ISRAEL DISCOUNT BANK

ANNUAL REPORT 2004

04

This is a translation from the Hebrew and has been prepared for convenience only. In case of any discrepancy, the Hebrew will prevail.

CONTENTS

BOARD OF DIRECTORS

ARIE MIENTKAVICH Chairman, the Bank; Mercantile Discount Bank Ltd.; Discount Bancorp, Inc.; Israel Discount Bank of New York; Discount Management of Provident Fund Ltd.; Israel Discount Capital Markets & Investments Ltd.; The Provident Fund of the Staff of Israel Discount Bank 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 and Audit Committee, The College of Management and Academic Studies. Member, Administrative Committee, The Veteran Pension Funds. Member Audit Committee of The Israeli Management Center.

NISSIM BARUCH Economics Consultant.

ITTAMAR GIVTON Managing Director, Automotive Equipment Group. Director, Automotive Equipment Ltd.; Moto Parts Ltd.; Israel Automobile Corporation Ltd.; Metive Ltd.; Automotive Industries Ltd.; Advanced Vehicles C.R.M Ltd.; Metropolitan Public Transport Ltd.; Metrodan Be'er Sheva Ltd. Member of Management Committee, Buxenbaum-Neta Fund (private fund).

ELIE GOLDSCHMIDT Manager & Communications. Consultant & Mediator. Strategic Advisor (Managing Partner), G.C.S. Issue Management (Israel) Ltd. Partner and Director, Goldman Goldschmidt Ltd. Chairman, D.N.A.B. Holdings Ltd.; D.N.A.B Consulting and Marketing Ltd. Member, Investment Committee, Lehava Training Fund Ltd. Director, A.F.S.K. Industries Ltd. (External Director); Gan Shmuel Foods Ltd. (External Director) Yaad Communications Ltd. (Vol.). 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.

YAACOV LIFSHITZ Lecturer, Ben Gurion University. Director, Dor-Alon Gas Technologies Ltd.; Spring-Pension Management Ltd.; Carmel Investment Group Ltd.; Tesnet Software Testing Ltd. Elbit Systems Ltd.; KALI-Insurance Agency Ltd.

YEHUDA MILO 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.

Dr. ARIE OVADIA Companies Consultant. University Lecturer. Chairman: The Israel Phoenix Assurance Co. Ltd.; Giron Development & Building Ltd. Director, 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.

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 Ltd.

DAVID SCHLACHET Chief Financial Officer, Syneron Medical Ltd. Director & Joint Manager, BIOCOM Management & Investments (2002) Ltd. Director, Harel Capital Markets Ltd.; Poalim Capital Markets & Investments Ltd.; United Studios Ltd.; Taya Investments Co. Ltd.; Pharmos Ltd.; Adgar Investments & Development Ltd. (External Director); Proseed Venture Capital Fund Ltd.; Compugen Ltd.; Medson Ltd.

TIDA SHAMIR Attorney at Law and Partner in Tida Shamir Law Firm. External Director, Gazit Globe (1982) Ltd.

JOSEPH SINGER (External Director) Director & Managing Partner, Giza Singer & Even Ltd. Director, Singer & Even Ltd.; Midroog Ltd.; Midroog Holdings Ltd; Giza Singer & Even Finance Ltd.; Singer, Even & Kraizberg Holdings Ltd. External Director, Edmond de Rothschild Mutual Funds Management Ltd. and Chairman, Investment Committee.

NOGA YATZIV Corporate Secretary, The Israel Corporation, Assistant General Manager and Personnel Manager. Director, Amanet Management & Systems Ltd. (External 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.). Secretary: Magnesium Dead Sea Ltd.

MANAGMENT

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 \ Legal Advisory Group. NISSIM ALAGEM Executive Vice President \ Commercial Banking Division. LINDA BENSHOSHAN 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.

04

REPORT OF THE BOARD OF DIRECTORS TO SHAREHOLDERS

The Board of Directors, on March 29, 2005, approved and authorized for publication the consolidated financial statements of the Bank and its subsidiaries for the year ended December 31, 2004.

MAIN DEVELOPMENTS IN THE ISRAELI ECONOMY IN 2004

PRINCIPAL ECONOMIC DEVELOPMENTS[1]

The year 2004 was a year of change in economic activity. The Israeli economy moved from a decline in the per capita product in the last three years, at a cumulative rate of 6.5%, to a fair increase of 2.5% in 2004. The change in 2004 is explained on the backdrop of the positive effect of several principal factors: (a) Accelerated global growth and in particular the significant recovery in the hi-tech industry in the world. (b) A reliable budgetary policy and the advancement of several structural reforms in the market as a whole and in the public sector in particular. (c) A gradual and continuous decrease in Bank of Israel interest rate along with a decrease in the market risk premium. (d) The relative relaxation in the security situation and positive developments in the political field.

According to early estimates of the Central Bureau of Statistics, the Gross Domestic Product (GDP) increased in 2004 by 4.3%, compared with an increase of only 1.3% in 2003, and to negative growth rates in the years 2001 and 2002. Reviewing the data on a semi-annual basis shows that the rate of growth of the GDP accelerated in 2004 as follows: an annualized rate of 4.0% in the second half of 2004, compared with an annualized rate of 3.0% in the first half of the year. The population in Israel increased in 2004 by a rate of 1.7%. Accordingly the per capita GDP increased by 2.5%, following a decline of 0.5% in 2003. The business product also increased in 2004 at a sharp rate of 6.1%, following an increase of 1.7% in 2003.

The combined market condition index published by Bank of Israel, serving as an indicator for real-term economic activity, recorded during 2004 a sharp rise of 5.2%, following a rise of 1.5% in 2003. This increase reflects the growth in industrial production and in world trade, as well as the increase in the turnover index in the commercial and services sectors. The survey of companies performed by Bank of Israel also reported a satisfactory rise in economic activity from the beginning of 2004, following a long period of rather moderate activity.

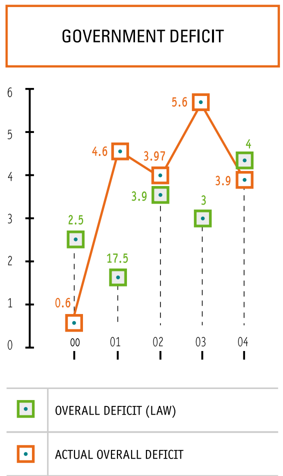
The accelerated growth rate in 2004 derived mostly from the continued improvement in the export of goods and services and from the continued expansion in private consumption. The per capita expenditure for current consumption in 2004 increased by 3.9%, following a decrease of 0.5% in 2003. The increase reflects mostly increases in expenditure on services, apparel and footwear and electricity and fuel. The per capita acquisition of durable goods increased outstandingly at the rate of 17.7%, as compared with a decrease of 1.6% in 2003, the major part of the increase comprising vehicles for private use.

The export of goods and services increased sharply in 2004 at a rate of 14.9%, following an increase of 6.2% in 2003 and a decrease of 2.4% in 2002. The rise in exports reflects expansion of activity in most industrial sectors and, in particular, in the export of tourist services, which rose in 2004 at a high rate of 39%, following an increase of only 4% in 2003.

The import of goods and services recorded in 2004 an increase of 12.0%, following a drop of 1.8% in 2003. The major part of the increase related to imports of investment goods (excluding vessels and airplanes) and to the import of raw materials (excluding diamonds and energy products), which serve as an indicator for future activity in the industrial sectors.

The deficit on the goods and services account decreased in 2004 to US$ 1.7 billion, in contrast to a deficit of US$ 1.9 billion in 2003.

The tourist industry data for 2004 show a considerable growth, thanks to the improvement in the security situation. Foreign tourist entries amounted to 1.5 million entries, an increase of 40% compared with 2003. Notwithstanding, this number is still lower by 38% than that



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

of the year 2000 – a record year for tourism in Israel. Occupancy in tourist hotels in 2004 totalled 17 million nights, of which 72% related to Israelis and the rest were foreign tourists. The average level of occupancy for Israeli tourists during the year was over one million nights per month, which was 3% higher than that of the preceding year. The average level of occupancy for foreign tourists however was 392 thousand nights per month, an increase of 46% in comparison to last year.

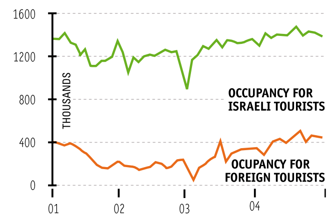
The considerable improvement in economic activity this year passed over the construction industry, which data continues to indicate a low level of activity, both on the demand side and on the supply side. According to the Ministry of Construction and Housing, the slowdown centered mostly on peripheral areas, though since the beginning of the second half of 2004, the slowdown is noticed also in certain regions in central Israel. National accounting data show that investments in housing construction decreased in 2004 by 5.5% following a decrease of 4% in 2003, and a continuous downward trend in the last seven years. Investments in construction other than housing decreased in 2004 by 14.5%. This gloomy picture is further verified by the survey of companies published by Bank of Israel, which forecasts a further slowdown in volume of operations.

In the first ten months of 2004, construction of 22.2 thousand dwelling units began (18.5 thousand units by the private sector and the balance by the public sector) – a decrease of 2.5% compared with the corresponding period last year (which level was also very low). The drop this year resulted from a sharp decline in new building projects initiated by the public sector, while construction initiated by the private sector showed stability though at a low level. A slowdown was also noted this year in completion of building projects, and the number of dwelling units the construction of which was completed in the first ten months of 2004 reached 24 thousand units, compared with 28.5 thousand units in the corresponding period last year. In addition, the number of employees in this sector – Israelis, foreign workers and workers from the Palestinian Territories – continues to decline, mostly as a result of the continuous decrease in the number of foreign workers, following the enforcement measures by the Immigration Police.

The average unemployment rate (based on a manpower survey data) reached in 2004, 10.4% of the civilian workforce, as against a rate of 10.7% in 2003. However, the increase in the number of employed Israelis reflects a significant increase in the number of part-time employees, while the number of full-time employees continued to decline.

GROWTH AND UNEMPLOYMENT IN ISRAEL

HOTEL OCCUPANCY FOR ISRAELI AND FOREIGN TOURISTS



ECONOMIC DEVELOPMENTS IN THE PERIOD JANUARY – MARCH 2005

The current monthly indicators as of the beginning of 2005, the review of companies of Bank of Israel and the state of the economy combined index indicate the continued expansion of economic activity, though at a slightly slower pace than that of the last quarter of 2004. The expansion in activity continued in most economic sectors. However, the first two months of the year registered a decline of 3% in the export of goods. The unemployment rate continued to drop in January to 9.9% compared with the average rate for 2004 of 10.4%.

As of the middle of March, 2005, the Knesset has not approved the State budget for 2005, and the Government operated under an expenditure limitation derived from the 2004 budget. This limitation resulted in a high surplus of NIS 3.8 billion in the overall Government activity in the period from January to March 2005, due to a surplus of NIS 3.4 billion in the domestic activity. The State's income from taxes in this period amounted to NIS 26 billion.

In January 2005, the shekel was devalued against the US dollar by 2%. However, since the beginning of February, the trend in the foreign currency market has changed and the shekel recovered against the dollar, so that in the middle of March 2005, the exchange rate of the shekel as against the dollar returned to its level as at the end of 2004. Activity in the foreign currency market during the first quarter of 2005 was characterized by low trading

volumes and low volatility, similarly to the last quarter of 2004.The sharp drop in volume of activity covered all the sectors active in the foreign currency market.
In the first two months of 2005, the Consumer Price Index fell by 0.4%. The CPI, excluding the fruit and vegetable component, fell by 0.3%, and the CPI, excluding the housing component, fell by 0.6%. The development in prices was mostly affected by the exchange rate trend and by seasonal factors.

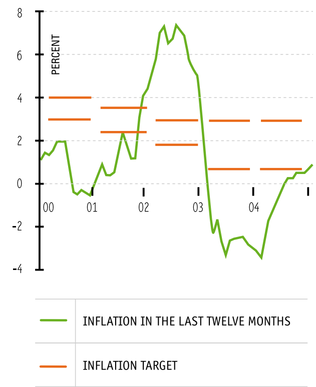
PRICE INDICES AND CURRENCY EXCHANGE RATES

In 2004, the CPI increased by 1.2%, compared with a decline of 1.9% in 2003. The development in the inflation rate was not uniform over the year, where most of the annual increase was concentrated in one month – April. A cumulative drop in prices at the rate of 0.2% was even recorded at the second half of the year. The rate of inflation in 2004 was higher by 0.2% than the lower limit of the annual inflation target, thus, for the first time in four years, the inflation target determined by the Government has been reached. The stability in the shekel/dollar exchange rate contributed to the low inflation rate in 2004, and the housing index, which is affected to a large extent by this exchange rate, dropped this year by 2.5% and deducted 0.6% from the overall rise in the CPI.
The “basic inflation” (the CPI excluding fruit and vegetables and housing) rose in 2004 by 2.1%, compared with a moderate rise at the rate of 0.6% in 2003.
The industrial output wholesale price index rose in 2004 by a sharp rate of 7.6%, compared with an increase of 3.3% in 2003. The housing construction input index rose in 2004 by 4.9% compared with an increase of 2.4% in 2003.
The development in the shekel/dollar exchange rate during 2004 is divided into two main periods: in the first period, from the beginning of the year to the middle of May, the shekel was devalued against the dollar by 6%.
Among other things, the devaluation was affected by the process of modification of investment portfolios by Israeli residents, in response to the early implementation as of the beginning of 2005, of equalizing the tax applying to foreign securities, as well as from the continued decline in the differential between the interest paid on the dollar and that paid on the shekel.
In the second period, from the middle of May to the end of the year, the shekel appreciated against the US dollar at a sharp rate of 7%. The appreciation was affected by several factors: an improvement in the basic accounting, deriving from the inflow of foreign capital to the market along with a balanced current account, the continued improvement trend in the net foreign debt of the economy, the continued trust in the fiscal policy and a decrease in the risk premium of the Israeli market along with positive developments on the political side.
The shekel appreciated against the dollar in the course of 2004 at a nominal rate of 1.6% (comprising an appreciation in real terms at the rate of 2.8%), compared with an appreciation at a nominal rate of 7.6% (comprising an appreciation in real terms at the rate of 5.8%), in 2003.
The shekel was devalued against the currency basket in the course of 2004 at a nominal rate of 0.8% (comprising an appreciation in real terms at the rate of 0.4%), compared with an appreciation at a nominal rate of 1.6% (comprising a devaluation in real terms at the rate of 0.3%), in 2003.
The shekel was devalued against the Euro in the course of 2004 at a nominal rate of 6.2% (comprising a real terms devaluation at the rate of 5%), compared with devaluation at a nominal rate of 11.5% (comprising a devaluation in real terms at the rate of 13.5%), in 2003.

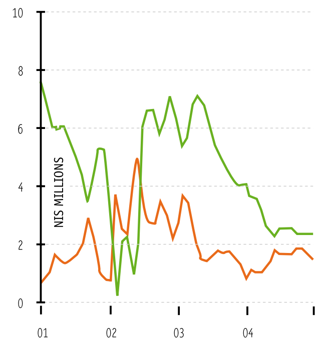
MONETARY DEVELOPMENTS AND THE MONEY MARKET

The money supply, M1 (cash and bank current accounts held by the public) increased sharply in 2004 at a rate of 12%, compared with an increase of 6.7% in 2003. M2 (defined as M1

INFLATION



PUBLIC'S INFLATION EXPECTATIONS AND REAL EFFECTIVE INTEREST RATE



with the addition of daily and fixed term deposits) increased in 2004 by 3.5%, compared with an increase of 5.3% in 2003.

In December 2004, the monetary interest rate of Bank of Israel was 3.9% (an effective annual rate of 4.1%), a rate lower by 1.3% than its level in December 2003, and lower by 5.2% than the level of December 2002. In the first quarter of 2004, the interest rate was reduced consecutively at a cumulative rate of 0.7%. The gradual reduction in the rate of interest came on the backdrop of the low inflation rate, the continuing decline in expectations for inflation, as they are reflected in the capital market rates of interest for periods of one year and over, and the relaxation in the financial markets. As from the second quarter of the year, interest rates remained unchanged for eight consecutive months until December. The break in the reduction in interest process, following reductions at a cumulative rate of 5% since the beginning of 2003, came on the backdrop of several factors, including: the beginning of the process of rising interest rates in the United States, a certain increase in the actual rate of inflation, which was accompanied by the expected increase in inflation derived from the capital market, increased inflation forecasts by various experts, an increase in the money supply, increased returns in the bond market, increased return on Treasury Notes (MAKAM) for one year, and the continued recovery in real term activity.

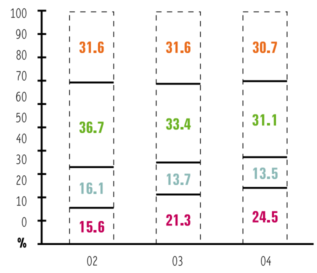
The total financial assets held by the public totalled NIS 1,509 billion at the end of 2004 (current data), an increase of 10.5% compared with the end of 2003. The strengthening of the shekel exchange rate against the dollar, low interest rates and a low level of inflation, particularly in the second half of the year, contributed to the increase in the shares component, mostly on account of the CPI linked component. The share of the CPI linked component in the public's asset portfolio totalled 30% at the end of 2004, compared with a rate of 33.5% at the end of 2003, and a rate of 37% at the end of 2002. The share of the foreign currency component decreased slightly to a rate of 13.5%, compared with a rate of 13.7% at the end of 2003. The rate of the non-linked component remained unchanged at a level of 31.5%, similar to that at the end of 2003.

The average effective return on the total non-linked shekel applications at the seven major banks decreased in December 2004 to a rate of 6.4%, compared with a return at the rate of 7.6% recorded in December 2003.

The average effective cost of the total non-linked shekel resources at the seven major banks decreased in December 2004 to a rate of 3.2%, compared with a rate of 4.2% recorded in December 2003.

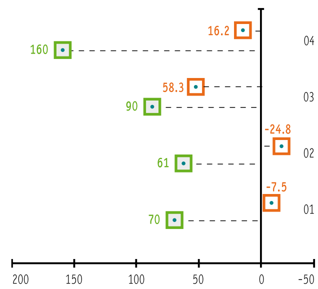
The financial margins, including management fees, in the non-linked shekel segment at the seven major banks stood at 3.7% in December 2004, similarly to the level of December 2003.

ASSET PORTFOLIO OF THE PUBLIC



NON-LINKED
CPI-LINKED
FOREIGN CURRENCY-LINKED
SHARES

STOCK MARKET



REAL RATE OF CHANGE IN GENERAL SHARE INDEX
TRADING VOLUME IN NIS BILLIONS (CURRENT PRICES)

THE CAPITAL MARKET

Developments in the capital market during 2004 were affected by several factors, including: (a) The continued decline in the estimated risk of the Israeli market. (b) Local developments in the political arena and the continued relative relaxation in the force of the confrontation with the Palestinians. (c) A fiscal policy that agrees with compliance with the deficit target. (d) Continued expansionary monetary policy.

2004 was a record year in the volume of trade in shares, bonds and derivatives based on the TA 25 index. The positive trend that characterized the share market in 2003 continued in 2004, though at a lesser intensity, and the corporation bonds market recorded a sharp increase in fund raising compared with 2003, particularly in view of the continued reduction in Government bond issues on the domestic market.

In summing up the year 2004, the general share index rose by 18%, following a rise of 56% in 2003. The remainder share index (YETER index) increased by 31%, while the TA 25 index, the TA 100 index and the TelTech index increased by 16% to 23%. The sector indices recorded a mixed trend, with the commercial banks and investment companies indices rising by 37% and 30% respectively, and in contrast the oil industry index falling by 6%.

The average daily volume of trade on the share market, including off-market transactions, was the highest in the history of the Stock Exchange, amounting in 2004 to NIS 658 million, higher by 80% than the average daily volume in 2003. In December 2004, the daily volume of trade amounted to NIS 865 million, being the highest level since the record of January 1994.

The market value of company shares traded on the Stock Exchange amounted at the end of 2004 to NIS 370 billion, an increase of 23% compared with the end of 2003. The increase in market value derived from share price increases, from 25 additional companies joining the market, and from an amount of NIS 14 billion of new capital raised by existing companies. The number of companies traded on the Stock Exchange fell at the end of the year to 562 companies compared with 577 companies at the end of 2003.

A significant increase took place during the year in the raising of capital by public share issuance both in Israel and the United states, amounting to NIS 4.9 billion, compared with NIS 1 billion in the course of 2003. Of the said amount NIS 3.3 billion was raised on the Tel-Aviv Stock Exchange and dual traded companies raised the balance in the US.

The increase in activity in the market for derivatives on the TA 25 index continued also in 2004. The average daily volume of trade amounted to 153 thousand contracts, compared with 120 thousand contracts in 2003. A record volume was recorded in December 2004, in which an average of 225 thousand contracts were traded.

The downward trend in volume of trade in US dollar derivatives continued also in 2004, due to the low volatility in the dollar exchange rate during the year, which reduced attractiveness for investment. The volume of trade in 2004 amounted to 24 thousand options on a daily average, compared with 34 thousand options in 2003.

The bond market experienced vigorous activity in 2004, that was reflected in high trade volumes, in the increase in the raising of capital and in moderate price increases. The downward trend in the issue of Government bonds on the local market continued. In summing up 2004, the general bonds index increased by 5.3%, following an increase of 14% in 2003.

The CPI linked Government and other bonds index rose during 2004 by 5.1%. A price increase of 2.6% was recorded in bonds with short-term redemption periods of up to two years. In the redemption period range of between two to five years bond prices increased by 3%, in the redemption period range of between seven to ten years bond prices increased by 3.9%, and in the long-term redemption periods of between ten and fifteen years bond prices increased by 3.8%.

The prices of dollar linked Government bonds increased during the year at a moderate rate of 0.7%, along with an appreciation of 1.6% in the shekel exchange rate against the dollar, in contrast to a decrease in prices of 4.8% in 2003. The non-linked Government bonds registered a price increase of 5.6%.

The Treasury Notes (MAKAM) prices increased during 2004 by 5.1%, following an increase of 8.6% in 2003.

