*276
To other auditors	882	2,372	8	142
Total	4,998	4,549	1,432	1,273
Total Auditors' Remuneration	15,187	14,699	5,153	4,506

* Reclassified

** Restated

***The data for 2002 relating to certain subsidiaries was not reclassified in accordance with the presentation required in 2003.

(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.

(4) Includes mainly audit work at the overseas branches of the Bank, dealing with tax assessments 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 THE CHAIRMAN OF THE BOARD OF DIRECTORS AND SENIOR EXECUTIVE OFFICERS

Adjusted for the effect of inflation to the December 2003 CPI (in NIS thousands):

Loans given on beneficial terms ⁽³⁾								
	Salary and bonuses	Employer's provisions ⁽¹⁾	Supplemental reserves ⁽²⁾	Total salary and related expenses*	Balance	Average repayment period (in years)	Benefit given during the year	Loans given on usual terms
2003								
Arie Mientkavich	⁽⁴⁾⁽⁵⁾ 1,442	522	28	1,992				
Giora Offer ⁽⁶⁾	2,233	⁽⁷⁾ 1,457	9	3,699	35	1.10	2	124
Dr. Amnon Goldschmidt	1,074	327	42	1,443	14	0.58	-	26
Shlomo Pitchon ⁽⁶⁾	952	306	64	1,322	9	0.58	-	318
Dr. Ehud Kaufman	⁽⁸⁾ 975	317	7	1,299	-	-	-	117
Michael Fokschaner	⁽⁹⁾ 1,560	101	17	1,678	11	0.58	-	26
2002								
Arie Mientkavich	⁽⁴⁾⁽⁵⁾ 1,358	492	7	1,857		1.70	2	
Giora Offer	2,379	⁽⁶⁾ 1,469	-	3,848	51	1.12	1	122
Dr. Amnon Goldschmidt	1,054	322	4	1,380	26	1.12	1	26
Shlomo Pitchon	932	298	2	1,232	17	1.12	1	312
Nissim Alagem	1,287	1,086	43	2,416	20	1.12	1	26
Michael Fokschaner	⁽⁹⁾ 1,493	160	4	1,657	22	1.12	1	26

* Excluding VAT on salary.

(1) Including severance, emoluments, vocational studies fund, leave and National Insurance.

(2) Supplemental reserves for related expenses in consequence of salary changes.

(3) Loans upon terms and conditions given to all Bank employees.

(4) The remuneration and employment conditions were approved at Shareholders' Meetings held on January 15, 1998 and on October 5, 1999.

(5) The subject of the terms and conditions of the Chairman's remuneration for 1999 was discussed and approved by the Board of Directors' audit committee and the Board of Directors' plenum and was also discussed at the Committee for Shares of the Bank that resolved to recommend to the general meeting approve of a remuneration increment of 10% from January 1, 2000 and a grant of NIS 575 thousand for 1999. This subject was to have been discussed at the General Meeting held on December 28, 2000. On December 6, 2000 Mr. Mientkavich wrote to Judge (Ret.) Ostrovsky-Cohen, Chairperson of the Committee for Shares of the Bank and requested that the discussion on the terms and conditions of his remuneration should be postponed to another date, due to the Bank's business results. The Bank has provided the amounts committed by these, however these amounts have not been included in the figures above.

The notice of Mr. Mientkavich requesting that the discussion regarding his remuneration should be deferred once again to a different date, was on the Agenda of the General Meetings of Shareholders for the years 2000 and 2001. The General Meeting of shareholders for 2002, held in November 2003, was informed that Mr. Mientkavich had asked to postpone the discussion in the matter of his remuneration to another date. It was resolved that the discussion in the matter of the remuneration terms of Mr. Mientkavich and in the matter of his bonus for 1999, shall be postponed once again, and will be held in 2004.