THE DISCOUNT GROUP - GENERAL OVERVIEW AND STRUCTURE OF THE GROUP

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

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

DOMESTIC OPERATIONS

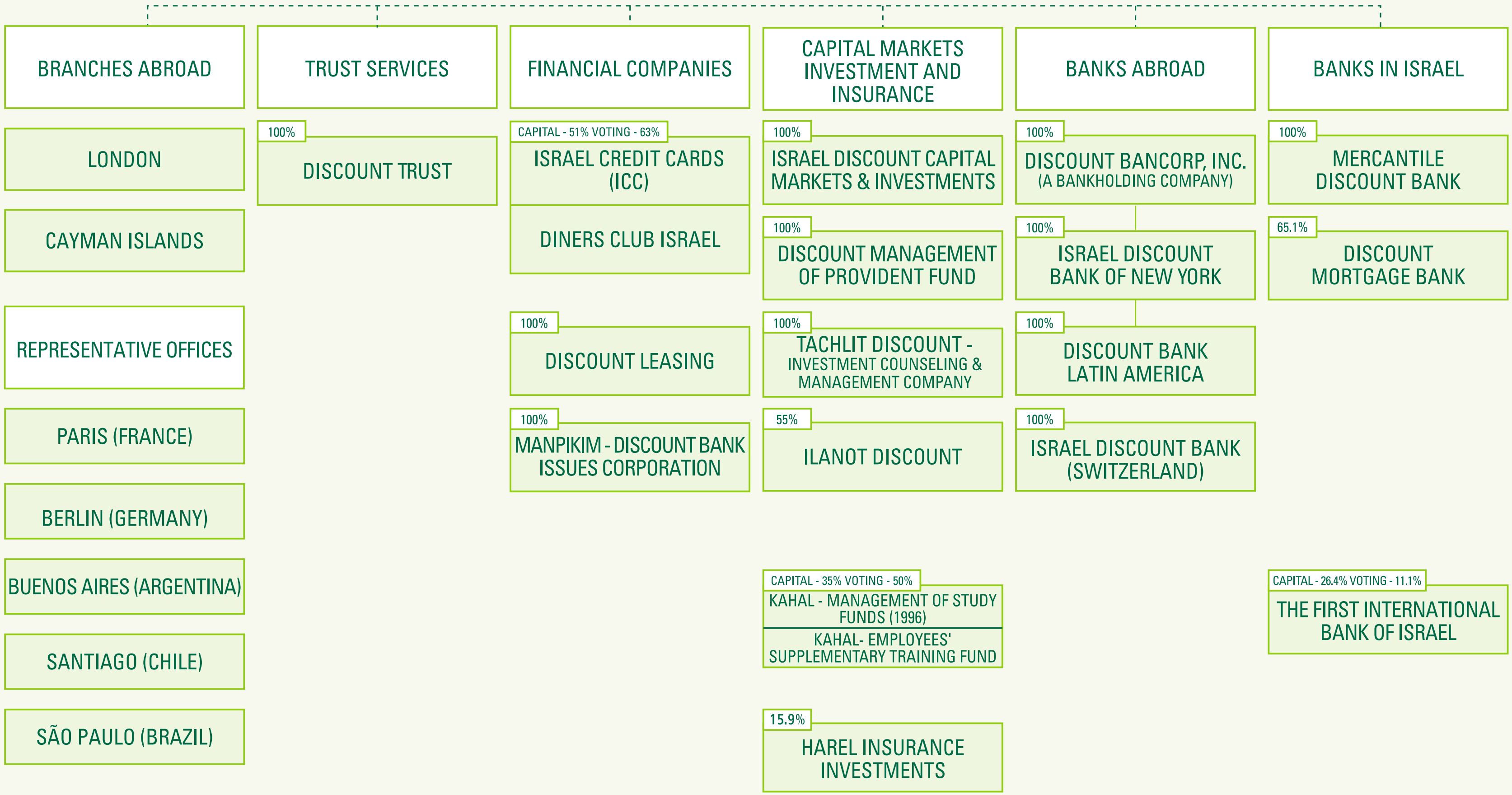
The Bank is a universal bank, which grants its customers comprehensive banking services in all areas of financial activity, throug 124 branches in Israel. The Bank also offers its customers a variety of direct banking, on-line banking and Internet services.
The Bank is an "authorized dealer" entitled to conduct foreign currency operations in accordance with the Control of Foreign Exchange Law, 1978.
The Bank is active in receiving deposits of foreign residents, in providing credit to foreign residents and in an array of foreign currency services, both to Israeli and foreign residents.
The Bank is a member of the Tel-Aviv Stock Exchange (hereinafter – "the Exchange") and acts, among other things, as a securities dealer and broker for its customers, including for companies of the Group and for provident funds managed by it. The Bank has two banking subsidiaries in Israel – Mercantile Discount Bank Ltd. – a commercial bank serving customers in all fields of financial activity through 62 branches, and Discount Mortgage Bank Ltd., serving as the main arm of the Group in the mortgage loan field. In addition, the Bank has an affiliated company, The First International Bank of Israel Ltd., being also one of the five major banking groups in Israel.
The activity in Israel covers additional areas of activity as described hereunder:

- Credit cards – The Bank controls Israel Credit Cards Ltd. ("ICC") and Diners Club Israel Ltd. ("Diners"), which issue and market "VISA", "Diners" and "MasterCard" credit cards, both for domestic and overseas use.
- Mutual investment trust funds – The Bank controls Ilanot Discount Ltd., a company marketing a variety of mutual funds.
- Securities portfolio management – The subsidiary, Tachlit Discount – Investment Counselling & Management Company Ltd., which manages securities investment portfolios for private customers, corporations, not-for-profit organizations and institutional bodies.
- Underwriting, investments and venture capital funds – The subsidiary, Israel Discount Capital Markets and Investments Ltd., is engaged in securities issuance underwriting and management, in investment banking, as well as in investment in venture capital funds together with foreign institutional bodies.
- Provident funds – The subsidiary, Discount Management of Provident Fund, manages a variety of provident funds.
- Trustee services – The subsidiary, Discount Trust Ltd., provide varied trust services.
- Advanced training funds – Kahal – Management of Study Funds (1996) Ltd. and Kahal – Employees' Supplementary Training Fund Ltd. are affiliated companies engaged in the field of advanced training savings.
- Leasing – Discount Leasing Ltd. is a subsidiary providing a variety of leasing services.
- The raising of secondary capital for the bank – effected by Manpikim – Discount Bank Issues Corporation Ltd.
- Harel Insurance Investments Ltd., an affiliated company of the Bank, engages in varied insurance and investment fields.

OVERSEAS ARMS OF THE BANK

The major part of the Bank's operations abroad is conducted by Discount Bancorp Inc., which owns Israel Discount Bank of New York. IDB New York is the largest of all Israeli banks operating abroad. Discount Bank (Latin America) operates as a commercial bank in Montevideo, Uruguay. Israel Discount Bank (Switzerland) S.A., located in Geneva, focuses on private banking. The Bank operates a London branch, which provides commercial and private banking services. The Bank has an additional branch in the Cayman Islands.
In addition, the Bank has representative offices in Paris, Berlin, Buenos Aires, Santiago and São Paolo.

DISCOUNT GROUP STRUCTURE

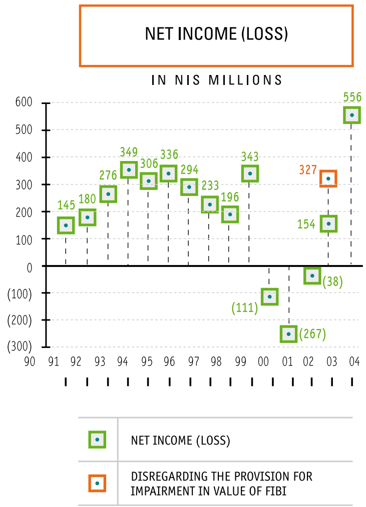


FORWARD-LOOKING INFORMATION

The information detailed in this report regarding the description of the business of the Bank, its financial position and results of operations, might include forward-looking information as defined in the Securities Law, 1968. Expressions that denote an assessment, belief, an explicit or implicit intent or expectation, indicate that the matter constitutes forward-looking information, which, in the nature of things, its realization is uncertain.
Such information reflects the viewpoint of the Bank at the date of preparation of the financial statements as regards future events based on uncertain estimates.

DISCONTINUATION OF THE ADJUSTMENT OF FINANCIAL STATEMENTS TO THE EFFECT OF INFLATION

Starting January 1, 2004, the Bank discontinued the adjustment of the financial statements to inflation and they are being presented in reported amounts. Up to December 31, 2003, the financial statements were prepared in inflation adjusted terms (for details as to the discontinued adjustment of the financial statements in accordance with Accounting Standard 12 of the Israeli Accounting Standards Board and the instructions of the Supervisor of Banks, see Note 1 B to the financial statements).
In view of the materiality that the Supervisor of Banks attaches to income and expenses from financial instruments included in the business results of banking corporations, and in order to enable users of their financial statements to examine the data included in the financial statements for 2004, in comparison to the data of 2003, special instructions were determined in respect of the comparative figures included in the financial statements for 2004. Accordingly, the comparative figures for income and expenses included in the income statement up to and including the item "operating income before taxes" in reported amounts, are stated in reported amounts, when the discontinued adjustment to the effect of inflation in their respect was made according to the CPI for December 2002. The difference in the comparative figures between the income before taxes in reported amounts as stated above, and the income before taxes as adjusted on the basis of the CPI for December 2003, is stated in the item "erosions and adjustments". This form of presentation allows a fair comparison between the said items in 2004 with those of 2003.
In contrast, the comparative figures for income statement items appearing after the line item "operating income before taxes" are stated, as said, in amounts adjusted for the effect of inflation based on the CPI for December 2003. Care should therefore be taken when comparing such items in the reported period with the comparative figures relating to them. The same applies to the data calculated on their basis, such as : "Income per share" and "Return on equity".
Furthermore, the comparative figures for 2002 are presented as reported while adjusted to the effect of inflation based on the CPI for December 2003. Accordingly, care should be taken when comparing the data for the years 2004 and 2003 to the data of 2002.



INCOME AND PROFITABILITY

The Group's Net Income in 2004 totalled NIS 556 million, compared with NIS 154 million in the preceding year, an increase of 261.0% (and compared with NIS 327 million disregarding the provision for impairment in value mentioned hereunder – an increase of 70.0% in net income). Net income for 2004 is net of completing the provision for doubtful debts in respect of a certain borrower, in accordance with an instruction of the Bank of Israel, which affected the net income of the Bank, both directly and indirectly, due to a decline in income from the Bank's share in the First International bank. Were it not for the direct and indirect effect of the said provision, the Group would have produced a net income of NIS 651 million, in 2004.
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. (The Bank received an opinion and updates thereof, according to which the recoverable value of the Bank's investment in the First International Bank is not below the equity value of the investment as of December 31, 2002, December 31, 2003, March 31, 2003, June 30, 2003, September 30, 2003, March 31, 2004, June 30, 2004, September 30, 2004 and December 31, 2004. Therefore, according to generally accepted accounting principles, no provision for impairment in value is required For details as to an updated opinion, according to which the recoverable value of the investment in the First International Bank does not fall below the equity value of the investment also as of December 31, 2004, and for details regarding the said directive – see note 6D. to the financial statements).

The Bank alone had income from ordinary operations after taxes amounting to NIS 104 million in 2004, compared with income from ordinary operations after taxes of NIS 148 million in the previous year.

Not considering the effect of the hedge of the investment in the Bank's overseas units, the income in 2004 from ordinary operations after taxes amounted to NIS 84 million, compared with NIS 55 million in the previous year.

Return on shareholders' equity for 2004 was 9.3%, compared with 3.0% in the preceding year. The return on equity for 2004, disregarding the direct and indirect effect of completing the provision in respect of a certain borrower, would have reached an annualized rate of 10.9%.

The return on equity, disregarding the provision for impairment in value, would have reached 6.5% in 2003.

Net earnings per NIS 1 par value of the share capital amounted in 2004 to NIS 5.67, compared with NIS 1.57 in the preceding year (and compared with net earnings per share computed disregarding the provision for impairment in value of NIS 3.33).

The following are the main factors, having a positive effect on the business results of the Group in 2004, compared with 2003:

(a) An increase of NIS 506 million in earnings from financing operations before provision for doubtful debts, a rate of 17.0%.

(b) An increase of NIS 109 million in other operating income, constituting a rate of 5.2%, of which an increase in operating commissions of NIS 97 million, as a result of an expansion of operations, and an increase of NIS 94 million in the gains on investment in shares, net, which were partly offset by the decline in other income of NIS 82 million, resulting from a drop in the earnings of the severance pay fund of the Bank.

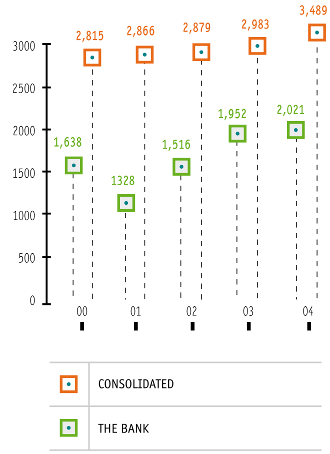
(c) Net earnings from extraordinary operations after tax of NIS 24 million, compared with a loss of NIS 23 million in 2003.

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

(a) An increase of NIS 35 million in the provision for doubtful debts, a rate of 4.1%, which resulted mainly from the increase in the provision for doubtful debts in consolidated subsidiaries. The provision for doubtful debts at the Bank decreased by NIS 74 million, comprising a decrease of 11.3%.

(b) An increase in the operating and other expenses of NIS 408 million, comprising a rate of 11.3%, of which an increase in payroll expenses of NIS 247 million and an increase in other expenses of NIS 165 million.

INCOME FROM FINANCING ACTIVITIES BEFORE PROVISION FOR DOUBTFUL DEBTS THE BANK/CONSOLIDATED
IN NIS MILLIONS



DEVELOPMENTS IN INCOME AND EXPENSES

Income from financing activities before provision for doubtful debts amounted to NIS 3,489 million in 2004, compared with NIS 2,983 million in the preceding year, an increase of 17.0%.

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

(a) An increase of 1.5% in the average outstanding balance of financial assets generating financing income.

(b) An increase in the overall financial margin (including the effect of derivative financial instruments), which in 2004 reached a rate of 1.73%, compared with 1.53% in 2003.

(c) Gains (loss) net on sale of available-for-sale bonds and a provision for the decline in value of available-for-sale bonds in 2004, totaling NIS 98 million compared with NIS 15 million in 2003.

(d) Realized and non-realized gains on adjustment to fair value of trading bonds, net, amounted to NIS 29 million in 2004, compared with a loss of NIS 64 million in 2003.

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						
	2004			2003			
	Contribution to profit			Contribution to profit			Changes in contribution
	Volume of activity* in%	NIS millions	in %	Volume of activity* in %	NIS millions	in %	NIS millions
Israeli Currency	28.9	1,384	39.7	27.9	1,202	40.3	182
Unlinked shekels	13.6	434	12.4	15.4	408	13.7	26
CPI-linked shekels	57.5	1,229	35.2	56.7	1,019	34.2	210
Foreign Currency	100.0	3,047	87.3	100.0	2,629	88.2	418
Options		5	0.1		(47)	(1.6)	52
Other derivative financial instruments (not including hedged derivatives and ALM)		22	0.6		80	2.7	(58)
Financing commissions		120	3.5		109	3.6	11
Other financing income (expenses), net		295	8.5		212	7.1	83
Total		3,489	100.0		2,983	100.0	506

* According to the average balance of the assets.

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

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, 2004, was NIS 2.8 billion, compared with NIS 2.9 billion in the preceding year. (The average rate of return on credit in the different linkage segments in 2004 is between 2.3% and 7.5%).

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

In the non-linked shekel segment, net interest income totalled NIS 1,384 million in 2004, compared with NIS 1,202 million in the preceding year, an increase of 15.1%. Income from this segment constituted 39.7% of total net interest income in 2004, compared with 40.3% in the preceding year.

In 2004, assets exceeded liabilities in this segment by NIS 1,465 million, compared with 2003, where assets exceeded liabilities by NIS 1,149 million, contributing to the increase in earnings from financing operations in this segment.

The average balance of assets in this segment increased in 2004 by 5.2% compared with the preceding year.

In 2004 the interest margin reached 2.67% compared with 2.38% in the previous year.

In the CPI-linked shekel segment, net interest income totalled NIS 434 million in 2004, compared with NIS 408 million in the preceding year, a rise of 6.4%. Its proportion of total net interest income in 2004 was 12.4%, compared with 13.7% in the previous year.

The average asset balance in this segment in 2004, fell by 10.6% compared with the preceding year.

The interest margin in 2004 reached the rate of 1.49%, compared with a rate of 1.30% 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 1,229 million in 2004, compared with NIS 1,019 million in the preceding year, an increase of 20.6%. Its proportion of all net interest income was 35.2% in 2004, compared with 34.2% in the preceding year.

In 2004, the average balance of assets in this segment increased by 2.9% compared with the preceding year.

The interest margin in this segment in 2004 was 1.25%, compared with 1.08% in the preceding year.

Other net financing income totalled NIS 415 million in 2004, compared with NIS 321 million in the preceding year.

Total interest margin in 2004 was 2.14%, compared with 1.25% 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 1.73% in 2004, compared with a rate of 1.53% in the preceding year.

Provision for doubtful debts totalled NIS 880 million in 2004, compared with a provision of NIS 845 million in the preceding year, an increase of 4.1%. In 2004, the provision constituted 25.2% of the income from financing activities before provision for doubtful debts, compared with 28.3% of this income in the preceding year.

The increase derives from the rise in the specific provisions for doubtful debts of consolidated subsidiaries. The specific provision for doubtful debts of the Bank decreased at a rate of 11.3%.

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

The annual provision for doubtful debts, as a ratio of credit to the public, not including off-balance sheet credit risk, was 1.06% in 2004 (0.70% - including off-balance sheet credit risk), compared with 1.04% (0.70% - including off-balance sheet credit risk) in 2003.

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 5,540 million in 2004 (NIS 5,663 million - including provision for off-balance sheet credit risk). The balance of this provision constitutes 6. 67% of the credit to the public (4.48% - including off-balance sheet credit risk), compared with a balance of the provision in the amount of NIS 5,040 million, not including provision for off-balance sheet credit risk (NIS 5,177 million - including provision off-balance sheet credit risk), constituting 6.19% of the credit to the public (4.26% - including off-balance sheet credit risk) at the end of the preceding year.

The specific provision for doubtful debts amounted to NIS 845 million in 2004, compared with NIS 853 million in the preceding year, a decrease of 0.94%.

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 2004 relates to the following industries: construction and real estate industries 41.4% in 2004, compared with 35.4% in 2003; hotel industry 0.9% in 2004, compared with 5.2% in 2003; communications and computer services 20.1% in 2004, compared with 20.8% in 2003; commercial branches 8.1% in 2004, compared with 6.4% in 2003; various industrial sectors 12.2% in 2003, compared with 21.1% in 2003.

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 1.9% in 2004, compared with 1.7% in 2003.

The Bank's specific provision for the hotel sector, as a ratio of credit to the public in this sector, was 0.2% in 2004, compared with 1.1% in 2003.

The Bank's specific provision for the commercial sectors, was 0.8% in 2004, compared with 0.7% in 2003.

The Bank's specific provision for the various industrial sectors, was 0.8% in 2004, compared with 1.3% in 2003.

The Bank's specific provision for the communications and computer services, was 4.5% in 2004, compared with 2.8% in 2003.

The specific provision in the Bank, in respect of all other economic sectors, as a ratio of the credit granted to such sectors, was 0.7% in 2004, compared with 0.4% in 2003.

The supplemental provision for doubtful debts of the Bank and the banking subsidiaries in Israel, in 2004, totalled NIS 6 million, compared with a supplemental provision of NIS 34 million in the previous year.

The total of the said amount included, in 2004, an additional provision in respect of prior years, in the amount of NIS 16 million, compared with NIS 13 millions in 2003.

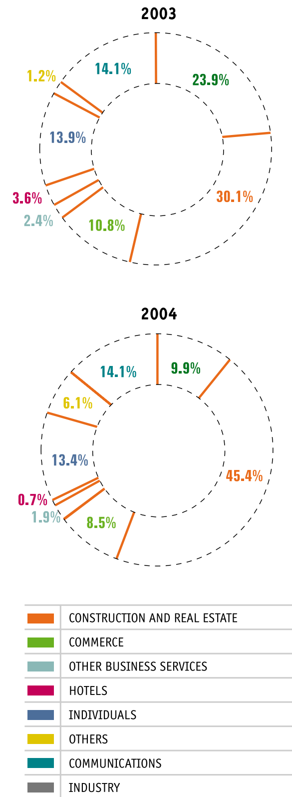
The supplemental provision for doubtful debts. The supplemental provision for doubtful debts is based on the quality of the credit portfolio in accordance with risk characteristics, as determined by the directives for proper banking procedures. In respect of these risk characteristics, the initial directive 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 15 million as of December 31, 2004, 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.

PROVISION FOR DOUBTFUL DEBTS BY ECONOMIC SECTORS



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.
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.
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.
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 was included in "Other liabilities".
Only towards the publication of the financial statements for December 31, 2004, the Supervisor of Banks allowed the Bank to reverse the said supplemental provision. Whereas the said approval was received towards the end of February 2005, the provision included in the books of Mercantile Discount Bank will be reversed only in the first quarter of 2005.
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 has been 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. Nevertheless, 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.
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, and in the first and second quarters of 2004, he delayed it once again.
On November 4, 2004, the Supervisor of Banks informed the Bank that it has to complete the provision for doubtful debts in accordance with the value of the security derived from a value of US$ 1,150 per subscriber. In the opinion of the Bank, transactions entered into in the course of the last year for acquisitions in the cable TV field as well as the transaction being formed at the present time for the acquisition of subscribers of the customer by another company, reflect an objective market value of US$ 1,400-1,500 per subscriber. This estimate is also supported by evaluations based on available cash flows of companies in this field, and therefore, in the opinion of the Bank no further provision is required. In a letter of November 15, 2004, the Supervisor of Banks informed the Bank that, based on the data submitted to him by the Bank, he had performed an indicative examination testing a wide range of scenarios and assumptions in relation to various parameters in the valuations provided to him by the Bank. The Supervisor informed the Bank that based on scenarios that seem to him reasonable and even optimistic, he does not see grounds for relating a value of over US$ 1,150 per subscriber, for the purpose of computing the provision for doubtful

debts, and accordingly the Bank is requested to complete the provision. In accordance with the instruction of the Supervisor of Banks, the Bank provided NIS 97 million in this respect, and completed the provision in the fourth quarter of 2004, by an additional amount of NIS 14 million. (This instruction resulted also in a decline in income from the Bank's share in the First International Bank, in an amount estimated at NIS 12 million).

Income from financing activities after provision for doubtful debts amounted to NIS 2,609 million in 2004, compared with NIS 2,138 million in the preceding year, an increase of 22.0%.

Non-financing income in 2004 amounted to NIS 2,200 million, compared with NIS 2,091 million in the preceding year, an increase of 5.2%.

Commissions totalled NIS 1,745 million in 2004, compared with NIS 1,648 million in the preceding year, an increase of 5.9%. The increase results, mainly, from income from credit cards, income from securities transactions, handling of credit and drafting of contracts and foreign trade and foreign currency special services activity 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 519 million in 2004, compared with NIS 470 million in 2003, an increase of 10.4%. Interest income on credit to customers via credit cards amounted to NIS 56 million in 2004, compared with NIS 74 million in 2003.

Gains on investment in shares amounted to NIS 103 million in 2004, compared with NIS 9 million in 2003. The gains in 2004 and in 2003 include dividend income of NIS 5 million and NIS 6 million respectively, received on shares of Israel Credit Cards Ltd. designated for sale.

Other income in 2004 totalled NIS 352 million, compared with NIS 434 million in the preceding year, a decrease of 18.9%. This decline derives mainly from a decline in profits of severance pay funds, which amounted to NIS 29 million in 2004, compared with NIS 183 million in 2003.

Following are the main components comprising non-financing income:

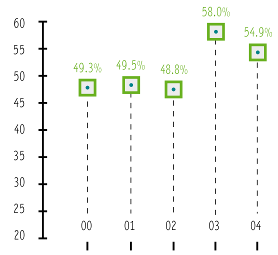
	2004	2003	2002
	%	%	%
Revenue from management fees	13.0	13.2	15.1
Payment order system services	18.8	19.4	21.6
Revenue from credit cards	24.7	22.6	24.8
Revenue from capital market activities	23.5	18.2	20.0
Profits of the severance pay fund	1.4	8.8	-
Computerized services, information and confirmations	2.1	2.1	2.3
Foreign trade activity	3.6	3.0	3.0
Margins and collection fees on loans out of deposits refundable according to collection	1.0	1.0	1.3
Other	11.9	11.7	11.9
Total	100.0	100.0	100.0

Non-financing expenses totalled NIS 4,013 million in 2004, compared with NIS 3,605 million in 2003, an increase of 11.3%.

Salaries and related expenses (including expenses for encouraging early retirement) amounted to NIS 2,511 million in 2004, compared with NIS 2,264 in the preceding year, an increase of 10.9%.

Salaries and related expenses (excluding expenses in respect of encouraging early retirement) amounted to NIS 2,390 million in 2004, compared with NIS 2,183 million in 2003, an increase of 9.5%.
In 2004, 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 2004, include an expense of NIS 121 million in respect of early retirement (2003: NIS 81 million).
Salary and related expenses in the Bank alone (including expenses for encouraging early retirement) amounted to NIS 1,671 million in 2004, compared with NIS 1,445 million in the preceding year, an increase of 15.6%. The increase stems from the wage agreement signed at the Bank, as well as from the fact that the payroll expenses in 2004 include the expense of a special “appreciation bonus”, a bonus in respect of the sale of the Bank, and an expense as regards the early retirement of employees.
Salaries and related expenses, excluding the effect of the “appreciation bonus”, the bonus in respect of the sale of the bank and the expense regarding the early retirement of employees, amounted in 2004 to NIS 1,464 million, compared with NIS 1,364 million in 2003, an increase of 7.3%.
Salary expenses, excluding related expenses, in the Bank alone, amounted to NIS 1,017 million in 2004, compared with NIS 924 million in the preceding year, an increase of 10.1%.
The Bank expense for salaries, excluding related benefits and excluding the effect of the “appreciation bonus” and the bonus in respect of the sale of the bank, amounted in 2004 to NIS 994 million, compared with NIS 924 million in the previous year, an increase of 2.2%.
Salary related expenses in the Bank alone, amounted in 2004 to NIS 537 million, compared with NIS 440 million in 2003, an increase of 22.0%.
Plan for the encouragement of early retirement. In May 2004, the board of directors approved a plan for the encouragement of early retirement of employees. The plan was focused on an employee population having defined characteristics, in respect of which a special effort was made to encourage their early retirement under improved terms. The financial statements include an expense of NIS 30 million in respect of the said plan. In October 2004, the board of directors approved another plan for the encouragement of early retirement of employees. The financial statements include an expense of NIS 30 million in respect of the said additional plan.
In addition, another expense of NIS 57 million, was recorded in 2004 respect of the encouragement of early retirement of employees.
See the section on “Human Resources” below, for details of employee retirement in 2000-2004.
Depreciation and maintenance of building and equipment totalled NIS 632 million in 2004, compared with NIS 636 million in the previous year, a decline of 0.6%.
Other expenses totalled NIS 870 million in 2004, compared with NIS 705 million in the preceding year, an increase of 23.4%. The increase results mainly from an increase in computer expenses of the Bank and the increase in expenses, of the consolidated companies of the Bank.
The ratio of non-financing income to non-financing expenses reached 54.8% in 2004, compared with 58.0% in the preceding year.
Operating income before taxes totalled NIS 796 million in 2004, compared with NIS 654 million in the preceding year, an increase of 21.7%.
Provision for taxes on operating income totalled NIS 342 million in 2004, compared with NIS 371 million in the preceding year.
Final tax assessments have been issued to the Bank for the years up to and including the tax year 2002. Finalizing the assessments for tax years 2001 and 2002 resulted in the reduction in the tax expense in 2004, in the amount of NIS 41 million. Following the finalization of assessments for tax years up to and including 2000, excess provisions for tax in the amount of NIS 51 million, created in prior years on a conservative basis, were reversed in 2002.

RATIO OF NON-FINANCING INCOME TO NON-FINANCING EXPENSES - CONSOLIDATED



Due to carryforward tax losses, in respect of which no deferred tax assets were recorded in the past, the Bank did not record in 2004 a current tax expense in an estimated sum of NIS 51 million in respect of current earnings and timing differences, compared with NIS 64 million in 2003. (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 29 to the financial statements).

In view of the amendment to the Income Tax Ordinance, and the expected gradual reduction in the rate of company tax, the provisions for the future recording of the net tax expense (deferred tax assets) have been recalculated on the basis of the tax rates expected to apply upon realization of the deferred taxes. The said updating of the deferred tax provisions increased the tax expense of the Group in 2004, by NIS 4 million (for additional details see Note 29 to the financial statements).

Operating income after taxes totalled NIS 454 million in 2004, compared with NIS 283 million in the preceding year, an increase of 60.4%.

The Bank's share in operating income of affiliated companies after taxes totalled in NIS 135 million in 2004, compared with NIS 117 million in the preceding year, an increase of 15.4%.

Net operating income totalled NIS 533 million in 2004, compared with NIS 340 million in the preceding year, an increase of 56.8%.

The ratio of operating income before taxes to shareholders' equity, including minority interest, was 15.3% in 2004, compared with a ratio of 15.5% in the preceding year.

The ratio of operating income after taxes to shareholders' equity, including minority interest, was 8.7% in 2004, compared with a ratio of 6.7% in the preceding year.

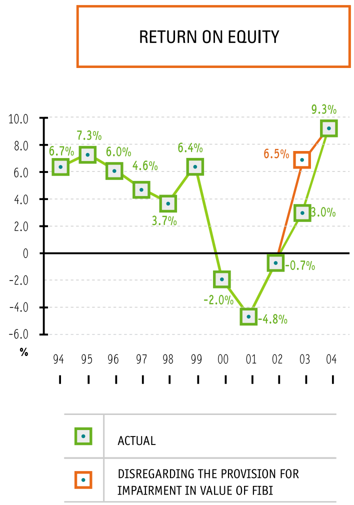
The net gain on extraordinary items after tax amounted to NIS 24 million in 2004. This comprises mainly of a gain on realization of an investment in an investee company (NIS 32 million) and the reversal of a provision for taxes recorded in previous years in respect of Mercantile Discount Bank (NIS 33 million), which were partly offset by a loss on the sale of the building in Ramat-Gan and by provisions for impairment in value recorded prior to the sale (NIS 32 million). For additional details, see Note 30 to the financial statements. The loss from extraordinary operations recorded in 2003 amounted to NIS 196 million of which an amount of NIS 173 million resulted from the provision for impairment in value of the investment in the First International Bank, made in accordance with instructions of the Supervisor of Banks (See Note 6 to the condensed financial statements).

The net cumulative effect as of the beginning of the year of changes in accounting method (in 2003) 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).

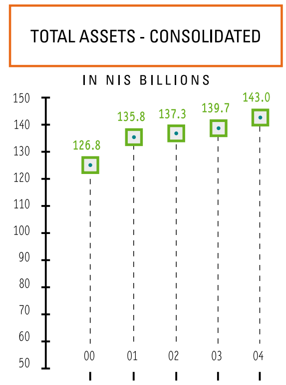
Net income in 2004 amounted to NIS 556 million, compared with of NIS 154 million in the preceding year, an increase of 261.0%, (and compared with income of NIS 327 million, excluding the provision for impairment in value, an increas of 70%). Disregarding the effect of completing the provision in respect of a certain borrower, the Group would have produced in 2004 a net income of NIS 651 million.

Return on shareholders' equity reached a rate of 9.3% in 2004, compared with a rate of 3.0% in the preceding year.

The return on equity, disregarding the provision for impairment in value, would have reached a rate of 6.5% in 2003. The return on equity for 2004, disregarding the direct and indirect effect of completing the provision in respect of a certain borrower, would have reached a rate of 10.9%.



Net earnings per NIS 1 par value of the share capital amounted in 2004 to NIS 5.67 compared with a loss of NIS 1.57 in the preceding year, (and compared with net earnings per share of NIS 3.33 in 2003 excluding the provision for impairment in value).



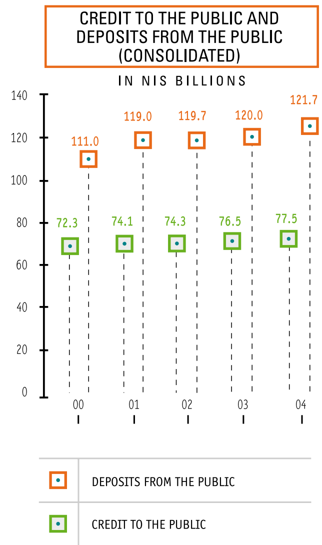
DEVELOPMENT OF ASSETS AND LIABILITIES

Total assets as at December 31, 2004 amounted to NIS 143,051 million, compared with NIS 139,702 million at the end of the preceding year, an increase of 2.4%.

Following are the developments in the principal balance sheet items:

	December 31		Rate of
	2004	2003	change
	In NIS millions		in %
Assets			
Cash and deposits with banks	17,751	16,888	5.1
Securities	40,068	38,774	3.3
Credit granted to the public	77,508	76,464	1.4
Credit granted to governments	271	367	(26.2)
Liabilities			
Deposits from the public	121,692	119,953	1.4
Deposits from banks	5,078	5,097	(0.4)
Debentures and subordinated capital notes	4,809	4,223	13.9
Shareholder's equity	6,386	5,955	7.2

Credit granted to the public as at December 31, 2004, totalled NIS 77,508 million, compared with NIS 76,464 million on December 31, 2003, an increase of 1.4%. The ratio of credit granted to the public to total assets reached 54.2% at the end of 2004, compared with 54.7% at the end of 2003.



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

	December 31, 2004		December 31, 2003		
	In NIS millions	% of total credit to public	In NIS millions	% of total credit to public	Rate of changes in %
Non-linked shekels	27,441	35.4	26,832	35.1	2.3
CPI-linked shekels	18,768	24.2	18,840	24.6	(0.4)
Foreign currency and foreign currency-linked shekels	31,299	40.4	30,792	40.3	1.6
Total	77,508	100.0	76,464	100.0	1.4

Credit in the foreign currency and foreign currency-linked shekel segment increased by 1.6%, representing an increase of US$ 234 million from December 31, 2003.

Directive concerning the treatment of credit facilities in current accounts. On February 9, 2005, The Supervisor of Banks issued a Directive in the matter of credit facilities granted within the framework of creditory and debitory current accounts. The Directive is intended to stop the practice prevalent in Israel of having current accounts that often and for long periods show overdrawn balances over and above the approved credit facilities.

The Directive provides that:

- Banks have to determine credit facilities in accordance with the needs of the customer, his repayment ability and the collateral provided by him, based on a documented analysis performed for the purpose of approving the credit facility by the authorized credit officer at the bank;
- Determination of the credit facility in an educated manner can be achieved also according to characteristics of groups of customers, and the bank may fix different threshold amounts for groups of customers in respect of which general criteria are to be defined for the documented analysis of credit requirements;
- The credit line agreement will determine the obligations of the two parties – the bank and the customer – to operate solely within the approved credit line without exceeding it;
- The bank may grant to a customer having an approved credit facility or to a group of such customers, an additional unilateral credit line, provided that the bank informs the customer accordingly. Such unilateral credit line shall not carry a commission charge and the rate of interest in respect thereof shall not be in excess of the interest rate in respect of the most recent credit line agreed in writing with the customer and signed by him;
- In cases where the customer asks the bank to honor a charge to his account that would result in him exceeding the approved credit facility, and the bank consents to such request, an appropriate credit facility, even though temporary, shall be agreed in advance and in writing, in line with the requested additional credit;
- Charging the customer with an excessive interest rate and with special commissions in respect of an account that has exceeded the credit limits, shall be permitted only in cases where the bank had been unable to prevent the account from being overdrawn, and even this only with respect to accounts classified by the bank as problematic debts (in default). No interest income is to be recognized in respect of overdrawn amounts in accounts classified as problematic, until such income is in fact collected (and the overdraft settled).

The new Directive will be effective as from January 1, 2006.

Management of the Bank is studying the general provisions of this Directive and is preparing to apply them. It should be noted that for some time the Bank endeavors to convert overdrawn accounts into loans and approved credit facility accounts, and to reduce the rates of overdrafts.

In view of the various alternatives of implementing the said guidelines, it is not possible at this stage to estimate the effect of these guidelines on the results of the Bank in the future.

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	
	2004	2003
Non-performing debts[(2)]	2,820	2,872
Reorganized debts[(3)]	360	*639
Debts due for reorganization[(4)]	84	39
Debts temporarily in arrears	591	*679
Debts under special supervision[(5)]	4,466	*4,862
Total balance sheet credit to borrowers	8,321	9,091
Off-balance sheet credit risk regarding problematic borrowers[(6)]	525	531
Debentures of problematic borrowers	42	1
Other assets in respect of derivative instruments of problematic borrowers[(7)]	8	-
Total overall credit risk concerning problematic borrowers	8,896	9,623
Assets received with respect to the settlement of loans	-	2

* See Note 4 H.
(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 3 D. 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 reorganized 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 1,730 million, presented net of specific provision made thereof, and housing loans of NIS 199 million, in respect of which a provision according to the period of default exists (December 31, 2003: NIS 1,600 million and NIS 207 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.
(7) The provisions concerning the reporting to the public were amended in January 2005, and among other things, a requirement was included for the addition of the item presented in this line. The comparative figures for December 31, 2003, do not include this data.

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:

In 2004, the Supervisor of Banks amended the Directives concerning reporting to the public and the provisions regarding the reporting to the Supervisor of Banks in the matter of credit risk according to economic sectors. According to the amendment, which applies the financial statements for 2004 and thereafter, the definition of the balance sheet credit risk presented in these statements has been extended to include also other assets in respect of derivative instruments created with the public. As the data for 2003 do not include the said extension, and in order that the following explanations should relate to comparable data, the comparison made hereunder between the 2003 data and the 2004 data excludes the additional credit risk in respect of derivative instruments.
Balance sheet credit risk for the construction and real estate sector totalled NIS 16.3 billion as at December 31, 2004, compared with NIS 15.7 billion on December 31, 2003, an increase of 3.8%, which constituted about 20.0% of the total balance sheet credit risk to the public, compared with 19.5% on December 31, 2003. Off-balance sheet credit risk for the construction and real estate sector (mostly sales guarantees and non-utilized credit lines) amounted to NIS 7.6 billion as at December 31, 2004, compared with NIS 6.5 billion on December 31, 2003, and it constituted 17.6% of the off-balance sheet credit risk, compared with 16.3% as at December 31, 2003.

Off-balance sheet credit risk for this sector, as at December 31, 2004, includes NIS 3.2 billion in respect of non-utilized credit lines.

Total credit risk for the construction and real estate sector constituted 19.2% of the total credit risk to the public as at December 31, 2004, compared with 18.4% on December 31, 2003.

Total credit risk for the industrial sectors totalled NIS 22.7 billion as at December 31, 2004, compared with NIS 21.2 billion at December 31, 2003, an increase of 6.9%, and it constituted 18.2% of the total credit risk to the public under the Group's responsibility, compared with 17.6% as at December 31, 2003. 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, 2004 totalled NIS 3.6 billion, compared with NIS 3.3 billion as at December 2003.

Total credit risk for the commercial sector amounted to NIS 15.8 billion as at December 31, 2004, compared with NIS 14.3 billion as at December 31, 2003, an increase of 10.1%, and it constituted 12.6% of the total credit risk to the public, compared with 11.9% the preceding year.

Total credit risk to individuals was NIS 26.7 billion as at December 31, 2004, compared with NIS 27.6 billion as at December 31, 2003, a decline of 3.3%, and it constituted 21.4% of the total credit risk to the public, as compared with 23.0% as at December 31, 2003.

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 1.2 million. Credit to this group constituted 29.2% of total credit to the public as at December 31, 2004, compared with 28.7% as at December 31, 2003.

The credit bracket between NIS 1.2 million and NIS 200 million constitutes about 58.6% of all credit as at December 31, 2004, compared with 58.5% as at December 31, 2003.

The 36 largest borrowers, in the credit bracket between NIS 200 million and NIS 1,200 million, were granted credit constituting 12.2% of total credit as at December 31, 2004, compared with 41 borrowers that were granted credit constituting 12.9% of the total credit as at 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.

The limitations setout 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 amendments in this instruction are the expansion of the term "control" and the significant expansion of the definition "group of borrowers" which increase the number of borrowers belonging to one borrower group.

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.

Together with the amended instruction, the Supervisor of Bank has informed that he is considering a further amendment to the instruction, 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 is examining 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 board of directors has determined guidelines as to the Bank's policy regarding materiality, as required by the instruction. It transpired that the amendments to the instruction resulted in the increase in liability in certain cases.

For details as to the deviation from the limitations on the indebtedness of a borrower and of a group of borrowers, which has come to light only recently, following information that had reached the Bank as a result of audit activities performed by the Supervisor of Banks, see Note 4G. to the financial statements.

Credit granted to the Government - totalled NIS 271 million as at December 31, 2004, compared with 367 million as at end of 2003, a decrease of NIS 96 million (26.2%). 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 deposits with the Treasury. These issues were discontinued in 1987, and the outstanding balance is gradually being paid-off.

Securities totalled NIS 40,068 million as at December 31, 2004, compared with NIS 38,774 million at the end of 2003, an increase of 3.3%.

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

	December 31		Rate of
	2004	2003	change
	(in NIS millions)		in %
Non-linked shekels	12,784	10,431	22.6
CPI-linked shekels	1,978	3,513	(43.7)
Foreign currency and foreign currency-linked shekels	24,401	23,872	2.2
Shares - non-monetary items	905	958	(5.5)
Total	40,068	38,774	3.3

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, 2004			December 31, 2003		
	Net adjusted cost	Fair value	Book value	Net adjusted cost	Fair value	Book value
	In NIS millions					
Bonds						
Held-to-maturity	5,566	5,559	5,556	45	46	45
Available-for-sale	30,647	30,889	30,889	35,884	36,171	36,171
Trading	2,679	2,708	2,708	1,543	1,600	1,600
Shares						
Available-for-sale	883	894	894	872	898	898
Trading	10	11	11	55	60	60
Total Securities	39,785	40,061	40,068	38,399	38,775	38,774

Deposits from the public as at December 31, 2004, totalled NIS 121,692 million, compared with NIS 119,953 million at the end of the preceding year, an increase of 1.4%. 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, 2004		December 31, 2003		
	In NIS millions	% of total deposits from public	In NIS millions	% of total deposits from public	Rate of change in %
Non-linked shekels	45,405	37.3	43,488	36.3	4.4
CPI-linked shekels	14,872	12.2	17,534	14.6	(15.2)
Foreign currency and foreign currency-linked shekels	61,415	50.5	58,931	49.1	4.2
Total	121,692	100.0	119,953	100.0	1.4

The ratio of total credit to the public to deposits from the public was 63.7% at the end of 2004, similar to the end of the previous year.

CAPITAL RESOURCES

The Bank's capital resources as at December 31, 2004, including minority interest, totalled NIS 6,835 million, compared with NIS 6,439 million at the end of the preceding year, an increase of 6.2%.

Shareholders' equity as at December 31, 2004, totalled NIS 6,386 million, compared with NIS 5,955 million at the end of the preceding year, an increase of 7.2%.

The increase in shareholders' equity in 2004, resulted, inter-alia, from an increase of NIS 126 million in the component representing the net adjustments to fair value of available-for-sale securities, net of the tax effect.