(6) In addition the Board of Directors of the Bank resolved in 2003, that if the President and CEO of the Bank or any of the Vice Presidents would be dismissed or would be compelled to retire from the Bank due to change of ownership of the Bank, this within a period of twelve months from the date of the said change, they will be entitled to a payment, over and above the amounts due to them under the personal employment agreement with them, subject to the limitations specified in the resolution. The financial statements include a general provision of NIS 1.3 million, (including – Mr. Giora Offer – NIS 0.5 million; Mr. Shlomo Pitchon – NIS 0.1 million) which constitute 25% of the maximum theoretical liability, based on a conservative assessment of the total risk in this respect.

(7) Including adjustment grant.

(8) Retired from his position on January 15, 2004.

(9) Including overseas employment conditions.

The terms of engagement of executive officers are determined in personal employment contracts.

In determining payments included in the report, the Board of Directors took into account the contribution of the executive to the activities of the Bank and its profitability, and the position he holds at the Bank.

BOARD OF DIRECTORS AND MANAGEMENT

GENERAL

On December 31, 2003, the Board of Directors decided to grant Mr. Reuven Spiegel, Executive Vice President and Head of the Banking Division, the title of Senior Executive Vice President.

On December 31, 2003, the Board of Directors approved the appointment of Mr. Rony Hizkiyahu as Head of the Corporate Banking Division of the Bank with the title of Executive Vice President. Mr. Hizkiyahu took office on January 16, 2004, and replaces in this position Dr. Ehud Kaufman, Executive Vice President. The Directors and Management of the Bank wish to thank Dr. Kaufman for his efforts and contribution to the Bank.

A list of the members of the Board of Directors and their occupation 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.

In 2003, the Board of Directors held 21 meetings. In addition, 52 meetings of committees of the Board of Directors were held.

The Board of Directors wishes to thank the President & Chief Executive Officer, 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 Group.

REPORT ON DIRECTORS HAVING ACCOUNTING AND FINANCIAL QUALIFICATIONS

In October 2003, the Israeli Securities Authority issued a guideline under Section 36A of the Securities Law, 1968, in the matter of "Report on Directors having accounting and financial qualifications" (hereinafter – "the ISA Guideline"). On December 11, 2003, the Supervisor of Banks advised of the adoption of the Guideline and of it becoming effective with respect to financial statements of banking corporations as of December 31, 2003 and thereafter.

The ISA Guideline defines a "Director having accounting and financial qualifications" as a non-executive Director, who due to his education, experience or qualifications, as detailed in the report, is highly proficient in and has an understanding of business, accounting, internal control and financial reporting matters, in a way which enables him to have an in-depth understanding of the financial statements of the company, and to raise on the agenda of Board meetings issues and questions relating to the financial reporting of the company, with the aim of approving and publishing fairly presented financial statements.

The ISA Guideline emphasizes that, to remove any doubt, it is not intended to provide a special status for Directors having accounting and financial qualifications, and to make any changes in the responsibilities imposed upon them and the other Directors, under any law.

According to the Guideline, each company has to determine the proper minimum number of Directors having accounting and financial qualifications, having regard, inter-alia, to the size of the company, the type and complexity of its activity, etc., in a way, which would enable the Board of Directors to carry out its duties, in particular with respect to its responsibility for the examination of the financial position of the company and the preparation of financial statements and their approval. The Guideline further requires that the Directors' Report shall identify all the Directors having accounting and financial qualifications, even if their number exceeds the proper minimum number determined.

In view of the above, the Board of Directors of the Bank, in its meeting of March 4, 2004, decided that the proper minimum number of "Directors having accounting and financial qualifications" is three Directors.

The above was decided considering the size of the Bank and the activity carried out by it, its complexity, as well as considering the fact that the proficiency of all members of the Board is being scrutinized in the light of the instructions of the Supervisor of Banks regarding the qualification of Directors.

The Directors having accounting and financial qualifications, as defined in the Guideline, and the factual background providing the basis for attributing these qualifications to them, are as follows:

Arie Mientkavich – Lawyer by qualification; served for approximately a decade as legal consultant of the Ministry of Finance and thereafter served for approximately a decade as Chairman of the Israel Securities Authority. Since November 1997, has been serving as active Chairman of the Board of Directors of Israel Discount Bank Ltd. as well as Chairman of the Board of Directors of Mercantile Discount Bank Ltd., of Israel Discount Bank of New York and of additional companies in the Discount Bank Group, and also as Director of Harel Insurance Investments Ltd.