The ratio of shareholders' equity, including minority interest, to total assets as at December 31, 2004, stood at 4.8%, compared with 4.6% 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 3,556 million as at December 31, 2004, including NIS 3,301 million of subordinated capital notes and NIS 254 million of general provision for doubtful debts.
During 2004, the Group issued certificates of deposit - subordinated capital notes totalling NIS 53 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, 2004, the Bank exhausted the said limitation (December 31, 2003 – 50.0%).
Issue of subordinate capital notes – March 2004. 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 Supervisor of Banks approved 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 were gradually sold by the said subsidiary, in accordance with the needs of the Bank.
Issue of subordinate capital notes – November 2004. On November 10, 2004, Manpikim successfully concluded an issue of deferred capital notes (series B) in the amount of NIS 73 million. Additional deferred capital notes (series B) in the amount of NIS 227 million, were issued prior to the publication of the Prospectus to a subsidiary of Manpikim and were registered for trade on the Stock Exchange.
Near to that date, deferred capital notes (series A) in a total amount of NIS 300 million, were registered for trade (these were added to deferred capital notes (series A) of a par value of NIS 500 million that are traded already) of which NIS 40 million were issued to institutional investors, and the balance was issued to a subsidiary of Manpikim.
The deferred capital notes series A and B that were issued to a subsidiary of Manpikim will be gradually sold by it, in accordance with the needs of the Bank. The balance of subordinated capital notes that had not yet been sold by the subsidiary of Manpikim as of December 31, 2004 was NIS 472 million. The proceeds of the issue were deposited with the Bank, which has accepted responsibility towards the note holders for the repayment in full of the principal, interest and linkage increments of all the capital notes.
Most of the said deferred capital notes were issued to replace capital notes that had been issued in the past and which in accordance with Bank of Israel instructions are to be deducted from the second tier capital of the Bank in the course of the years 2004 – 2005. The Supervisor of Banks approved the said subordinate capital notes as second tier capital 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 2004, 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, 2004, reached a rate of 6.93%, compared with 6.60% at the end of the preceding year.
The ratio of capital to risk assets stood at 9.83% on December 31, 2004, compared with 9.35% at the end of 2003.

Disregarding the effect of completing the provision for doubtful debts in respect of a certain borrower, the ratio of equity to risk assets as of December 31, 2004, would have reached a rate of 9.96%

Rating the liabilities of the Bank. Ma'alot – The Israeli Securities Rating Company Ltd. determined an "AA-" rating for the subordinated capital notes of the Bank. This rating will apply also to the other liabilities of the Bank, including the other subordinated capital notes and subordinated deposits as well as all other deposits in the Bank.

Issuance of Debt Notes in 2005. An amount of NIS 425 million of capital notes issued in the past will be deducted in the course of 2005 from the secondary capital of the Bank, used in calculating the ratio of capital to risk assets.

In the estimate of the Bank, maintenance of the capital ratio at its present level would require the issuance of new capital notes in a similar amount.

The distribution of dividends. In recent years, the Bank did not distribute dividends to its shareholders, except on the Cumulative Preference Shares of the Bank, in an annual amount of £24 thousand (see Note 13B. to the financial statements), which the Bank distributes regularly. The main limitation affecting the ability of the Bank to distribute a dividend in the past two years was the capital base limitation (see the Section on "Expansion of the capital base" hereunder).

For details as to the limitation on the distribution of a dividend out of gains from a possible future sale of IDB New York, see the Section "Agreement with the employees" hereunder).

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 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, Bank 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. has begun preparations for executing the process of sale.

Concurrently, 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 working paper, 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.

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 issuance of capital and in the alternative, the sale of IDB New York.

The Bank was informed on April 20, 2004, that the board of directors of M.I. Holdings Ltd.

had considered the various options presented to it by the Bank, and decided in agreement with the Director General of the Ministry of Finance and the Accountant General, that it does not approve the request of the Bank for an additional issue of share capital by the Bank or for the sale of its holdings in IDB New York.

The Bank believes that the said resolution might halt the pace of the implementation of its business plans.

For details concerning the sale subsequent to balance sheet date of the controlling interest in the Bank, see "Sale of the Bank" and Note 37 to the financial statements.

LIQUIDITY AND THE RAISING OF SOURCES IN THE BANK

GENERAL

The year 2004 has been characterized mostly by the continued trend of improvement in most financial indicators, alongside the improvement in the reliability level of implementation of the policies of the Ministry of Finance and of the Bank of Israel. A low rate of inflation was recorded in 2004, near to the lower limit of the inflation target, and the interest rate has also continued in its downward trend. These developments affected the preferences of the public and the manner in which its financial resources have been allocated to the various investment channels.

Following are the main factors affecting the asset portfolio of the public in 2004:

- The continued gradual reduction of the Bank of Israel interest rate: during 2004, the interest rate was decrease by a cumulative rate of 1.3%, to 3.9% in December 2004. In the first third of 2004, the interest rate was decreased from a rate of 5.2% to a rate of 4.1%. The reduction in interest rates was renewed towards the end of 2004. In the first quarter of 2005, the reduction in interest rates continued to a level of 3.5% in February 2005;
- Moderate inflation rate: The CPI rose by 1.2% in 2004, near to the lower limit of the inflation target;
- Despite the said reduction in interest rates the shekel was devalued by only 0.83% as against the currency basket. Vis-à-vis the US dollar, the shekel appreciated by 1.62%, while against the Euro it was devalued by 6.2%;
- The recovery experienced in world economy and particularly in the United States, and in the domestic economy brought about the continued upward trend in the price of shares and long-term bonds (both non-linked and CPI linked);
- The Government reduced in 2004 the volume of fund raising on the domestic bond market.

Following the developments described above, changes were noted in the structure of the asset portfolio of the public:

- An increase in the weight of shares (both in Israel and abroad) in the asset portfolio, from a rate of 21.2% at the end of 2003 to a rate of 24.9% at the end of 2004. The total increase was due to the increase in the weight of shares in Israel;
- A drop in the weight of CPI linked assets from a rate of 33.4% at the end of 2003 to a rate of 30.5% at the end of 2004;
- Stability in the weight of non-linked assets, about 31%, and in the weight of foreign currency linked assets, about 13.5%;
- An increase in the preference of the public for investment in publicly traded shares, the price of which rose by a high rate during the year, as compared with deposits with banks. A sharp increase in the volume of corporation bonds issues was recorded in 2004.

THE BANK

During 2004, 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 2004 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.
The rating of the capital notes issued by the bank remained unchanged in 2004, at AA-.
The non-linked segment. At the beginning of 2004, 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 2004 an amount of NIS 36.7 billion, compared with NIS 35.6 billion at the end of 2003, an increase of 3.1%.
The volume of non-linked interest bearing NIS deposits of the Bank with the Bank of Israel reached at the end of 2004 an amount of NIS 0.6 billion, compared with NIS 3.7 billion at the end of 2003, a decrease of 83.8%. 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 10.9 billion at the end of 2004, compared with NIS 12.5 billion at the end of 2003, a decline of 12.8%. The demand by the public in 2004 for CPI linked deposits was affected by the decline in interest rates, following the decline in the return on bonds and by the relatively low rate of inflation.
The foreign currency and foreign currency linked segment. The volume of deposits of the public in or linked to foreign currency decreased in 2004 by a rate of 3.2% and reached an amount of US$ 6.7 billion at the end of the year. The preference of the public in this segment has been affected, among other things, by the beginning of interest rate increases in the United States and by the weakness of the US dollar as against other currencies.
The raising of secondary capital. In the course of 2004, the bank raised secondary capital in an amount of NIS 650 million. The raising of capital has been achieved by the issuance of CPI linked capital notes in two series: one with an average maturity of 7.5 years and the other with an average maturity of 10 years. Ma'alot has rated both series at AA-.

EXPOSURE TO RISKS AND RISK MANAGEMENT

GENERAL

The Bank's activity as a financial broker engaged in all fields of financial activities involving risk 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 support the achievement of 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 – "risks management", 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 of risk managers was established at the end of 2000, headed by the risk manager of the Bank. The committee's members are the following members of Management:

Dr. Amnon Goldschmidt –	Risk manager of the Bank, market and liquidity risks manager and chairman of the committee;
Mr. Ronnie Hezkiyahu –	Credit risk manager;
Mr. Noam Hanegbi –	Operational risk manager;
Mrs. Ronit Abramson-Rokach –	Legal risk manager.

This committee is engaged with the forming of the risk management policy of the Bank in the various areas, in identifying new risk areas and risk centers and the ways of treating them, and in initiating changes required in the risk management policy. The committee was also defined as the supreme steering committee in the matter of the preparations of the Bank for the implementation of the "Basel II" guidelines.

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 (for example: options imbedded in savings deposits).

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 embedded in the base exposure.

On the background of the transition to accounting in nominal terms, the Bank began in March 2004, to actively manage the available capital, subject to the limitations set by the board of directors (until this change, the available capital was defined as a CPI linked source). The economic available capital, on which the linkage base exposure is calculated, includes the equity capital, net of non-financial assets, with the addition of investments in foreign consolidated subsidiaries and certain reserves.

Respectively, the limitations on the linkage base exposure have also been updated. The limits of exposure defined by the maximum surplus or deficit in the various linkage segments in relation to the Bank's free capital: Exposure in the non-linked segment is permitted within the limitation of 140% up to (30%) of the available capital. The permitted exposure in the CPI linked segment is within the limitation of 120% up to (40%) of the available capital, and the exposure in the foreign currency linked segment is limited to 50% up to (50%) of the available capital[1].

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) Until the said change, the maximum exposure in the non-linked, CPI linked and Foreign currency linked segments was 25%, 20% and 10% of the equity capital, respectively.

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

	Non-linked shekels	CPI linked shekels	Foreign currency(*)	Non-monetary asset	Total
			As at December 31, 2004		
Assets	35,120	15,579	33,497	7,418	91,614
Liabilities	38,575	14,520	32,066	67	85,228
Balance sheet difference	(3,455)	1,059	1,431	7,351	6,386
Derivatives	3,343	184	(3,527)	-	-
Options	529	50	(579)	-	-
Total Difference	417	1,293	(2,675)	7,351	6,386
			As at December 31, 2003		
Assets	35,401	17,031	30,727	7,422	90,581
Liabilities	37,461	16,226	30,878	61	84,626
Balance sheet difference	(2,060)	805	(151)	7,361	5,955
Futures contracts, net	1,952	(256)	(1,696)	-	-
Options	514	35	(549)	-	-
Total Difference	406	584	(2,396)	7,361	5,955

(*) 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 2004, reached NIS (1,035) million in the CPI linked segment, NIS 1,775 million in the non-linked segment, and US$ 37 million in the foreign currency segment. This compared with an amount of NIS (988) million in the CPI linked segment, an amount of NIS 989 million in the non-linked segment and an amount of US$ 37 million in the foreign currency segment, in 2003.

(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 interest rate risk, in practice, is being managed on the basis of economic exposures, computed on the basis of all the Bank's positions and based on various behavioral assessments as to redemption dates of the assets and liabilities. Among other things, the policy of the Bank is to spread a part of the current account balances in the non-linked segment in a uniform quarterly manner over five years.

Alongside the change in the definition of the available capital, as stated above, The board of directors also changed the limitations on the interest risk exposure in each of the linkage segments. The new limitations that were determined relate to the effect of the overall exposure of the Bank in a scenario of a parallel change of 1% in the interest rate in each segment. According to these limitations, and under the said scenario, the exposure permitted in the non-linked segment should not cause a loss in excess of NIS 120 million; the exposure permitted in the CPI linked segment should not cause a loss in excess of NIS

180 million; and the limitation on the exposure in the foreign currency segment was limited to a level of up to NIS 60 million. In addition, a parallel change of 1% in the three yield graphs taken together should not cause a loss in excess of NIS 290 million[(1)].

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 – A decline was recorded this year in the Bank's exposure to interest risk in this segment. This derived from the reduction in medium and long-term assets bearing a fixed interest rate, which resulted in a decrease in the average maturity of assets, as well as from an increase in the average maturity 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 – A high average maturity of assets was maintained in this segment during the year, as compared with the average maturity of liabilities. In the second half of the year, the Bank acted to gradually reduce the exposure to the increase in returns in this segment, so that at the end of the year, the exposure to interest risk in this segment was not materially different from the exposure at the end of last year.

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 longer period in accordance with a model used by the bank (see hereunder). 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.

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's and its consolidated subsidiaries' exposure to fluctuations in interest rates, including the internal rate of return (IRR) and the average maturity, as per the various linkage segments (in NIS millions):

	As at December 31, 2004			As at December 31, 2003		
	Non-linked shekels	CPI linked shekels	Foreign currency[(1)]	Non-linked shekels	CPI linked shekels	Foreign currency[(1)]
Total Assets	44,616	22,321	71,785	44,673	24,072	66,540
Total Liabilities	48,035	20,017	68,068	46,586	22,181	64,415
Average maturity (years):						
Assets	0.50	3.79	1.38	0.49	3.67	1.84
Liabilities	0.32	3.45	1.02	0.28	3.22	1.10
Average maturity gap	0.18	0.34	0.36	0.21	0.45	0.74
IRR gap	2.66	1.27	0.93	2.39	1.30	1.49

(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, 2004, between the average maturity of liabilities and the average maturity of assets, amounting to 0.18 years, compared with an average maturity gap on December 31, 2003 of 0.21 years.
- In the CPI-linked shekel segment, the average maturity gap between assets and

(1) Until the said change, the maximum exposure in the non-linked, CPI linked and foreign currency linked segments was 1%, 1.2% and 0.5% of the equity capital, respectively.

liabilities as at December 31, 2004, was 0.34 years (about 4 months), compared with 0.45 years (about 5 months) on December 31, 2003. 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, 2004, was 0.36 years, compared with a gap of 0.74 years on December 31, 2003. 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 board of directors has also set limitations as to the volume and as to the market risk exposure of activity in foreign currency options.

(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 of the Bank's assets and liabilities as well as for trading.
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.
The exposure created both as regards the linkage base and as regards the interest as a result of this activity, is included in the framework of the limitations set by the Board of Directors on exposure to linkage base, interest and options.

Following are data as to the volume of operation in derivative financial instruments, of the Bank and its consolidated subsidiaries (in millions of NIS):

	As at December 31, 2004	As at December 31, 2003
Hedging derivatives	4,605	3,774
ALM derivatives	32,190	31,504
Other derivatives	38,566	25,821
Credit derivatives and SPOT foreign currency	2,921	4,757

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 generally 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 an increase in the earnings from financing operations by NIS 16 million in 2004, compared with a decrease of NIS 38 million in earnings from financing operations in 2003. Details of financing income from derivative financial instruments are presented in Note 23 to the financial statements.

Activity in the Ma'of market. The Bank operates in the Ma'of share index market only on behalf of customers, while maintaining the security level required by the Tel-Aviv Stock Exchange. The Bank operates in options on the dollar exchange rates in the Ma'of market both on customers' behalf and on behalf of the Bank itself. The Bank permits selected customers to operate on credit in the Ma'of market while monitoring closely, on an ongoing basis, the risk involved in the portfolio as compared with security received.

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 honor his obligations, net of the effect of enforceable setoff agreements. In computing the fair value, the Bank takes into account the credit risk attached to the counter party to the transaction, in relation to two categories: customers and banks and considering the type of product.

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 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.
The Bank monitors continuously the credit risk inherent the derivative financial instrument activity of major customers.
Considering the fact that the risk involved in derivative financial instrument activity is not market risk only, the board of directors approves a monetary framework for each of these instruments in addition to other limitations applying to the activity in specific instruments.

(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 updated format for the measurement of the liquidity risk at the Bank was approved during 2004, considering the provisions of Directive 342, as detailed further on, and it includes among other things:

- 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.

Proper Banking Procedures Directive Regarding Liquidity Risk Management. Proper Banking Procedure Directive No. 342 – “Liquidity risk management”, which is effective as from December 31, 2004, requires a banking corporation 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.
The Directive requires the board of directors to approve the policy document, and to verify that Management has efficient tools for the control and supervision of the liquidity risk and to receive periodic reports as to the liquidity position of the Bank and as to trends in the development of liquidity (including reference to the banking group).
To ensure that 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.
The Directive entitles banks that manage the liquidity risk by way of a well-based internal model to define the said liquidity ratio, while considering assets in addition to the liquid assets and while making adjustments to liabilities with a maturity of up to one month.
Management of liquidity risks. 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 model, 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.
During 2004 the Bank maintained a relatively high liquidity level in Israeli currency as well as in foreign currency.
In addition 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 of which may indicate a change in the liquidity situation of the Bank.

(6) THE MAIN CHANGES OCCURRING IN 2004 IN RISK MANAGEMENT POLICY:

- **A liquidity risk management policy document** has been written and approved.
- **Implementation of the changes stipulated in Directive 341** - Allocation of capital to market risks (in view of the transition to nominal accounting).
- **Change in the definition of available capital** - The Bank began to dynamically manage its available capital, subject to the limitations set by the board of directors (until 2004, the available capital was defined as a CPI linked source). The interest and linkage base risks limitations applying to the balance sheet of the Bank have been changed accordingly.
- **The VAR limitation** - A VAR limitation has been added to the market risk of the Bank, which is defined in relation to the equity capital of the bank.
- **Changes have been approved in the market risks of the dealing room**, which among other things include extending the limitations on the trading in foreign currency by the dealing room, changes in the characteristics of the portfolio of foreign bonds in foreign currency, reducing the limitation on interest risk of transactions in NIS of the dealing room, and changes in the operating framework of the derivative financial instruments dealing room.
- **Net Interest Income (NII) measurement** - The net interest income expected by the Bank Changes have been approved in matters relating to the Bank's risk management committees.

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, liquidity risk, etc.

(2) BANK MECHANISM RELATING TO MARKET AND LIQUIDITY RISKS 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 and liquidity risks 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 Finance Division any exceptional

events such as a loss which exceeds the determined limit, or a deviation from the limits set. The Head of the Finance 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 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, according to the procedures setup.
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 and stress test 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 2004 in the implementation of the risk policy of the Bank.

(4) MANAGEMENT OF POSITIONS IN THE TRADING PORTFOLIO

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.
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 AND LIQUIDITY RISKS

(1) MODELS USED FOR MEASURING MARKET AND LIQUIDITY 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 (the Bank):

	December 31, 2004			December 31, 2003		
	Non-linked	CPI linked	Foreign currency(1)	Non-linked	Foreign currency(1)	CPI linked
Internal rate of return						
Assets	4.81	5.65	3.39	5.39	5.61	3.59
Liabilities	2.54	4.54	2.49	3.26	4.65	3.01
Average maturity						
Assets	0.56	3.37	0.44	0.54	3.31	0.55
Liabilities	0.33	3.92	0.41	0.27	3.64	0.53

(1) including foreign currency - linked shekels.

Creditory 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).

The VAR limitation was approved at the beginning of 2004, according to which the VAR of the portfolio of the Bank (for a forward period of ten days and at a clarity level of 99%) shall not exceed 3% of the equity capital of the Bank

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

	2004		2003	
	at year end	Yearly average	at year end	Yearly average
Estimate of VAR amount (in NIS millions)	31.6	44.7	60.9	74.1

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, 2004, stands at 0.5%, compared with 1.2% at the end of 2003.

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)

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 levels which had been determined. This explains the importance of the stress tests as a complementary measuring tool.

Stress tests enable the examination if the possible implications of remote events that are not envisioned in statistical 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.

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 Finance 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.

(4) THE NET INTEREST INCOME (NII) MODEL AND THE EARNINGS AT RISK (EAR) INDEX

In 2004, the Bank began calculating a dynamic simulation of the net interest income of the Bank for the next two years, in order to examine the effect of various strategies of asset and liability management of the Bank on its future interest income.

The Bank assesses the sensitivity to changes in market yields of the forecasted interest income by way of the EAR index. This index serves as an additional risk index to that of the VAR, which measures the market risk in terms of the possible effect on the economic value of the Bank.

(5) INTERNAL MODEL – LIQUIDITY RISK

The object of the internal model used for liquidity risk management is to provide decision makers with an additional indicator to identify situations in which the liquidity risk increases.

In the internal model, the Bank classifies its assets and liabilities in accordance with the maturity period on an economic basis, while adjusting assets and liabilities, as follows:

- Assets serving as a reliable source of cash inflow are added to the balance of assets in the maturity period.
- Payments that would bring the balance of liabilities to the amount expected to be redeemed, based on estimate of the Bank, are added or deducted from the balance of liabilities

The parameters for the classification of assets are based on the assessments of the Bank regarding the quality of borrowers, on the Bank's policy and trends in the financial markets, and the classification of liabilities is based on the rate of recycling according to historical series. In determining the parameters, the Bank takes into account the possible implications on liquidity of other risks, including credit risks, market risks and operational risks. The Bank also takes into account the following: the Bank's goodwill and rating, volume of the marketable securities portfolio and its spread, the size of the market and volatility of prices, the structure and spread of deposits, and the effect of flows that are not taken into account in computing the liquidity.

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 centers.
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 borrowers. 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 2005, the Bank rated some 95% 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 auditing department performs an examination as to the propriety of loan approval processes and their compliance with the various procedures.

Repayment and collection arrangements. In 2004, 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 performed periodic analysis of the said developments in the various sectors of the economy, which served to define the proper policy in the matter. It should however be mentioned that as from the second half of 2003, several central indicators showed an improvement, and the year 2004 has already been defined as a year of change in economic activity.

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 has increased control over this sector, has increased where possible the collateral required and has tightened demands where new applications for finance are concerned. The weight of this segment in the provision for doubtful debts has grown in the course of 2004, mostly as a result of a one-off provision in respect of a certain borrower, in accordance with instructions of the Bank of Israel. Nevertheless, as from the second half of 2003, an increase in the volume of activity in this sector was noted, stemming from the recovery of the communications market in the world and especially in the hi-tech industry.

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 Bank has adopted measures to increase supervision, control and the monitoring of operations of companies belonging to this sector. During 2004, the industry has shown a significant improvement reflected in the number of tourists, the increase in the country's overall occupancy rate to 48%, and an estimated further improvement for the coming year.

The industrial sector: As from the second half of 2003, the volume of activity of companies belonging to the industrial sector has improved, which was reflected in increased production, sales and imported inputs, and in an improved repayment ability of borrowers in this sector. Certain of the borrowers involved in real estate activities do not as yet enjoy improved business conditions. As a result of the above the weight of this sector in the provision for doubtful debts has been reduced.

The construction and real estate sector: In view of the continued slowdown in activity in this sector, which is reflected, inter-alia, in reduced demand on the one hand and in a drop in earning of contractors and promoters on the other hand, the Bank strengthened control over its customers, increased the collateral where possible defined a policy for the financing of fields of operations in this segment. Although the loans in question are generally loans which have already been classified as problem loans in the past, the continuous economic slowdown, was 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 October 2004, the Supervisor of Banks distributed to the banks a first draft of guidelines concerning the credit rating of companies, banks and countries, which was prepared in the framework of the preparations of the Supervisor of Banks in Israel for the application of the Basel Commission principles for the supervision of banks (of June 26, 2004) – "Basel II".

From the contents of this document, as well as from the publications of "Basel II", it is assumed that the implementation of the principles and requirements included in this framework would be a long and resource consuming process.

The Basel II principles, which were formed by a lengthy international process conducted by the Basel Committee, were primarily intended to advance the level of risk management at the international banking industry, including also the management of capital adequacy.

The targets of "Basle II" are: assuring the stability of the financial system, more comprehensively addressing risks, and the development of capital requirements that would agree with the risk level of each individual bank.

The innovations 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 draft distributed to the banks determined basic standards for the formation of borrower rating systems, their management, the assessment of risk components and the performance of validity tests as to the systems and assessments. The draft focuses on the control and supervision mechanisms over the rating systems and particularly the involvement of management and the board of directors and their responsibility for the proper operation of the rating systems and the reliability of the rating model.

The Supervisor of Banks informed that, in continuation, it is his intention to conduct discussions with the banks with respect to the document that had been distributed. The discussions are to be held by a joint professional forum to be formed for this purpose and also at separate meetings with the banks, in order to enhance the final format of the instructions and the upgrading of the required infrastructure. The Supervisor believes that the implementation in full of advanced rating systems along the above standards is expected to be realized in Israel only in a few years time.

Despite the uncertainty existing as regards the exact requirements that would apply to banks in Israel and as to the timetable that would be determined for their application, the Bank began preparations in this respect already in 2003.

This preparation includes the study of the Commission's recommendations and the ways for their application. The committee of risk managers at the Bank, headed by the Finance Division Head, is in charge of the preparations, and it has established two steering sub-committees for credit risks and for operational risks. Heading the credit risks sub-committee is the head of the Corporate Banking Division and credit risk manager of the Bank. Heading the operational risk subcommittee is the head of the Operations & Information Division Systems and manager of operational risks at the Bank.

An annual budget has also been approved, which would enable the Bank to carry out in the coming year the first stages of the project: The formation of an appropriate risk management strategy, analysis of differentials that would enable the assessment of preparedness at the Bank and the implications expected as a result of the implementation of "Basel II" in the various areas, and preparing a plan for the project.

An operational risk is defined in the directives of Bank of Israel as a loss risk resulting from faulty data processing systems, human error and the lack of proper checks and controls.

OPERATIONAL RISKS

Following the publication of the **"Basel II"** guidelines, the Bank accelerated its inner preparations regarding operational risks. The principle guiding the Bank with respect to operational risks is that readiness to tackle this matter is essential, even without considering the allocation of capital for this purpose that would be required in the future. Furthermore, the application of advanced measuring systems, as required by the said guidelines, would require the assembly of extensive and sufficiently comprehensive information over a number of years.

At the beginning of 2004, a comprehensive survey mapping the operational risks, prepared during 2003 by an independent entity, was submitted to Management. The findings of the survey are being attended to by the various Divisions, under the supervision of the internal audit department. The steps taken in continuation therewith by the different divisions, include:

- An individual mapping of the operational risks based on the findings of the survey.

- Attending to the operational risks indicated by the findings of the survey, which can be dealt with immediately.

Operational risk management policy. During 2004, the "Operational risk management policy" document was created and approved by the Bank's Management and board of directors. In accordance therewith, preparations have begun, continuing also in 2005, for the implementation of the policy, forming detailed processes, design of procedures and reporting routines and the forming of computerized information management tools. In this respect a chief controller of operational risks has been appointed for the Bank, reporting to the operational risks manager, and divisional operational risks controllers have also been appointed.

The Operational Risks Forum was also institutionalized headed by the operational risks manager, among the duties of which are:

- Forming an operational risks policy on the basis of the detailed mapping of these risks and updating the policy document accordingly;
- Discussion of operational risks deriving from crosswise processes;
- Examination of operational failure events materializing;
- Forming models for assessing operational risks;
- Examination of the insurance coverage aspect and adopting decisions with respect to the minimization of operational risks.

Reporting operational failure events. As from the middle of 2004, the Bank determined an internal procedure requiring all units of the Bank to submit quarterly reports as to operational risks that have become realized. In this respect, the Bank endeavors to reach extensive reporting that would include also failure events that did not result in a financial loss to the Bank. The purpose of this is the establishment of a wide database that would enable future use of advanced models for operational risk evaluation.

LEGAL RISKS

A legal risk is defined in the Directives of the Bank of Israel as the risk of a loss resulting from the lack of ability to enforce the performance of an agreement by legal means.

Among the principal legal risks that may affect the ability of the Bank to enforce an agreement by legal means, the following may be noted:

- Lack of authority and/or lack of legal competence of a party to the agreement;
- Absence of appropriate documents or improper documentation;
- Illegality;
- Insolvency of a party to an agreement with the Bank (a legal risk that exposes the Bank to a situation of credit risk);
- Disappearance of the base asset.

The policy of managing legal risks. In the course of 2004, the Bank formed the "Policy for the management of legal risks" document, which was approved by Management and the board of directors. Accordingly, the Bank is preparing for the implementation of this policy, including the guidelines for the treatment of agreements and engagements of the Bank, the formation of processes, design of procedures and routine reporting. In this respect an officer has been appointed with responsibility for the assembly and processing of data regarding legal risks, and for collating findings with respect to the treatment of various issues brought to notice in the reporting on legal risks.

ACTIVITY OF THE GROUP ACCORDING TO PRINCIPAL SEGMENTS OF OPERATION

GENERAL

In December 2001, the Supervisor of Banks in Israel issued directives concerning segment information reporting in a banking corporation, which followed the approval of Accounting Standard No. 11 regarding segment reporting by the Israeli Accounting Standard Board and in view of the application abroad of accounting standards concerning segment information, and in particular the application of the US Accounting Standard FAS 131 (Disclosure about segments of an enterprise and related information), implementing certain modifications concerning the special characteristics of banking corporations, mostly on the basis of the disclosure prevalent in the US banking system.

According to the directives, a segment of operations is a component of a banking corporation having the following three characteristics:

(a) Engaged in business activities that may produce income and bear expenses (including income and expenses deriving from transactions with other components of the same banking corporation);

(b) The results of its operations are reviewed on a current basis by Management and the Board of Directors in order to make decisions as to the allocation of resources to the segment and evaluate its performance;

(c) Separate financial information exists with regard to the segment.

In addition, the directives determine the disclosure requirements and the manner of presenting the financial results of segments in the financial statements.

The Supervisor of Banks clarified in January 2002, that he expects that a banking corporation heading a banking group would include disclosure as to the following segments: corporate banking, retail banking, middle market banking, private banking, real estate and construction, mortgages, credit card operations, capital market operations, non-financial companies.

Towards the publication of financial statements for 2004, the Supervisor clarified that the retail banking segment should be split into two segments, as follows: “household segment” and “small business segment”, and the “financial management segment”, which previously appeared as part of “other operations and adjustments, should be presented separately”.

The Bank is installing a management information system to manage profit centers according to customers, products and additional profiles (the “Tomar” system). As from the first quarter of 2004, the level of development of the system and its implementation reached a stage that enables the Bank, for the first time, to present data regarding the results of operation of the Group according to principal segments of operation, in accordance with the directives of the Supervisor of Banks.

In prior reporting periods, as the Bank was unable to present information as to financial results according to segments of operation, only partial information was presented in the reports of the Bank, with the approval of the Supervisor of Banks.

As it is not possible to retroactively extract information from the system, and the information published in the past was, as stated, partial information only, no comparative information for prior periods is presented at this stage, with the approval of the Supervisor of Banks, as regards the results of the Group according to main segments of operations.

It should be noted that due to the short time that has elapsed since the system was put into operation, and since the system as a whole has not yet been completed and implemented, the use of it as a management tool has not yet begun. Furthermore, as the organizational structure of the Bank does not fully coincide with the reported segments of operations, the model used for providing the data is based on various assumptions and estimates. In the future, once the information produced by the system is studied and analyzed over a period of time, and concurrently with the process of implementation of the system, certain changes in the said assumptions and estimates may be required.

It should also be noted that the consolidation of the segments of operations of the banking subsidiaries has been made based on the segments of operation reported by them, without adjustment for the differences, if any, that exist between the characteristics of operation of customers of the Bank and those of customers of the subsidiaries in the same segment, except for the segmentation of the data relating to the retail and middle market banking segments of Mercantile Discount Bank, as detailed below.
Until 2003, as it was not possible at that stage to provide information regarding the results of operations of the Bank according to segments, the Bank, with the approval of the Supervisor of Banks, provided partial data only. With the absence of comparative data for the segment information provided for 2004, the Supervisor of Banks instructed that the partial data presented in the Note concerning segment information included in the financial statements for the years 2002 and 2003, respectively, should be presented separately. Accordingly, Note 31 to the financial statements presents partial data as to the segment operations of the Bank in 2002 and 2003 (sections (d) and (e) of Note 31), as well as details regarding segments of operations of Mercantile Discount Bank Ltd. for the years 2002 and 2003 (section (f) of Note 31) and details regarding segments operations of Discount Mortgage Bank Ltd. (section (g) of Note 31).

ADMINISTRATIVE STRUCTURE

The Discount Group operates in Israel and overseas by way of the Bank, subsidiaries, branches and representative offices, in all areas of banking and financial services.
The business operations of the Bank are conducted by six divisions: Corporate banking Division, Banking Division, Commercial Banking Division, Finance Division, Marketing and Strategic Planning Division and Asset Management Division.
The Corporate Banking Division conducts business with large and medium size companies and provides services to specific customer sectors: diamond industry, construction companies (real estate project financing) and "approved enterprises".
The Banking Division conducts business with VIP customers, households, small companies and businesses, foreign residents and private banking customers.
The Commercial Banking Division conducts business with middle market business customers and is responsible for the operations of the business centers, foreign trade department, the Tel-Aviv main branch as well as the business branches.
The Finance Division is responsible for the Bank's financial investments and for management of the Bank's own account and liquidity.
The Marketing and Strategic Planning Division is responsible for operations with customers of direct banking.
The Asset Management Division is responsible for the securities department, the capital markets department and for subsidiaries engaged in managing customer asset.

RETAIL SEGMENT – GENERAL

This segment includes customers of the Banking Division of the Bank, except for the real estate and construction industry customers and customers of the international private banking centers. In accordance with a directive of the Supervisor of Banks issued towards the preparation of the financial statements for 2004, this segment was divided into "households" and "small business" segments.
The segment also includes customers of the middle market and retail banking of Mercantile Discount Bank. The Supervisor of Banks has agreed that Mercantile Discount Bank will present in its financial statements for 2004, the said data, until it is ready to divide them into at least two segments (households and middle market segments). The data for this segment have been divided between the household segment and the small business segment, for the purpose of the segment data of the Discount Group, on the basis of an estimate.

TARGETS AND BUSINESS STRATEGY

In order to create a relative advantage in retail banking for the Bank, the Banking Division of the Bank conducted several moves in the three most recent years, including:

1. Establishing of departments in the Banking Division focusing on customers: private, business, foreign residents.
2. Dividing management operations at the regional management offices and in the branches according to segments – private (households) and commercial (small business)
3. Modifying the branches disposition – merging of branches and establishing specialized concept branches. Three specialized concept branches of the "Discount your way" type were opened in 2004, and four more such branches are planned for 2005 to be opened in large shopping centers and in well populated areas (Raanana, Givataim, Negev Shopping Mall and the Tel-Aviv University).
4. Establishing indices and targets supporting the retail components – service and sales.
5. Developing the consumer credit field as a clear retail need.
6. Recruiting new customers, by the "Circles" activity.
7. Commercializing – Modifying the appearance of branches to retail banking:
   - Setting up meeting points at the branches – in response to the need to conduct in a very short time technical transactions at the branch and utilizing the meeting as a marketing opportunity.
   - Introducing in all the branches plasma screens, Internet and background music – in response to the need to create an exceptional experience when entering the branch, while combining advertising items of the Bank and value offers to customers.
8. A project intended to remove operational work from the branches in order to provide more time for new initiatives and marketing.

A customer visiting a branch should undergo a retail experience as a result of a combination of four major components: A pleasant appearance of the branch and its staff, quality service throughout his stay at the branch, clarity and simplicity of the products offered and messages given to him and the availability and timeliness of consumption – simple processes and efficient performance.

Alongside this, the Division is in the midst of an advanced process of modifying the branches to a customer-focused structure, where against each group of customers the Bank provides a separate and different arrangement.

The way: the segment strategy – the strategy that outlines a way according to which a distinct differentiation is to be made between customers in order to succeed in maintaining the customers and exhaust the potential inherent in them.

The way of applying the strategy of differentiation between segments:

- A correct segmentation of customers;
- Differentiation in service – organizational attachment to a certain team and modification of complementing channels;
- Development of customer relations with customers of the segment;
- Marketing.

THE RETAIL SEGMENT AT MERCANTILE DISCOUNT BANK

As part of the work plan for 2005, Mercantile Discount Bank set out growth targets in the retail segment.

CUSTOMER SEGMENTATION

Private Segment. Four principal segments of customers have been identified in the private segment: VIP customers; preferred private customers; private customers (households); the growing segment.

Following are the financial criteria in each segment:

Segment	Sphere	Financial limits (in NIS thousands)	
		Deposits and/or	net wages
VIP customers	VIP banking	Minimum of 120	Individual - 10 and over
			Family - 15 and over
Preferred customers	Individual banking	25 to 120	Individual - 4 to10
			Family - 4 to15
Growing segment		Students	
Private	General banking	Up to 25	Up to 4
Growing segment		Soldiers and young persons	

In recent years emphasis was put on the private sector and all its segments.

Based on the segmentation of the private sector, account channels have been established allowing the granting of structured credit facilities while offering unique channels to customers having financial wealth and/or salaried customers. These customers were offered a credit line of 30% of their net available financial wealth and/or up to three times the amount of their salary, respectively.

Modifying the credit facilities to the said population segments is achieved by initiating approach to the customer and accordingly adjusting the credit facility to the requirement of the customer, his repayment ability, and the acquaintance with him over the years as regards structured credit lines, in which the interest rate decreases gradually in line with the increasing utilization of the credit facility. This activity supports the development of the consumer credit field at the Bank, allows full compatibility with the needs of the customer and leads to a significant decline in overdrawn current accounts.

Business sector. Three main segments have been identified in the business sector: complex business; ordinary business; general business.

The characteristics of the segmentation, in addition to the financial limits, address also to the type of activity, to its complexity and to the inputs required for handling the customer.

Following are the criteria for the segmentation:

Segment	Sphere	Financial limits (in NIS thousands) Assets	Type of activity
Complex business	Commercial banking	500 and over	Complex
Ordinary business	Commercial banking	Limited company: 0 to 500	Ordinary
		Registered trader: 50 to 500	
General business	Individual banking	Registered trader only: 0 to 50	Technical

SERVICE CONCEPT

The object: Providing an overall service to the customer deriving from the understanding that the customer is interested in receiving service from a banker who is aware of all his financial needs, and will modify the services and products in accordance with his unique characteristics.

Accordingly, the overall service concept has been formed, the principles of which are:

- One stop service;
- Team service – provides a response for a more comprehensive service at one address at the branch;
- Deployment according to spheres – teams that specialize in the customer sphere (rather than in the product sphere);
- Personal familiarity and relations;

- The allocation of resources based on the meeting point of the customer needs with the Bank's order of preferences.

COMPLEMENTING SERVICES

Direct and complementary service layouts that serve as an alternative to the services provided in the branches:

The "Bank gateway" project. Customer telephone answering service – automatic direction to direct banking for customers calling the branch switchboard (and not the direct lines of the staff). This project enables improvement of the quality of telephone reply on the one hand, and gives the branch staff more free time for developing initiative, sales and the improvement of service to the customer on the other hand.

The project was started during 2004. As of February 2005, all branches of the Sharon region are connected to direct banking. The plan is to implement the project in the remainder of the branches during 2005.

The above comprises forward-looking information that is based on assessments and plans of the Bank as of date of preparation of the financial statements. The application of the project may be delayed because of various reasons or unexpected events inside or outside the Bank.

Telebank Internet. Development and improvement of the service channel via the Internet. Encouraging customers to use this channel results in significantly lower costs as compared with the cost of identical services provided at the branches.

Investment centers. Customers having deposits of over NIS 400,000 or customers active in the capital market are entitled to receive comprehensive consultancy services regarding their funds at eleven investment centers. The account of the customer is managed at the branch, however the service is provided at the investment centers by expert investment consultants.

Business center for private banking. The center combines two concepts: the concept of a business center and the concept of an investment center. The center handles customers having a private banking profile, who manage their accounts at the branches.

CUSTOMER RELATIONS WITH THE SEGMENT AND SALES

Following the segmentation of branch customers and differentiating the services in their respect, the implementation of the segment strategy focuses on the manner of managing the operations in each sphere – specialization in the sphere.

The service team is required to deepen its activities with customers – to develop customer relations with the segment and to initiate activities with the customer.

Required for this purpose is:

- Awareness of customer characteristics (banking activity, needs and preferences);
- Achieving compatibility of the required professionalism and training with the customers' needs – for this purpose, courses, seminars and training sessions have been devised for the staff of the branches with respect to various issues. Study is conducted both through self-learning and at the Discount College. Among other things training is provided as regards the following matters: consumer credit, advanced business credit, deposits, members' training, foreign currency, provident funds, sales, securities, etc. In 2005, the Discount College plans to open a retail school that would provide comprehensive training in the retail field;
- Modifying products that focus on the customers' investment and credit needs;
- Expanding the personal familiarity with customers;
- Modifying the manner of approach and sale.

Various strategic emphases have been determined for the activity in each sphere in accordance with its characteristics, needs and the order of preference of the Bank.

Generally the emphases are:

1. **The VIP sphere** – personal, specialized, professional and quick service. The emphasis is

on the development of personal relationship with the circle of all customers as a basis for development of activity with them.

2. **Personal banking sphere** – development of an array of activities and identifying and attending customers classified as "the future VIP's".
3. **General banking sphere** - the reduction of operating expenses (by way of directing customers to the direct banking channels and to the use of automatic for facilities conducting simple banking operations) and identifying secondary customers for the purpose of increasing activity with them.
4. **The complex and ordinary business segment** – professional and specialized service as well as personal attention to the customer. Expanding the activity with customers who also conduct business with other banks. Transferring the private account to the handling of the business team as part of the overall service concept.

RETAIL BANKING SECTOR – HOUSEHOLD SEGMENT

SEGMENT CUSTOMERS

This segment includes customers of the Bank's Banking Division who are private customers, who are defined as customers who are either salaried employees, possess the potential for growth, or may be viewed as VIP customers (the definition excludes customers of the international private banking centers). The segment also includes an estimated cross-section of household segment customers of the Mercantile Discount Bank on the basis of the relevant weighting accorded to this segment at the Discount Bank.

LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SEGMENT

The Bank operates within the framework of laws regulations and regulatory directives applicable to the banking sector in Israel as promulgated by various supervisory bodies, viz., the Supervisor of Banks, the Commissioner of the Capital Market, Insurance and Savings, the Commissioner of Restrictive Trade Practices, the Securities Authority etc. The principal restrictions applicable to this segment are briefly described hereunder.

Commissions. In the course of 2004, the question of bank commissions was discussed by the Knesset Economic Committee, and many private law proposals in the matter of bank commissions have been tabled. During the course of the year, the Committee also examined various proposals for easing the procedures for the transfer of customers' accounts between banks. With regard to bank commissions, the chairman of the committee suggested that all the banks adopt a package deal comprised of two alternative 'packages' of commissions in all the Banks, as follows:

1. The "18 Package" – "the Knesset package": private customers will be entitled to a basket of services for a monthly payment of NIS 18.

The basket will contain the following services:

- Four ATM cash withdrawals (one per week);
- Eight check deposit transactions and/or payments by check;
- The extraction of computer-generated information by the customer on six separate occasions;
- Five separate standing order instructions for payments to utilities or other public institutions.

For customers not holding a cash withdrawal card or a credit card, the following facilities will also be available:

- The obtaining of information from a bank clerk on two separate occasions;
- Two cash withdrawals at the bank counter.

For any excess operations with respect to each of the above items or the entire basket, the customer shall pay a commission of NIS 1.21 per transaction.

2. The "10/10 Package": customers who carry out very few transactions will be entitled to

carry out any ten transactions (including requests for information) for a monthly payment of NIS 10.

The Commissioner of Restrictive Practices has conditioned his consent to the package deal to a freeze of bank commission tariffs for a period of one year. This condition also requires the freezing of special bank commission tariffs, such as 'Discount Fix', for the same period of time, and the removal of obstacles preventing the transfer of accounts between banks. If the banks consent to the above suggestion, the Commissioner has agreed to defer for one year the treatment on the question of the banks acting together as a concentrated group, that commenced in June 2004.

The Bank has expressed its readiness to adopt the suggested tariff packages and to implement the directives with respect to the transfer of accounts between banks, but has refused to freeze bank commissions and the related tariff packages. The reasoning behind the refusal is that, if the Bank agrees to adopt the "10/10" and "18" packages, there is no logic or purpose to freezing other packages, such as 'Discount Fix', because customers can decide which basket of services to select.

In practice, the proposal of the Knesset Economic Committee with respect to the package deal will not be implemented in light of the ruling by the Supervisor of Banks to the effect that the proposed system does not accord with Paragraph 26A of the Banking Rules (Service to the Customer) (Proper Disclosure and the Submission of Documents), 1992, which requires the provision of notice to the customer with regard to the commission for a service prior to implementation of that service, as well as the provision of notice with regard to the exceeding of quotas in the basket of services.

The Supervisor of Banks has requested that the Economic Committee reconsider the matter in order to arrive at an acceptable alternative proposal that is in accord with the requirements of law.