Gad Arbel - Bachelor of Economics and Master of Business Administration. Engaged in economic and financial consulting and acts as an external director of Nitsba Holdings 1995 Ltd. Member of the Board of Trustees and of the Audit Committee of the College of Management Academic Studies NPRO, member of the Administrative Committee of the Veteran Pension Funds and member of the Audit Committee of the Israel Management Center. Between the years 1971 – 1992 fulfilled various tasks at the Ministry of Finance, including service as Deputy Accountant General, as representative of the Ministry of Finance in the United States (1983 – 1987) and as Commissioner of the Capital Market, Insurance and Savings and as Supervisor of Insurance Business as well as Deputy Chairman of the Israel Securities Authority (1988 – 1992). In the years 1992 to 1997 served as economic and financial consultant and as member of boards of various companies, including Israel Discount Bank, Israel Discount Bank of New York, The Central Securities Company (Mutual Fund Management) (served as Chairman), Avner - Motor Vehicle Accident Victims Insurance Ltd., New Initiative Pension Fund for Employees, and others. In the period from 1997 to 2001, served as Executive Vice President and member of Management of Mizrahi Bank as head of the Capital Market Division. As part of his duties he also served as Chairman and Director of various companies in the Mizrahi Bank Group as well as Director of the Tel-Aviv Stock Exchange and of Ma'alot – The Israel Rating Company Ltd.

Nissim Baruch - Bachelor of Economics and Political Science and Master of Economics and Business Administration. Serves as an economics consultant. Served as the CEO of the National Insurance Institute (1984 – 1986), as Director General of the Ministry of Finance (1984) and as Economic Consultant to the Prime Minister (1983). As part of these duties served also as director of companies, such as Israel Aircraft Industries and El-Al Israel Airlines. In the period 1965 – 1979 and since 1986 is engaged in the private and public sectors, performing financial and economic research, valuation of companies and serving as consultant to various organizations, including Governmental and other public entities. In this period served as a director of companies, including Bank Tefahot and Bet Shemesh Engines. In the period 1979 - 1983 served as Chairman and President of Rassco Rural and Suburban Settlement Company Ltd. and as director of subsidiary companies of Rassco. In the years 1956 – 1965 served in the Budget Division of the Ministry of Finance as Deputy Head of Budgets.

Joseph Singer – Bachelor of Economics and Business Administration and Master of Business Administration. Serving for over a decade as General Manager of Singer & Even Ltd., economic and business consulting firm

specializing in two central areas; one, analysis and valuation of companies, and the other, financing of companies and projects. In addition, serves as director of companies, including Midroog Ltd., a rating company, Midroog Holdings Ltd., Singer & Even Finance Ltd., Singer, Even & Kraizberg Holdings Ltd. as well as an external director of Edmond de Rothschild Mutual Funds Management Ltd. and chairman of its investment committee and served as an external director of Otzarit Mutual Funds Management Company Ltd.

Jacob Lifshitz – Bachelor of Economics and Political Science, Master of Economics and a research student for Ph.D. degree at the Ben-Gurion University specializing in Economic Policy Under Terrorism. Lecturer in the Economics Department of Ben-Gurion University, at the Academic College Tel-Aviv-Yaffo and at the College of Management. Acts as director of companies (including Carmel Investment Group, Tesnet Software Testing and Elbit Systems). In the period 1994 to 2002 served at various times as Chairman of companies (Hamashbir Lazarchan, Israel Military Industries, Spectronics, Dor Chemicals and Dor Energy, DorGas, Foreign Trade Risk Insurance Corporation) and as Director (Frotarum Industries and Dankner Investments). In the years 1992 – 1994 served as Executive Vice President in charge of credit at Israel Discount Bank. In the years 1989 – 1991 served as Director General of the Ministry of Finance. In the years 1984 – 1989 served as President of Electra (Israel) Ltd. During the second half of the 1970's served as financial advisor to the Ministry of Defense.