The Supervisor of Bank's proposal:

1. Abolition of the line entry charge in the customer's bank statement;
2. The tariff for certain services included within the list of basic services set out in the package deal proposal and subject to supervision (and for which no charge is levied at present), shall be NIS 1.21 per entry. These services are: the withdrawal of cash from an automatic dispensing machine, the depositing of a check at the counter, a payment made by check and the honoring of a standing order instruction. The banks will also be entitled to levy this charge for a number of services that are not subject to supervision, and for which a transaction listing charge has previously been made (the debiting of credit card payments and the crediting of receipts through the clearing system);
3. On the one hand, the account management standing commission shall be abolished, and, on the other hand, the banks shall be entitled to levy a minimum charge of NIS 10 per month on the transactions set out in paragraph 2 above, even on customers who carried out a small number of transactions and accordingly did not reach the NIS 10 charging level, but without also levying an additional fixed management charge.
4. Should the banks agree to implement the "18" Package, (the basket on which agreement was reached in the Knesset Economic Committee), customers may elect to adopt that particular bank charge tariff. Customers opting for this package will not be entitled to benefit from the arrangements described in paragraphs 1-3 above.

Removal of obstacles with respect to the transfer of accounts between banks. Another issue examined by the Economic Committee related to the easing of procedures for the transfer of accounts between banks. The issue in question concerns the abolition of charges that constitute an obstacle to the transfer of accounts, complete cooperation and providing information required by the customer regarding the transfer without charging the customer therefore, the easing of technical procedures, etc.

In light of the Bank's efforts to attract new customers, the Bank has indicated its consent to this initiative. The Bank sees itself as a leader in the process of easing the procedures for the transfer of accounts between banks and even employs the services of external companies for this purpose.

MARKETS DEVELOPMENT

As from 2002, the Bank has been engaged in a marketing effort to attract private customers. This marketing decision is rooted in the Bank's strategy, which is to lead retail banking in Israel while focusing on the retail segment as a major source of growth and profitability.
Since the beginning of the "Circles" campaign, the Bank has attracted approximately 180,000 new customers, mainly from the household sector.

NEW PRODUCTS – "DISCOUNT FIX"

From a concept of leadership in retail banking and in response to the public call for a reduction in the bank commissions tariff in the household sector, the Bank has, as from May 2004, led the way by promoting its 'Discount Fix' tariff package amongst its customers in the household sector. The significance of this new tariff lies in the abolition of the line entry charge in the customer's bank statement, and the granting of a package of benefits to the Bank's private customers.
The level of management commissions payable under the 'Discount Fix' tariff is determined by reference to the extent of the customer's transactions during any particular month.
Monthly management charge:
- Package A – NIS 14 for up to six transactions a month;
- Package B – NIS 25 for more than six transactions a month.

The two packages also include the following:
- A complete exemption from line entry charges in the bank statement;
- Exemption from credit commitment fee;
- Nine self-service bank statements;
- Exemption from charge on transfer to another Discount Bank customer;
- Exemption from Telebank personal service charge;
- Two free checkbooks per year.

Specific customer segments also benefit from the following preferential 'Discount Fix' charges:
- Pensioners and students – NIS 12 for all transactions;
- New customers – NIS 12 for all transactions throughout the first year;
- Growth segments (young people, soldiers and new immigrants) – total exemption;
- Customers included within group/workplace arrangements – 50% of the tariff (i.e., NIS 7 or NIS 12.50).

As stated above, the Bank's strategy is focused on the private customer, and 'Discount Fix' begins the revolution supporting that strategy: a unified system of commissions and automatic benefits for all private customers; simplicity; clarity; transparency of information for the customer with respect to all types of transaction (no double-charging; absolute certainty as regards the cost of managing the customer's bank account – in advance and not afterwards); adapted to the activity of the customer and to his particular needs; reducing the number of charges relating to account management to one charge only – account management charge; the customer can undertake his transactions freely in accordance with his own financial needs without being concerned about the number of entries on his bank statement; more ways in which a transaction can be implemented or information acquired through the abolition of Telebank charges and the increase in the number of times information can be extracted from the self-service machines without charge.

COMPETITION

As of today, the Bank's principal competitors are the four other major banks in Israel – Bank Hapoalim, Bank Leumi, the First International Bank of Israel and the United Mizrachi Bank. Israel Discount Bank is third in size amongst the five banks. The Bank may be differentiated from its competitors from the point of view of both quality of service and specialization in the retail banking sector (see above).

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

Net income of the segment in 2004 amounted to NIS 104 million.

The return on equity in 2004, calculated on the capital allocated to the segment on the basis of the average balance of segment risk assets, was 25.3%.

In accordance with the directive of the Supervisor of Banks, the segment has been charged with expenses relating to the encouragement of early retirement of segment employees who have retired, and of staff members at various levels whose salaries are attributed to the segment. Disregarding these expenses, segment's net income would amount to NIS 128 million and the return on equity would have been 31.3%.

Provision for doubtful debts in this segment amounted to NIS 56 million.

As stated above, it was only in 2004 that the Bank's information system for the management of its segment profit centers reached the degree of development and implementation required to permit the presentation of data relating to the operations of the Discount Group by segments. Accordingly, the Bank is unable to present comparative data for 2003, as well as analyses and explanations with respect to changes that occurred in the data for 2004 in comparison with that for 2003.

Following are the principal data relating to the operations of the household segment in 2004:

	In NIS millions	As percentage of Group total
Income from financing activities before provision for doubtful debts	976	28.0
Operating and other income	469	21.3
Total income	1,445	25.4
Provision for doubtful debts	56	6.3
Operating and other expenses	1,202	30.0
Income from ordinary operations before taxes	187	23.5
Net income	104	18.7
Return on equity	25.3%	
Average balance of liabilities	55,761	41.2
Average balance of assets	5,592	3.9

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 2,643, including positions of employees directly related to the segment and positions of staff members at various levels whose employment costs are charged to the segment. In contrast, the positions of some branch employees are charged to other segments, the customers of which are serviced through the branch network.

All operations of the segment are conducted in a manner that reflects the characteristics of the target population, with special emphasis placed on the needs of that population.

RETAIL BANKING SECTOR – SMALL BUSINESS SEGMENT

SEGMENT CUSTOMERS

This segment includes customers of the Bank's Banking Division which are defined as small companies and small businesses with borrowings of up to NIS 4 million (except for customers of the construction and real estate segment). The segment also includes, on an estimated basis, the customers of Mercantile Discount Bank in that bank's small business and commercial banking segments.

SCALE OF OPERATIONS AND NET INCOME OF SEGMENT

Net income of the segment in 2004 amounted to NIS 21 million.
The return on equity in 2004, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 4.0%.
In accordance with the directive of the Supervisor of Banks, the segment has been charged with expenses relating to the encouragement of early retirement of segment employees who have retired, and of staff members at various levels whose salaries are attributed to the segment. Disregarding these expenses, the segment's net income would amount to NIS 30 million and the return on equity would have been 5.2%.
Provision for doubtful debts in this segment amounted to NIS 118 million.

Following are the principal data relating to the operations of the small business segment in 2004:

	In NIS millions	As percentage of Group total
Income from financing activities before provision for doubtful debts	433	12.4
Operating and other income	219	10.0
Total income	652	11.5
Provision for doubtful debts	118	13.4
Operating and other expenses	488	12.1
Income from ordinary operations before taxes	46	5.7
Net income	21	3.7
Return on equity	4.0%	
Average balance of liabilities	8,852	6.5
Average balance of assets	11,595	8.1

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 1,108, including positions of employees directly related to the segment and positions of staff members at various levels whose employment costs are charged to the segment.

SERVICE TO SEGMENT CUSTOMERS

The foreign trade department serves customers engaged in international trade. Every customer benefits from the entire range of the Bank's foreign trade services in specialist industry units that deal with all aspects of foreign trade, viz., exports, imports, financing, future financial instruments, electronic communication and relevant information on customers and suppliers. For further information, see below, 'Middle Market Banking Segment'.

CORPORATE BANKING SEGMENT

REVIEW OF DEVELOPMENTS IN THE BUSINESS SECTOR IN 2004

In 2004, there was an expansion of activity in the business sector, particularly in exports. The trend of expanding exports continued against a background of increasing world demand. Increased productivity and efficiency measures introduced by companies after the years of recession, led to an increase in industrial exports in general, and exports in the high technology industries in particular. Most indicators point to continuing growth and to rising expectations for a consolidation of that growth in the coming quarters.

The various factors giving rise to expectations of continued growth include the following:

- Continuing consolidation of worldwide growth and the expansion of world trade which lead to a rise in demand for local products, and in particular, for products of the high technology industries;
- Relative security calm;
- A fiscal policy that meets the deficit target, and which in turn leads to stability of long-term interest rates at a very low level;
- An expanding monetary policy against a background of market price stability.

This constitutes forward-looking information, which is based on the Bank's best evaluations as of the date on which these financial statements were prepared. Changes in any one of the parameters may lead to the non-realization of these expectations.

EVALUATION OF THE RISK LEVEL IN THE CORPORATE BANKING SEGMENT

In 2004, after three consecutive years of consistent, continuing deterioration, the Israeli economy managed to record an improvement in its average risk level of approximately 2.2% (according to the BDI integrated index) in comparison with 2003, a year that was generally regarded as being the peak year of the economic recession.

The risk rate of industries classified as at risk levels that were either higher than average or particularly high stood at 61.3% as of the end of 2004, a significant improvement compared to the rate of 90.3% as of the end of 2003. In spite of this significant improvement, the classification of industries by risk grading indicates that the path to economic stability is still long.

In 2004, the industrial sector was the strongest and most stable in Israel. The chemical industry is the strongest and most stable industry and is, in fact, the only industry where the risk level is classified as good and negligible.

The industries that recorded the most significant improvements in risk levels in 2004 are the industrial and electronic machinery and equipment industry and the plastic and rubber industry.

The industries classified as 'strong' industries are: the chemical industry; the paper and carton industry; the cosmetics, pharmaceutical and detergent industry; the food and drink industry; and the metal and steel industry.

The industries classified as 'weak' industries are: transportation of merchandise, equipment and cargo; tourism and leisure services; construction; general services; social and medical services; and the transportation product industry.

ASSESSMENT OF GROWTH IN CREDIT IN THE BANKING SECTOR

After a two-year period of retrenchment in the granting of banking credit, an increase in credit in the course of 2005 is anticipated. The expectation for 2005 is for continued expansion of economic activity domestically and worldwide, that will, in turn, influence the rate of growth in the business sector and exports. In addition, the business sector is expected to increase the scope of its investment. In view of the above, the assessment is that the demand for commercial credit will grow. On the credit supply side, growth is anticipated both within and outside the banking system. The supply of bank credit is expected to grow in the wake of the improvement in the capital adequacy ratio within the banking sector due to increasing profitability. In tandem with the trend towards expanding banking credit, a similar trend is anticipated with respect to the alternative suppliers of credit, viz., the capital market, institutions, insurance companies, the raising of capital through share and debenture issues etc.

THREATS AND OPPORTUNITIES IN THE CORPORATE BANKING SEGMENT

Threats:

- Strengthening of alternative sources of credit outside the banking industry – as from institutions, insurance companies, share and debenture issuances etc. It should be noted that, as of 2002, the rate of utilization of alternative sources of credit exceeded the rate of utilization of banking credit;

- Intensification of competition within the banking industry, as a result of the desire to increase the business and consumer credit portfolio. Competition between the banks has led to a decrease in credit margins;
- Exposure to groups of borrowers – implementation of related Bank of Israel directives (Proper Banking Management Directive No. 313), and in particular, the tightening of the provisions of the directive in the August 2003 amendment, has led to a reduction in the credit facilities made available to the large groups of borrowers, and the creation of restrictions on the financing of the country's large companies (for details of the amendment, see above: 'Amendment of the directive relating to limitations on the indebtedness of a single borrower and for group of borrowers').

Opportunities:

- The trend towards economic expansion that has characterized Israel's economy since the second half of 2003. The rise in economic activity has encompassed all of the country's principal industries, with the exception of the construction and transportation industries. It is felt that, in most industries, the trend towards increased economic activity in the domestic market will continue, especially in the field of exports;
- A decrease in the credit to the GDP ratio in tandem with an improvement in companies' cash flows. The significance of these trends lies in the improved repayment capacity of the corporate sector.

  The assessment provided in this paragraph and in the paragraph relating to the assessment of growth in credit facilities constitutes forward-looking information, which is based on the Bank's evaluations as of the date on which these financial statements were prepared. External events or errors in the evaluations may adversely affect the realization of these forecasts.

DEVELOPMENTS IN THE SEGMENT'S MARKETS

In 2004, there was a decline in the scope of operations in this segment. The large borrowers who, in the past, had contributed to the expansion of credit operations, made significant repayments during the course of the year.

The following may be viewed as contributory factors to the above development:

- The recovery in the capital market accelerated the process of tapping alternative sources of credit outside the banking industry. The development of the external market has been due to structural changes in the economy, the high liquidity of institutional investors, refinement of the capital market, and an improvement in the financial position of the large companies;
- A decline in the demand for credit on the part of the large companies as a result of improvements in commercial performance and cash flows, and the low rate of investment in fixed assets;
- The transfer of investments overseas by companies and entrepreneurs, and the financing of those investments by local banks overseas;
- In light of the implementation of the directives of the Supervisor of Banks concerning the limitation on the indebtedness of a group of borrowers, the large companies have taken steps to reduce their volume of banking credit.

LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SEGMENT

The Bank operates within the framework of laws, regulations and regulatory directives applicable to the banking sector in Israel as promulgated by various supervisory bodies, viz., the Supervisor of Banks, the Commissioner of the Capital Market, Insurance and Savings, the Commissioner of Restrictive Trade Practices, the Securities Authority etc. The principal

restrictions applicable to this segment are briefly described hereunder:
The Proper Bank Management directives contain restrictions with respect to the extent of the indebtedness allowed to any single borrower or group of borrowers, and the extent of the total indebtedness allowed to the bank's six largest borrower groups and to certain customers defined as 'related persons.' These restrictions may have adverse implications on the manner and scope of the Bank's business segment operations insofar as they relate to these customers. For information on the amendment of the directives relating to this matter, see above, 'Amendment of the directive relating to limitations on indebtedness of a single borrower and of a group of borrowers' and also Note 4 G to the financial statements.
The Proper Bank Management directives contain restrictions with respect to the extent of a bank's risk assets in relation to any given level of capital (as defined in the directive). In recent years, this directive affected the Bank's activities and led to the introduction of a restrained credit policy (for further information, see the paragraph below, 'Expanding the capital base of the Bank and also Note 14 to the financial statements). An improvement in the Bank's capital adequacy ratio in 2004 may allow the Bank to increase its credit portfolio and finance new ventures.
The Basel Commission has published new guidelines, commonly known as Basel II, which are due to enter into force in certain countries towards the end of 2006. As part of its preparations for meeting the requirements of Basel II, the Bank of Israel has, for the present, provided guidance in relation to the grading of customers (for further information on this matter, and for more general information on the Bank's plans for implementing Basel II, see 'Exposure to risks and risk management').

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

Net income of the segment in 2004 amounted to NIS 11 million.
The return on equity in 2004 calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 0.6%.
In accordance with the directive of the Supervisor of Banks, the segment has been charged with expenses relating to the encouragement of early retirement of segment employees who have retired, and of staff members at various levels whose salaries are attributed to the segment. Disregarding these expenses the segment's net income would amount to NIS 19 million and the return on equity would have been 1.0%.
The provision for doubtful debts in this segment amounted to NIS 217 million. In 2004, the provision was affected to a significant degree by the supplementing of a provision in respect of one particular borrower. The supplementary provision was made in accordance with instructions from the Bank of Israel (see above, 'Instruction relating to specific loan').
As stated above, it was only in 2004 that the Bank's information system for the management of its segment profit centers reached the degree of development and implementation required to permit the presentation of data relating to the operations of the Discount Group by segments. Accordingly, the Bank is unable to present comparative data for 2003, and analyses and explanations with respect to changes that occurred in the data for 2004 in comparison with that for 2003.

Following are the principal data relating to the operations of the business segment in 2004:

	In NIS millions	As percentage of Group total
Income from financing activities before provision for doubtful debts	391	11.2
Operating and other income	112	5.1
Total income	503	8.8
Provision for doubtful debts	217	24.6
Operating and other expenses	266	6.6
Income from ordinary operations before taxes	20	2.5
Net income	11	2.0
Return on equity	0.6%	
Average balance of liabilities	6,496	4.8
Average balance of assets	19,886	14.0

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 704, including positions of employees directly related to the segment and positions of staff members at various levels whose employment costs are charged to the segment.

SEGMENT CUSTOMERS

This segment includes customers of the Bank's Corporate Division (except for construction and real estate customers and customers of the private international banking centers). The segment in the Bank includes mainly companies with annual turnovers of over NIS 150 million and/or total indebtedness exceeding NIS 40 million. The segment also includes customers of the business segment of the Mercantile Discount Bank.

SERVICE TO SEGMENT CUSTOMERS

The business segment enjoys professional banking services provided by the Corporate Division. In 2004, the division intensified its expertise in the comprehensive financial guidance, i.e., an in-depth examination of the company's needs and the adoption of creative financial solutions. Customers are provided with personal, professional and quality service that relates to all their financial needs by offering customized various banking products in the credit, exchange-rate hedging, international trade, settlement through the use of credit cards, financing, specialist capital market investments, etc.

Concurrently, solutions are also devised for meeting the financial needs of the owners of companies, and their executives and staff, who thus benefit from arrangements that afford them the status of preferred customers.

The rolling finance arrangements for the big companies are implemented through **business managers** in the corporate company department of the Corporate Division. The teams are allocated to customers by reference to the field of business activity in which the companies are engaged. The teams include a business manager, a business banker, economists and credit officers. Such a team provides the banking support for all the financial needs of the business customer.

The Diamond Exchange Branch serves diamond industry customers. The branch specializes in accounts of diamond merchants as well as in all the special services required by the diamond industry.

The Unit for Approved Enterprises works with those customers entitled to benefits from the State by providing finance for the acquisition or construction of equipment and

buildings, and for the establishment or expansion of tourist and industrial projects, by virtue of the provisions of the Law for the Encouragement of Capital Investments.
The foreign trade department serves customers engaged in international trade. Every customer benefits from the entire range of the Bank's foreign trade services in specialist industry units that deal with all aspects of foreign trade, viz., exports, imports, financing, future financial instruments, and relevant information on customers and suppliers. For further information, see below, 'Middle Market Banking Segment.'
Discount Leasing Ltd. – a company wholly owned by the Bank, implements financing transactions for customers.
Deepening the current communication with segment customers is carried out by providing them with information packets several times a year, which include up to date banking information as well as an attractive set of offers, tailored to the needs of business people and companies.
Some of the segment's customers utilize the services of the Bank's dealing rooms (see below, 'Finance management segment') and the overseas offices of the Bank (see below, 'International operations segment').

STRUCTURE AND TERMS OF COMPETITION

The improvement in the commercial banks' capital adequacy ratio has contributed to a situation in which an abundance of sources for the provision of credit now exist. This, in turn, has sharpened the competition between potential lenders vis-à-vis borrowers seeking significant amounts of credit. The mix of potential financiers has been joined by foreign banks and insurance companies which have established lending units that are outside the domestic banking industry. An additional competitive factor is the network of lenders outside the banking industry. The competition between the banking industry and the external network of lenders is characterized by the fact that the network is used by the large companies as a source of funds – funds which serve as an alternative to traditional banking finance.
The credit market has witnessed a process of shifting demand from the banking industry to the capital market as a consequence of the following developments:

- A growth in demand by institutional investors for corporation debentures in light of the reduced supply of earmarked government debentures and the preference for excess returns;
- The policy of companies to change the structure of their financial leverage, with a view to reducing the degree of banking credit and increasing direct indebtedness to the public and institutions;
- The policy of companies to increase the extent of their medium- and long-term credit at the expense of short-term banking credit;
- The reduction in the cost of raising capital as a consequence of improved repayment capacity, a decreasing requirement for collateral, and close banking supervision of credit portfolio management. In light of the deteriorating competitive position and the changes in the mix of lenders, a process has commenced whereby, as of the second half of 2004, financial margins have been reduced. The margins in the business sector are now relatively lower than those in other sectors.
- The Bank is striving to increase its competitive edge and is making intensive efforts across the organization to improve its level of service and professionalism.

ALTERNATIVES TO BANKING PRODUCTS AND SERVICES

The large corporations have been raising capital from alternative sources, including the proceeds of issuance of commercial straight and structured bonds and convertible bonds purchased by institutional investors (insurance companies and pension funds).
Capital has been raised through the issuance of packages, which include shares, options,

warrants and convertible debentures.

Credit to the business sector is characterized by a relatively high weight accorded to long-term facilities – loans linked to the Consumer Price Index and loans denominated in foreign currency.

External financing (outside the banking industry) is an alternative financing source to medium and long-term banking credit, the scope of which is expected to decline along side with an anticipated increase in the weighting accorded to short-term credit in the credit portfolio.

The greater part of the credit facilities provided in 2004 was comprised of long-term facilities for financing the acquisition of controlling interests, as contrasted with the extent of the provision of facilities for investment in fixed assets, which has remained static.

ENTRY AND EXIT OBSTACLES

The large firms possess relatively good bargaining power in relation to financing costs and operating charges. Their costs of transferring from one bank to another are also relatively low.

Some firms prefer to utilize short-term on-call credit, which has a relatively low margin. The simultaneous use of such facilities at different banks improves financial flexibility on transfer from bank to bank and assists in reducing margins. This process also enhances the ability to raise funds in the capital market and from overseas banks.

GOALS AND BUSINESS STRATEGY

- Management of credit portfolio and its inherent risks;
- Improving the quality of credit portfolio;
- Preparing for implementation of the Basel II Accord.

CORPORATE BANKING SEGMENT AT MERCANTILE DISCOUNT BANK

In its business plan for 2005, Mercantile Discount Bank has set goals for increasing the number of corporate customers, whilst simultaneously seeking to improve the quality of its credit portfolio.

MIDDLE MARKET BANKING SEGMENT

SEGMENT CUSTOMERS

This segment includes customers of the Bank's Commercial Banking Division (except for construction and real estate customers). This segment in the Bank includes mainly companies with annual turnovers of NIS 15 – 150 million and/or total indebtedness of NIS 4 – 40 million.

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

The loss this segment incurred in 2004 amounted to NIS 39 million.

The return on equity in 2004, calculated on the capital allocated to the segment on the basis of the average balance of segment risk assets, was (7.4%).

In accordance with the directive of the Supervisor of Banks, the segment has been charged with expenses relating to the encouragement of early retirement of segment employees who have retired, and of staff members at various levels whose salaries are attributed to the segment. Disregarding these expenses, the segment's net income would amount to NIS (33) million and the return on equity would have been (6.1)%.

Provision for doubtful debts in this segment amounted to NIS 42 million.

As stated above, it was only in 2004 that the Bank's information system for the management of its segment profit centers reached the degree of development and implementation required to permit the presentation of data relating to the operations of the Discount Group by segments. Accordingly, the Bank is unable to present comparative data for 2003, and analyses and explanations with respect to changes that occurred in the data for 2004 in comparison with that for 2003.

Following are the principal data relating to the operations of the commercial banking segment in 2004:

	In NIS millions	As percentage of Group total
Income from financing activities before provision for doubtful debts	161	4.6
Operating and other income	68	3.1
Total income	229	4.0
Provision for doubtful debts	42	4.8
Operating and other expenses	255	6.4
Income from ordinary operations before taxes	(68)	(8.6)
Loss	(39)	(7.0)
Return on equity	(7.4%)	
Average balance of liabilities	4,859	3.6
Average balance of assets	6,985	4.9

The assets of the business centers have increased at an average rate of 8% per annum during the last three years.

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 668, including positions of employees directly related to the segment and positions of staff members at various levels whose employment costs are charged to the segment.

SERVICE TO SEGMENT CUSTOMERS

The commercial banking segment enjoys professional banking services provided through the Commercial Banking Division. In 2004, the division intensified its expertise in the **comprehensive financial guidance** meaning an in-depth examination of the company's needs and the adoption of creative financial solutions. Customers are provided with personal, professional and quality service that relates to all their financial needs by offering customized various banking products in credit, exchange-rate hedging, international trade, settlement through the use of credit cards, financing, specialist capital market investments, etc.

Concurrently, solutions are also devised for meeting the financial needs of the owners of companies, and their executives and staff, who thus benefit from arrangements that afford them the status of preferred customers.

Customer service is provided at six **business centers** situated in the Dan, Sharon, Tel Aviv, Southern, 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.

In order to adapt the service to the business customer, the customer is referred to a business-oriented branch of the Bank at which unique service teams are set up to meet customer requirements as and when they arise.

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

The support units for the Commercial Banking Division include the division's headquarter units, the banking business mangers for the asset and liability sides and the marketing support department.

Segment customers are invited to join the 'business club,' a feature unique to the Discount Bank. Within the framework of this 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 areas interfacing business activity such as: taxation, management, leadership, advertising, marketing, human resource management, etc.

Deepening the current communication with segment customers is carried out by providing them with information packets several times a year, which includes up-to-date banking information as well as an attractive set of offers, tailored to the needs of business people and companies.

The **foreign trade department** serves customers engaged in international trade. Each customer, according to his economic sector, benefits from the entire range of the Bank's foreign trade services in specialist industry units that deal with all aspects of foreign trade: exports, imports, financing, future financial instruments, electronic communication, and relevant information on customers and suppliers (for further information, see below).

Discount Leasing Ltd., a company wholly owned by the Discount Bank, implements financing transactions for customers.

FOREIGN TRADE OPERATIONS

General. The foreign trade department operates within the framework of the Bank's Commercial Banking Division, and offers a range of services to customers from the various business segments engaged in international trade.

Scale of operations. As part of the general recovery in economic activity, a sharp increase in the volume of foreign trade was recorded in 2004. Both imports and exports were up by approximately 20% in comparison with 2003. In comparison with the previous year, the Bank saw an increase of approximately 18.66% in import operations (the increase in operation of corporate segment customers was approximately 18.50%, in operations of commercial banking segment customers, approximately 11.64%, and in operations of small business segment customers, approximately 32.57%). According to data provided by the Bank of Israel, the increase in such operations throughout the banking industry as a whole was 20.9%. In 2004, the Bank's market share of such operations was approximately 10.5%, as compared to 10.73% in 2003.

In comparison with the previous year, the Bank saw an increase of approximately 22.60% in export operations (the increase in operations of commercial banking segment customers was approximately 14.47%, in operations of small business segment customers, approximately 49.41%, and in operations of corporate segment customers, approximately 21.93%). According to data provided by the Bank of Israel, the increase in such operations throughout the banking industry as a whole was 17.1%. In 2004, the Bank's market share of such operations was approximately 8.7%, as compared to 8.5% in 2003.

Customer service is provided by the foreign trade department, which has administrative and operational responsibility, and by sixty independent branches (including the Haifa and Jerusalem Main branches), which were selected for this task by virtue of the degree of activity at those branches.

In the last three years, the Bank's market share of foreign trade operations fell to a level of approximately 9%. At the same time, however, the Bank recorded an increase in revenues from foreign trade commission at an average annual rate of approximately 8%. This situation arises as a result of a decision to place the emphasis on profitability per customer, compared with the volumes of operations in previous years. The department's operations have also been expanded – from a unit providing operational/professional services to business units, to activities involving business development and the promotion and provision of personal service to customers together with the Bank's business officials.

In the coming years, continued focus will be directed towards the achievement of product profitability, as measured by an increase in revenues from commissions, both from the customer and from overseas correspondents, by deepening the operations vis-à-vis customers who carry out foreign trade transactions with competing banks, and by attracting new customers, subject to considerations of profitability.

Business operations of the foreign trade department are segmented by industry specialization, which brings together all the foreign trade services required by a customer in one department. In order to deepen the relationship with the customer, increased emphasis is placed on the development of personal and direct contact with the customer in tandem with the continuing contact of the customer with his business manager.

The above said includes forward-looking information, which is based on the Bank's plans and expectations as of the date on which these financial statements were prepared. Business changes or changes in the Bank's evaluations may lead to failure in realization of these plans.

ACCUMULATING INVESTMENTS AND SAVINGS AT BUSINESS CENTERS

Investments and savings of the medium size company sector comprise only approximately 3% of all such operations in the Bank. The sector is marked by such operations being implemented by controlling shareholders and not by the companies themselves. In order to increase the Bank's market share in this field, a service concept was implemented in 2004 to the effect that the business bank official should be responsible for all the banking operations of the business customer, including investments and savings operations.

The main focus in this regard was presenting the customer with a variety of investment possibilities, in close cooperation with specialists within the Bank. Due to the implementation of this policy, the end of 2004 saw a significant increase in the investments and savings balances.

COMPETITION

2004 was marked by a decline in business risk factors, an improvement in the position of trading companies, an increase in trade turnovers, and a general increase in commercial activity. As a result of these developments, there was growing competition in the second half of 2004 from the two largest banks in Israel and an erosion of financial margins.

COOPERATION IN THE LEASING FIELD

Following a cooperation agreement with external leasing companies and motor vehicle and equipment importers, and as a service to the Bank's business customers, an attractive leasing proposal has been forwarded to business segment customers (customers of the Corporate and Commercial Divisions) for the acquisition of motor vehicles, industrial equipment and mechanized engineering equipment. Telemarketing evenings, aimed at customers of the Bank, were subsequently held at business centers with the participation of a representative of Discount Leasing.

PRIVATE BANKING SEGMENT

SEGMENT CUSTOMERS

This segment includes customers of the Bank's Banking Division (both individuals and corporations) who maintain their accounts at private banking centers (except for customers of the construction and real estate segment).

STRUCTURE OF SEGMENT

The **international private banking department** was set up at the beginning of 1999, and from them has significantly grown in the extent of its assets. At the end of 2001, the Bank embarked on a program to intensify its efforts to recruit and retain customers. This program extended also to the domestic private banking segment, responsibility for which had been assigned to the department.

In the third quarter of 2004, the Bank began to formulate a declaration of strategy with respect to the private banking field. In formulating the declaration, the main difficulties with the existing situation were presented as a basis for re-evaluating the allocation of resources and the positioning of the private banking department within the Bank and the Group, together with an improved image of the Bank vis-à-vis existing and potential private banking customers, both domestic and international.

The department serves two types of customer, as follows:

- International private banking customers – foreign residents and Israelis living abroad permanently, in accordance with the customer's status and not with financial resources;
- Domestic private banking customers – Israelis with financial resources, in accordance with a determined profile.

In addition, the department supports operations designed to advance the status of the Bank's foreign extensions, in close cooperation with them. The operations include, inter alia, assistance in recruiting new customers and strengthening branches' and headquarter units' awareness to the services offered by the Group. These goals are achieved by answering enquiries from existing or potential customers, either orally or in writing, and by holding meetings with customers and employees.

COMPETITION

The private banking segment comprises a competitive niche within the banking industry.

STRATEGIC EMPHASES

As mentioned above, as part of the banking division's reorganization towards in preparation for the implementation of the Bank's segment strategy, various strategic emphases have been determined with respect to operations involving the different segments. These emphases take into account the characteristics and requirements of each segment, and the Bank's priorities. In the field of international private banking, emphasis has been placed on professional and specialized service, combined with a commitment to discretion and prompt response to customer requirements.

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

Net income of the segment in 2004 amounted to NIS 4 million.

The return on equity in 2004, calculated on the capital allocated to the segment on the basis of the average balance of segment risk assets, was 14.9%.

In accordance with the directive of the Supervisor of Banks, the segment has been charged with expenses relating to the encouragement of early retirement of segment employees who have retired, and of staff members at various levels whose salaries are attributed to the segment. Disregarding these expenses, the segment's net income would amount to NIS 8 million and the return on equity would have been 30.9%.

As stated above, it was only in 2004 that the Bank's information system for the management of its segment profit centers reached the degree of development and implementation required to permit the presentation of data relating to the operations of the Discount Group by segments. Accordingly, the Bank is unable to present comparative data for 2003, and analyses and explanations with respect to changes that occurred in the data for 2004 in comparison with that for 2003.

Following are the principal data relating to the operations of the private banking segment in 2004:

	In NIS millions	As percentage of Group total
Income from financing activities before provision for doubtful debts	65	1.9
Operating and other income	9	0.4
Total income	74	1.3
Provision for doubtful debts	-	-
Operating and other expenses	67	1.7
Income from ordinary operations before taxes	7	0.9
Net income	4	0.7
Return on equity	14.9%	
Average balance of liabilities	10,271	7.6
Average balance of assets	1,051	0.7

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 200, including positions of employees directly related to the segment and positions of staff members at various levels whose employment costs are charged to the segment.

SERVICE TO CUSTOMERS

Segment customers enjoy the highest level of banking services in four private banking centers.

The private banking center, located in the Ayalon-Insurance Building in the Diamond Exchange area in Ramat-Gan, offers overall banking solutions, tailored to the needs of its high net worth customers, both Israelis and foreign residents, including corporations, while focusing on initiative, service and unique and sophisticated products.

At the **international private banking centers** in Tel Aviv, Jerusalem and Netanya, specialized services are provided to foreign residents, individuals and overseas corporations (including Israelis residing overseas permanently) with respect to both investment and credit products, while emphasizing involvement in and contribution to Jewish communities overseas.

2004 saw a revival of tourism to Israel and an upsurge in trading volume on the Tel Aviv Stock Exchange. Along with the incorporation of the consequence of the prohibition of Money Laundering Law as it relates to private banking accounts. The private banking centers of the Bank continued to make their mark as leaders in the field of private banking in Israel. In this context, it may be mentioned that customer support services at the various branches were also reinforced as part of the Bank's customer-oriented strategy, in particular, at the private banking center in Haifa and the investment center for foreign residents.

During the course of the year, the **Global Center** and **Global Private Banking** at the David Intercontinental Hotel in Tel Aviv served as further avenues for the provision of services to customers who were interested in taking full advantage of the Bank's international coverage.

INTERNATIONAL OPERATIONS SEGMENT

SEGMENT CUSTOMERS

This segment includes the overseas operations of the Discount Group. These operations are mainly carried out by the Bank's subsidiaries in the United States, South America (including the Bank's representative offices) and Switzerland, and by the Bank's branch in the U.K. The international operations are characterized by commercial business activity and by private banking.

During the preparation of the financial statements for 2004, the Supervisor of Banks advised that the Bank is required to devide the data relating to the international operations segment between the segments relating to the Group's domestic operations. In view of the fact that, at this stage, the Bank's subsidiary in New York is not in a position to provide the required information, the Supervisor has agreed that, for the time being, the Bank may continue to present details of international operations in the segment Note to the financial statements.

LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SEGMENT

The principal restrictions applicable to this segment are briefly described below:

Exposure restriction with regard to overseas extensions. In accordance with the terms of a regulatory letter sent by the Supervisor of Banks, a restriction exists with respect to the extent of the exposure of the Bank in relation to the operations of its overseas extensions. The volume of the risk assets held by these extensions was determined as a risk index. The "imputed capital" in respect of the risk assets of overseas extensions is calculated in accordance with the provisions of the relevant directive, at a rate of 16% of the risk assets of the extension (calculated in accordance with the weighting determined by the Proper Banking Management Directive No. 311 which deals with the minimum capital ratio) is multiplied by the coefficient determined by reference to risk factors and the nature of the supervision in the country in which the extension is situated. In this connection, it has been determined that the coefficient shall be 1 for countries of the OECD and 4 for all other countries. The Bank's exposure with respect to the operations of its overseas extensions is calculated by multiplying the "imputed capital" by the coefficient determined by reference to risk factors and the nature of the banking supervision in the relevant country, as required by the directives.

The rate of exposure is calculated as a proportion of the calculated "imputed capital", as determined by Appendix A of directive no. 311, which deals with the ratio of capital to risk components.

In the past, the maximum exposure rate for overseas extensions was 30%. In May 2001, the Supervisor of Banks increased the maximum exposure rate to 32%.

The main overseas office is the New York subsidiary. The subsidiary's profitability and the high ratio of capital to risk components have allowed the subsidiary to continue to develop its business, which has, in turn, contributed to the increase in the calculated risk assets of the Bank's overseas extensions. In contrast to the above, however, the Bank's losses in 2000-2001 and the first half of 2002 led to an erosion of capital. The outcome of both the above processes constituted a deviation on the part of the Bank from the rules governing exposure restrictions with regard to overseas extensions.

As on December 31, 2004, the calculated rate of exposure of the Bank with respect to overseas extensions stood at 34.48%, as compared to a rate of 32.41% on December 31, 2003.

It should be noted that, in the regulatory letter from the Bank of Israel, no mention was made of sanctions to be applied in the event that the Bank were to deviate from the imposed limitation. Nevertheless, the Supervisor of Banks recently pursued the matter of changes to the Bank's calculated rate of exposure and requested that the Bank take steps to reduce the deviation. In addition, the Bank itself reviews, at monthly intervals, developments in the calculated rate of exposure regarding its activity at the overseas extensions.

The Bank has since applied to the Supervisor of Banks to agree to an increase in the restriction to a rate of 35% of the calculated capital. During the course of the year, discussions were held with the Supervisor with a view to formulating a mutually acceptable solution to this matter.

Overseas regulatory supervision. Operations of the international segment in the various countries are subject to regulatory supervision on the part of the appropriate authority in the country in question.

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

Net income of the segment in 2004 amounted to NIS 164 million.
The return on equity in 2004, calculated on the capital allocated to the segment on the basis of the average balance of segment risk assets, was 9.2%.
Provision for doubtful debts in this segment amounted to NIS 35 million.
As stated above, it was only in 2004 that the Bank's information system for the management of its segment profit centers reached the degree of development and implementation required to permit the presentation of data relating to the operations of the Discount Group by segments. Accordingly, the Bank is unable to present comparative data for 2003, and analyses and explanations with respect to changes that occurred in the data for 2004 in comparison with that for 2003.

Following are the principal data relating to the operations of the international operations segment in 2004:

	U.S. operations	European operations	Segment total	As percentage of Group total
		In NIS millions		%
Income from financing operations before provision for doubtful debts	766	38	804	23.1
Operating and other income	105	20	125	5.7
Total income	871	58	929	16.3
Provision for doubtful debts	29	6	35	3.9
Operating and other expenses	512	49	561	14.0
Income from ordinary operations before taxes	330	3	333	41.8
Net income	159	5	164	29.5
Return on capital	9.6%	4.2%	9.2%	
Average balance of liabilities	35,433	1,230	36,663	27.1
Average balance of assets	38,686	2,458	41,144	28.9

TAXATION

Under an agreement made with the Israeli tax authorities, the income of the Bank's overseas banking subsidiaries is added to the Bank's chargeable income, such that the Bank pays tax on the pre-tax accounting income of its overseas subsidiaries to the extent of the difference between the tax notionally payable in Israel on that income at the tax rate applicable to the Bank in Israel and the tax payable to overseas tax authorities.

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 906, of which 859 positions related to operations on the American continent and 47 positions to operations in Europe. This segment is not charged with any employment costs of staff members in Israel.

SERVICE TO SEGMENT CUSTOMERS

Europe. 2004 witnessed the continuing growth of assets of customers of Israel Discount Bank (Switzerland), a wholly owned subsidiary of the Bank. Israel Discount Bank (Switzerland), located in Geneva, focuses on exclusive **private banking** operations, by which it has succeeded in attracting customers and expanding the extent of its business. The Bank's Swiss office provides advanced private banking and investment management services to existing and potential customers of the Group, both foreign residents and residents of Israel, at an international financial center.

The Bank also maintains a branch in London, which provides commercial and private banking services, and a branch in the Cayman Islands. In addition, the Bank maintains representative offices in France (Paris) and Germany (Berlin).

United States. I.D.B. New York ("IDB Bank") continues to be the largest of the Israeli banks operating overseas. This bank maintains two branches in New York, three branches in Florida, one branch in Los Angeles and one branch in the Cayman Islands. IDB Bank has an Uruguayan banking subsidiary, Discount Bank (Latin America), and representative offices situated in various centers in South America.

SERVICES AND PRINCIPAL PRODUCTS OF IDB BANK

Credit – IDB Bank, and through its leasing subsidiary, provides financing to a variety of US based corporations and also, at times, to the principals of these privately held companies.

Middle Market Lending – In 2004, the IDB Bank loan portfolio again experienced double-digit growth vis-à-vis the previous year and acted as agent in important syndications. IDB Bank has a significant niche in Middle Market Lending in a wide variety of industries, particularly in the New York Metropolitan Area, South Florida and Los Angeles; furthermore, IDB Bank recently has initiated a strong marketing effort to develop the New Jersey market. Examples of some of the industries in which IDB Bank is active are apparel and accessories, textiles, electronics, food, not-for-profit and entertainment.

Asset Based Lending – This includes accounts receivable financing, inventory/equipment financing, letters of credit, terms loans as well as funding for mergers and acquisitions, for middle market companies. Asset Leveraging, is the process by which IDB Bank values and leverages a client's assets to provide working capital. In 2004, the total Asset Based Lending portfolio grew by 12%.

The distinction between asset-based loans and other secured loans resides in the amount of monitoring required to ensure the existence, value and integrity of the collateral. It is this constant collateral appraisal process that functionally differentiates asset based loans from other secured commercial loans. IDB Bank also began a small business program in 2003, providing services to small companies whose needs for lines of credit are between US$ 500 thousand and US$ 2 million.

Factoring – The factoring division, IDB Factors, continued to experience solid growth in 2004, with factoring volumes now approaching US$ 1 billion. Since its inception just four years ago, it has become one of the fastest growing factors in the industry. One of the Division's strengths is its ability to custom-design a factoring package to suit each client's needs. IDB Factors serves a wide range of diverse companies in many different industries. Clients are provided with a full range of services and financings, including accounts receivable management, customer credit guarantees, collections, advances against accounts receivable and inventory, seasonal over advances and import financing.

Commercial Real Estate Lending – Relationships are maintained with real estate owners and investors in the New York Metropolitan Area, Florida and California. Principal products include lines and letters of credit and fixed and floating rate loans for all real estate asset classes, e.g., facilities for the acquisition and adaptive re-use of retail, office, residential and hotel properties. There are also longer term loans on stabilized projects, including participations with other U.S. financial institutions. Focus is always put on maintaining a high degree of credit quality. IDB Bank continues to be committed to help support the development and revitalization of neighborhoods.

IDB Mortgage Corp. – This is a subsidiary of IDB Bank's holding company, Discount Bancorp, Inc., through which jumbo residential mortgages have been available to IDB Bank's high net worth customers in the Tri-State New York region and Florida.

Trade & Finance – Letters of credit and related documentary collections continue to be a significant source of fee income for the Bank. IDB Bank continues to be a major issuer of documentary letters of credit in its peer group and also continues to be ranked within the top

10% of all U.S. commercial banks as reported by Documentary Credit World, out of the 300 banks on their list. IDB Bank's Automated Letter of Credit Customer Initiation System is a state-of-the-art, personalized Internet-based Letter of Credit system that connects a company's personal computer directly with IDB Bank's Letter of Credit Department. The software makes issuing and amending Letters of Credit faster, easier and more accurate than ever before.

Household Banking – Offers the gamut of banking products and services, including personal and business checking accounts, money market accounts, time deposits, etc.

International Private Banking – This segment provides highly personalized service to non-U.S. clients. As in all segments of IDB Bank, building solid relationships with clients is paramount. Deposits from non-U.S. clients represent some 85% of IDB Bank's entire deposit base. The products and services of IDB Bank's broker-dealer subsidiary, IDB Capital Corp., are also available to customers. Officers of the International Private Banking Department are also licensed representatives of IDB Capital Corp.

U.S. Private Banking – 2004 was a year of growth, both in terms of new accounts and additional investments. Deposits made by U.S. customers in IDB Bank's innovative Structured Time Deposits with Principal Protection more than doubled over the prior year. Customers include personal and corporate clients alike. The products and services of IDB Bank's broker-dealer subsidiary, IDB Capital Corp., are also available to these customers.

Investment Products – The department continued to create and launch a variety of innovative bank deposit alternatives in 2004 that provided its U.S. and international clients with compelling opportunities for upside gain, without risk to principal. Among IDB Bank's extremely popular Structured Time Deposits with Principal Protection booked last year were Step-up Rate deposits; "Bump-up", extendable deposits; and various "linked" deposits, such as "inverse floaters" and range deposits linked to LIBOR, deposits linked to capital markets such as the S&P 500 Index and Dow Jones Industrial Index, and deposits linked to a basket of indices. These Structured Time Deposits with Principal Protection, which are also adaptable for the needs of IRAs, continue to enhance the diversification of IDB Bank's deposit mix and accounted for more than one-half of IDB Bank's time deposits at year-end 2004, versus less than one-third at year-end 2003. Investments in these special deposits totaled over US$ 1.7 billion at the end of 2004, a US$ 650 million increase over the previous year's end.