Yehuda Milo - Bachelor of Economics and Statistics. Economic consultant to companies and serves as director of companies, including Menorah Gaon Investments Ltd., Menorah Gaon Capital Markets Ltd., Menorah Gaon Investment House Ltd., Menorah Gaon Netivei Gemel Ltd., Menorah Gaon Underwriters and Investments Ltd., Arkal Filtration Systems Ltd., Arkal Plastic Products Ltd., Netivot Pensia Ltd. In the years 1989 to 1998 served as CFO of Koor Industries and as Deputy General Manager of Koor and also director of Koor Group companies. In the years 1985 to 1989 served as CEO of TAHAL - Water Planning for Israel Ltd. and TAHAL Consulting Engineers Ltd. In the period 1975 – 1985 served as CFO and Head of the Comptroller Division of Israel Electric Corporation. In the period 1970 – 1975 served as CEO of Maskit. In the years 1959 – 1970 served as Assistant Director General of the Ministry of Agriculture in charge of budget preparation.

Tzippi Samet – Bachelor of Economics and Mathematics and Master of Economics. Serves as Chairperson of the Investment Committee of Avner - Motor Vehicle Accident Victims Insurance Ltd. and as director of companies (Hazera Genetics Ltd., Mivtahim Pension Funds Ltd. and Mivtahim Provident and Education Funds Ltd.). In the period 1998 – 2002 served as Commissioner of the Capital Market, Insurance and Savings. At the same time served as director of M.I. Holdings Ltd. and in the years 1996 – 1998 was a member of the Israel Securities Authority.

Dr. Arie Ovadia – Bachelor of Economics and Accountancy, Master of Business Administration and Ph.D. Economics. Lecturer at universities and academic institutions in Israel and abroad. Consultant to companies on economic issues. Serves as Chairman of the Board of The Israel Phoenix Assurance Co. Ltd., and of Giron Development and Building Ltd. and as director of companies (Elite Industries Ltd., Participation in Real Estate in Israel Ltd., Orda Print Industries Ltd., Israel Petrochemical Industries Ltd., Carmel Ulpinim Ltd., Tadiran Communications Ltd., Hadar Ltd. Mehadrin Ltd.). Served as a member of the Israel Securities Authority (1981 – 1996), as a member of the Israeli Accounting Standards Institute (1998 - 2001), and as CEO of Dubek Ltd. (1996 – 1999). Concurrently served at various times as company director (including Dubek Ltd., Koor Industries Ltd.).

David Schlachet – Bachelor of Chemical Engineering and Master of Business Administration. Managing partner and director of BIOCOM Management and Investments (2002) Ltd. Serves also as company director (Harel Capital Markets Ltd., Poalim Capital Markets & Investments Ltd., United Studios Ltd., Taya Investments Ltd., Pharms Ltd., Taldor Computer Systems Ltd. (external director), Proseed Venture Capital Fund Ltd., Compugen Ltd.). In the years 1997 – 2000 served as active Chairman of the Board of Directors of Elite Industries Ltd. In the years 1996 – 2000 served as Vice President of the Strauss Group. In the years 1990 to 1996 served as Vice President of Finance and CEO of the Weitzman Institute of Science. Also served as CEO of Yeda Research and Development Company Ltd. (1989 – 1990) and as a senior company executive at Bank Hapoalim Investment Company (1974 – 1988). For various periods served as a lecturer on capital budgeting, financial risk analysis and portfolio management at the Israel Management Institute, and as a lecturer on various financing issues at LAHAV. Concurrently with the above duties, served also as company director (Reshet Communications and Productions Ltd., Yeda Research and Development Company Ltd., Africa-Israel Investments Ltd., Poalim Capital Markets – Investment Bank Ltd., DSL.Com Consulting and Management Ltd.).

Tida Shamir – Bachelor of Law and Master of Business Administration from the European Institute INSEAD in France. Practicing attorney, specializing inter-alia in capital markets and public offerings. Served as Director from the Public of the Tel-Aviv Stock Exchange (1996 – 2002).

March 29, 2004

Arie Mientkavich
Chairman of the Board
of Directors