Deposits – The largest part of IDB Bank's deposits, approximately 85%, are from residents of Latin America, namely, South America and Mexico. These depositors invest, principally, in short-term time deposits, step-up time deposits, equity-linked time deposits and time deposits tied to an inverse floating rate offered by a counter party, and to a lesser extent money market accounts. These same depositors vary their investment patterns between deposit based products offered by IDB Bank and investing with IDB Bank's brokerage subsidiary; dependent upon interest rates and maturities vs. opportunities in the bond and equity markets.

International Banking – This department continued in 2004 to expand IDB Bank's relationships with premier global financial institutions and highly rated corporations. In both emerging and non-emerging markets, IDB Bank dealt with financial institutions and corporations consistent with IDB Bank's conservative risk assessment policy and risk-reward criteria. Business was transacted either directly with financial institutions or by purchasing assets in the primary and secondary markets.

Branches – In addition to IDB Bank's head office at 511 Fifth Avenue, IDB Bank maintains 5 full-service branches: on Broadway in midtown Manhattan; in Miami, Aventura and West Palm Beach, Florida (West Palm Beach's closure is imminent, as is the opening of a new business center branch in Boca Raton, Florida); and in Los Angeles, California. There is also a Grand Cayman Island Branch.

PRINCIPAL SUBSIDIARIES OF IDB BANK

IDB Leasing, Inc. – A wholly owned subsidiary of IDB Bank. The portfolio of this subsidiary grew by more than 20% in 2004, as new business increased more than 30%. While IDB Leasing's business is mainly concentrated on the East Coast, the company has achieved a national presence. The quality of the leasing portfolio remains high, consisting of middle market and investment grade businesses, including several Fortune 500 companies. Transactions are with businesses looking to lease equipment and also with other leasing entities looking for a smart source for funding. IDB Leasing discounts all types of leases and installment obligations nationwide. In early 2005, IDB Leasing acquired substantially all the assets of Fleetwood Financial Corporation, a small ticket, vendor-driven lessor located in South Plainfield, New Jersey.

Discount Bank Latin America – IDB Bank's wholly-owned subsidiary in Montevideo, Uruguay.

IDB Capital Corp. – A wholly owned broker-dealer subsidiary of IDB Bank, was established three years ago and continues to be very successful. It has a solid foothold in various fixed income structures and markets but also provides a rich variety of choices for equity investors; for example, principal short-term notes linked to single stocks of varying sectors and markets.

Non-deposit investment products offered through IDB Capital Corp.: U.S. Government Obligations; Corporate Stocks and Bonds; Offshore and Domestic Mutual Funds; Capital Market Instruments.

CONSTRUCTION AND REAL ESTATE SEGMENT

SEGMENT CUSTOMERS

This segment includes customers of the Bank's various divisions whose industry classification is construction and real estate. This segment also includes customers of the construction and real estate segment of the Mercantile Discount Bank and the contractor loans segment of the Discount Mortgage Bank.

SEGMENT DEVELOPMENTS

In 2004, credit facilities made available to eligible borrowers, private individuals, contractors, promoters and others throughout the entire mortgage banking system totaled approximately NIS 22,757 million, as compared to NIS 20,838 million in the previous year, an increase of approximately 9%.

The merger of two of the three leading mortgage banks with their respective parent companies has changed the basis on which industry comparative data can be presented.

The above increase in credit facilities also includes loans repaid to one bank, and then re-lent by another bank (recycling). The large extent of the recycling was due mainly to the reduction in interest rates. In addition, the abolition of stamp duty has reduced the cost of transfer from one apartment to another – a factor that underlines the advantages of recycling. This development carries with it implications with respect to the extent of the life of bank loans, margins, increases in market risks, and the sharpening of competition within the mortgage industry. The Bank has made preparations to deal with the consequences of this phenomenon.

In 2004, loans made available for housing purposes from budgeted government funds (including grants and standing loans) throughout the mortgage bank system totaled NIS 3,143 million, as compared to NIS 4,066 million in 2003, a reduction of approximately 23%. Such loans made available from the banks' own resources totaled NIS 15,917 million in 2004, as compared to NIS 12,177 million in the previous year, an increase of approximately 31%. Total credit facilities for housing purposes made available in 2004 throughout the mortgage bank system as a whole thus amounted to NIS 19,060 million, as compared to NIS 16,243 million in the previous year, an increase of approximately 17%.

Despite the reduction in the Bank of Israel interest rate throughout the year, from a rate of 5.2% at the beginning of the year to a rate of 3.9% at the end of December 2004 (subsequent to a fall in the monetary interest rate from 8.9% to 5.2% in 2003), and despite the fall in long-term interest rates in the debenture market, 2004 saw a reduction of approximately 28% in mortgage redemptions by eligible borrowers in comparison with the extent of such redemptions in 2003. It would appear that this slowdown is connected with the continuing prevailing uncertainty with regard to the pace of economic recovery, as well as to the decision of the government in 2004 to convert housing assistance grants to enhanced loans.

The above notwithstanding, mortgage loans taken out by non-eligible borrowers in 2004 increased by approximately 25% in comparison with 2003. This increase is mainly explained by the fall in interest rates and the increase in the extent of mortgage loan recycling by bank customers.

Residential construction segment. 2004 saw a continuation of the trend towards decreased activity in the residential construction sector and decreasing housing starts. This continuing deceleration in activity stems from restrictions applying simultaneously to both supply and demand. The decrease in demand for housing units, particularly noticeable in peripheral areas, may be attributed to falling disposable incomes of households, to the rise in the rate of unemployment, to a lack of certainty with regard to the economic and security situation, and to the cutbacks in grants to eligible borrowers.

The restrictions on the supply side stem from a shortage of land in the areas of demand due to the slowness of the pace at which land is being released by the Israel Lands Authority; a shortage of qualified construction workers, accompanied with an increase in wages; and a shortage of sources of finance, the latter arising from the selective policy of the banks with regard to the construction projects for which rolling finance is made available.

As a result of the significant increase in the cost of construction inputs, and the effect of demand restrictions on the capacity of contractors to increase prices, contractors' profit margins have suffered a marked decrease. This decrease has prompted some of the big construction companies to transfer their operations overseas, in particular to Eastern and Western Europe.

The slowdown in residential construction operations is especially marked in peripheral areas, whilst in central areas and in specific spots of demand in the peripheral areas, stability and sometimes even improvement has emerged with respect to the sale of residential units – a situation that is also reflected by increases in housing starts and a moderate increase in prices.

The evaluations in the industry are that, in the second half of 2005, an improvement will occur in the sale of residential units in the center of the country and in areas of demand, which will be accompanied by a moderate increase in prices of between 4% and 6%, and by an increase in housing starts. In peripheral areas, the slowdown is expected to continue.

The industry evaluation in relation to the anticipated recovery in demand is supported by the following developments:

- An expected increase in disposable incomes;
- An improvement in the degree of certainty with respect to the economic and security situation;
- A significant increase in the sources of finance made available by the banks for projects;
- A low interest rate applicable to mortgages and a low rate of exchange.

The above discussion includes forward-looking information as well as projections and evaluations as of the date on which these financial statements were prepared. Regulatory changes and external events may lead to the non-realization of the above.

Office and Commerce Segment. Segment operations are divided as between office operations and commerce operations.

Office - 2004 saw a continuation of the slowdown in the scale of operations on account of

the over-supply of properties, especially in the Gush Dan region. Rental rates have stabilized at a level significantly lower than that prevailing in the boom years.
In 2005, another drop in rental rates is expected against the background of a glut of vacant properties. Equilibrium between supply and demand is not expected until 2007.
Commerce - The slowdown in the industry is not so noticeable in this sector since most of the projects were constructed after completion of advance rental agreements for a significant part of the available floor-space. The over-supply of floor-space in this sector is relatively low.
A significant number of the large companies have transferred their operations in the above sectors abroad on account of the relatively high rates of return available on properties overseas, the superior financing arrangements in contrast to those available from banks in Israel, and the potential for capital gains.

LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO SEGMENT

The Bank operates within the framework of laws, regulations and regulatory directives applicable to the banking industry in Israel as promulgated by various supervisory bodies, viz., the Supervisor of Banks, the Commissioner of the Capital Market, Insurance and Savings, the Commissioner of Restrictive Trade Practices, the Securities Authority etc. The principal restrictions applicable to this segment are briefly described below.
The Proper Banking Management Directives contain restrictions with respect to the extent of the indebtedness allowed to a single borrower or group of borrowers, and the extent of the total indebtedness allowed to the bank's six biggest borrower groups and certain customers defined as 'related persons.' These restrictions may have adverse implications on the manner and scope of the Bank's construction and real estate segment operations insofar as they relate to these customers. For details on the amendment of the directives relating to this matter, see above, 'Amendment of the directive relating to restrictions on the indebtedness of a borrower or group of borrowers.'
The Proper Banking Management Directives contain restrictions with respect to the extent of a bank's risk assets in relation to any given level of capital (as defined in the directive). In recent years, this directive affected the Bank's operations and led to the introduction of a restrained credit policy (for further information, see the section below, 'Expanding the Capital Base of the Bank' and Note 14 to the financial statements). An improvement in the Bank's capital adequacy ratio in 2004 may allow the Bank to increase its credit portfolio and finance new ventures.
The Proper Banking Management Directives contain restrictions with respect to the concentration of credit by industry. This situation arises when the credit facilities provided by a bank (including off-balance sheet facilities) to a certain industry (as defined in the directive) at the bank's risk, exceeds 20% of the total credit facilities made available to the public at that bank's risk. The exposure rate with respect to total credit facilities made available to customers of the Bank's construction and real estate segment as of December 31, 2004 was approximately 19.6%.
The Basel Commission has published new guidelines, commonly known as Basel II, which are due to enter into force in certain countries towards the end of 2006. As part of its preparations for meeting the requirements of Basel II, the Bank of Israel has, for the present, provided guidance in relation to the grading of customers (for further details on this matter, and for more general information on the Bank's plans for implementing Basel II, see 'Exposure to Risks and Risks Management').

CREDIT POLICY IN THE REAL ESTATE SECTOR

The Bank's credit policy is based on the following principles:
- The greater part of the credit facilities made available to the real estate sector will be processed through a professional project finance unit;

- Future credit policy will be selective, insofar as preference will be given to the financing of projects which bear a relatively low exposure vis-à-vis the slowdown in the industry;
- The provision of credit facilities for the acquisition of land and/or construction purposes will be conditioned on minimum capital investment rates on the part of the promoters;
- The release of unutilized facilities will be subject to simultaneous compliance with rates of sales and minimum rates of performance.

The preferred areas for granting of credit facilities:

- Construction of low-grade housing projects and more improved housing units in areas of demand;
- Land is available for construction in areas of demand with respect to which the Bank is prepared to provide closed financing for construction projects;
- The provision of credit facilities to real estate companies for the purpose of financing current projects and/or investment projects. Preference will be accorded to large well-established financially sound companies, whose requirements are for medium-term credit for a period of between one and three years.

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

In 2004, the segment's commercial operations were expanded. New lines of credit were extended for the acquisition of land and residential construction projects in areas of demand in accordance with the Bank's policy.

The shortage of land available for construction in areas of demand has intensified the competition between contractors, and the competition between the commercial banks and mortgage banks that engage in the provision of rolling finance.

Despite the continuing economic recession in the industry, the Bank has expanded the scale of its commercial operations vis-à-vis the promoting contractor companies. This situation has arisen as a result of the awakening of demand in the center of the country and in specific spots in peripheral areas and in anticipation of a further improvement in the situation during the course of 2005.

In 2004, the Bank approved new lines of credit for the acquisition of land and residential construction projects to the extent of approximately 1,250 dwelling units. The greater part of the new facilities was directed towards new customers with financial resources and experience in the industry, who were undertaking medium-sized operations. It is expected that the greater part of the above facilities will be utilized during the course of 2005.

In addition, the Bank expanded its commercial operations by extending new lines of credit for the financing of current and investment projects in accordance with its credit policy.

The loss this segment incurred in 2004 amounted to NIS 96 million.

The return on equity in 2004, calculated on the capital allocated to the segment on the basis of the average balance of segment risk assets, was (6.4%).

In accordance with the directive of the Supervisor of Banks, the segment has been charged with expenses relating to the encouragement of early retirement of segment employees who have retired, and of staff members at various levels whose salaries are attributed to the segment. Disregarding these expenses, segment's net income would amount to NIS (94) million and the return on equity would have been (6.2)%.

Provision for doubtful debts in this segment amounted to NIS 326 million in 2004, and was significantly affected by the increase in the provision made by Discount Mortgage Bank for this segment.

During the course of 2004, in view of the continued crisis in the real estate market, the additional slowdown in both the private housing and commercial property markets, the continued slowdown in the economic activity, and the many problematic debts owing to Discount Mortgage Bank from the 1990's, Discount Mortgage Bank conducted an in-depth survey and examination of all problematic debts in all segments of activity of this bank. Dozens of new appraisals were made during the course of the review; collateral was reviewed

from a legal, economic and taxation viewpoint, as was also the status of borrowers and their guarantors. In addition, the classification of all the problematic debts was re-examined.
By the final quarter of 2004, the greater part of the reviews carried out by Discount Mortgage Bank had been completed. The outcome of the completed reviews was incorporated within the specific provision for problematic debts for 2004 (see below, 'Discount Mortgage Bank Ltd.).
As stated above, it was only in 2004 that the Bank's information system for the management of its segment profit centers reached the degree of development required to permit the presentation of data relating to the operations of the Discount Group by segment. Accordingly, the Bank is unable to present comparative data for 2003, and analyses and explanations with respect to changes that occurred in the data for 2004 in comparison with that for 2003.

Following are the principal data relating to the operations of the construction and real estate segment in 2004:

	In NIS millions	As percentage of Group total
Income from financing activities before provision for doubtful debts	179	5.1
Operating and other income	26	1.2
Total income	205	3.6
Provision for doubtful debts	326	37.1
Operating and other expenses	74	1.9
Income from ordinary operations before taxes	(195)	(24.5)
Loss	(96)	(17.3)
Return on equity	(6.4%)	
Average balance of liabilities	1,876	1.4
Average balance of assets	9,708	6.8

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 196, including positions of employees directly related to the segment and positions of staff members at various levels whose employment costs are charged to the segment.

SERVICE TO SEGMENT CUSTOMERS

The Bank's project financing department services companies engaged in real estate and construction, and continually monitoring credit utilization in accordance with the construction progress of the project.
Deepening the current communication with segment customers is carried out by providing them with information packets several times a year, which include up to date banking information as well as an attractive set of offers, tailored to the needs of business people and companies.
For further information relating to services provided to segment customers, see above, 'Corporate segment.'
Discount Mortgage Bank offers its services to customers through its three branches (in Tel Aviv, Jerusalem and Haifa), as well as through thirty-six mortgage bank counters located in various branches of Israel Discount Bank Ltd.
Mercantile Discount Bank offers services to segment customers through several designated specialist branches under the supervision of this bank's mortgage and project financing division.

ORGANIZATIONAL CHANGES AT DISCOUNT MORTGAGE BANK

Discount Mortgage Bank is currently implementing changes to its organizational structure. In the current structure, there are two separate marketing and credit departments, which service respectively the business segment and the retail (mortgage) segment. Under the new structure, there will be a retail department specializing in marketing and sales, and a business department specializing in credit management.

MORTGAGE AND HOUSING LOAN SEGMENT

SEGMENT CUSTOMERS

This segment includes the mortgage operations of the Discount Group in Israel (Mercantile Discount Bank and Discount Mortgage Bank). At this stage, housing loans made by the Bank are excluded. This segment includes the granting of loans for housing purposes (purchase, construction etc.) and the granting of business loans and loans for any purpose secured by a mortgage on a residential apartment or other property.

SECTORS OF OPERATION OF THE SEGMENT

Loans for housing purposes. This sector covers loans designated for the purchase of apartments. This is the segment's principal field of activity.

Loans for housing purposes by reference to degree of repayment. Discount Mortgage Bank extends loans for housing purposes by reference to the degree of repayment on behalf of the Office of the Accountant-General in the Ministry of Finance. The total of such loans is approximately NIS 2,307 million, for which this bank receives a collection commission, which totaled approximately NIS 17 million in 2004.

On July 1, 2004, a new agreement between Discount Mortgage Bank and the Office of the Accountant-General in the Ministry of Finance came into effect. The agreement has been made for a period of two years and deals with the granting of loans and the provision of other services to eligible borrowers. Under the agreement, the bank will receive a collection commission at a rate of up to 1.08%, instead of up to 2.47% as hitherto, with respect to new loans granted as of July 1, 2004. In the coming years, the reduction in the rate of commission will lead to a gradual reduction in the bank's income from this source.

Insurance. Discount Mortgage Bank markets life assurance and property insurance to its customers. These policies provide an additional source of security for the repayment of the mortgage loan.

On February 20, 2005, the Supervisor of Banks published a circular relating to the marketing of life assurance and property insurance policies in connection with loans taken out for housing purposes. The circular was accompanied by a joint policy declaration of the Supervisor of Banks and the Supervisor of Insurance dated February 17, 2005, which prescribes the principles for marketing life assurance and property insurance as policies by a banking corporation as security for the repayment of a housing bank loan.

According to the policy declaration, which is expected to be anchored in legislation and Bank of Israel directives, the above insurance policies will be marketed at unmanned sales points operated by technological means that will be separated from all other banking activities. The policies will be sold through an authorized insurance agent acting as an authorized insurance agency, whose business is quite distinct from that of the Bank, by employees of the agency who are not employees of the Bank.

A banking corporation shall be entitled to possess full ownership of the insurance agency, whose business shall be limited to the insurance policies referred to above. The agency shall have a computer system at its disposal, access to which shall be available only to agency employees. It shall be forbidden to use the information obtained by the insurance agency for any purpose other than that for which the agency was established. Collection of the premiums on the insurance policies shall be made separately from those of the loan.

Any bank interested in receiving a permit to control an insurance agency for the aforementioned activities should apply to the Supervisor of Banks.

In the above circular, the Supervisor of Banks have clarified that, as of October 1, 2005, a banking corporation shall not market insurance policies except in accordance with the procedures described in the circular. The above notwithstanding, an insurance policy entered upon before October 1, in accordance with the previous arrangements, may be continued or renewed.

The restrictions imposed by the Supervisor's circular will, as of 2005, reduce the income of the segment from property insurance and life assurance. It should be noted that the greater part of this segment's operating income stems from commission received in relation to building insurance and life assurance policies.

For further information, see Note 19 C 15.4 and 17 to the financial statements.

Loans granted on security of residential apartment. Loans granted for any purpose are secured by means of a mortgage on a residential apartment.

MORTGAGE DEPARTMENT – SOURCES AND APPLICATIONS

In 2004, credit facilities made available to eligible borrowers, private individuals, contractors, promoters and others throughout the entire mortgage bank system totaled approximately NIS 22,757 million, as compared to NIS 20,838 million in the previous year, an increase of approximately 9%.

The merger of two of the three leading mortgage banks with their respective parent companies has changed the basis on which industry comparative data can be presented.

The above increase in credit facilities also includes loans repaid to one bank, and then re-lent by another bank (recycling). The large extent of the recycling was due mainly to the reduction in interest rates. In addition, the abolition of stamp duty has reduced the cost of transfer from one apartment to another – a factor that underlines the advantages of recycling. This development affects the life of bank loans, margins, increases in market risks, and the sharpening of competition within the mortgage industry. Discount Mortgage Bank has made preparations to deal with the consequences of this phenomenon.

In 2004, loans made available for housing purposes from budgeted Government funds (including grants and standing loans) throughout the mortgage bank system totaled NIS 3,143 million, as compared to NIS 4,066 million in 2003, a reduction of approximately 23%. Such loans made available from the banks' own resources totaled NIS 15,917 million in 2004, as compared to NIS 12,177 million in the previous year, an increase of approximately 31%. Total credit facilities for housing purposes made available in 2004 throughout the mortgage bank system as a whole thus amounted to NIS 19,060 million, as compared to NIS 16,243 million in the previous year, an increase of approximately 17%.

Despite the reduction in the Bank of Israel interest rate throughout the year, from a rate of 5.2% at the beginning of the year to a rate of 3.9% at the end of December 2004 (subsequent to a fall in the monetary interest rate from 8.9% to 5.2% in 2003), and despite also the fall in long-term interest rates in the bond market, 2004 saw a reduction of approximately 28% in mortgage redemptions by eligible borrowers in comparison with the extent of such redemptions in 2003. It would appear that this slowdown is connected with the continuing prevailing uncertainty with regard to the pace of economic recovery, as well as to the decision of the government in 2004 to convert housing assistance grants to enhanced loans.

The above notwithstanding, mortgage loans taken out by non-eligible borrowers in 2004 increased by approximately 25% in comparison with 2003. This increase is mainly explained by the fall in interest rates and the increase in the extent of mortgage loan recycling by bank customers.

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

Net income of the segment in 2004 amounted to NIS 12 million.

The return on equity in 2004, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 1.8%.

Provision for doubtful debts in this segment amounted to NIS 78 million. In 2004, the provision was significantly affected by the increase in the provision made by Discount Mortgage Bank for this segment.

During the course of 2004, in view of the continuing crisis in the real estate market, the additional slowdown in both the private housing and commercial real estate markets, the continuing slowdown in the economic activity, and the many problematic debts owing to Discount Mortgage Bank from the 1990s, Discount Mortgage Bank conducted an in-depth survey and examination of all problematic debts in all segments of activity of this bank. Dozens of new appraisals were made during the course of the review; collateral was reviewed from a legal, economic and taxation viewpoint, as was also the status of borrowers and their guarantors. In addition, the classification of all the problematic debts was re-examined.

By the final quarter of 2004, the greater part of the reviews carried out by Discount Mortgage Bank had been completed. The outcome of the completed reviews was incorporated within the specific provision for problematic debts for 2004 (see below, 'Discount Mortgage Bank Ltd.).

In view of the fact that the data for this segment includes data relating to the corresponding segments of Discount Mortgage Bank and Mercantile Discount Bank, comparative data for 2003 is, exceptionally, presented hereunder.

Following are the principal data relating to the operations of the mortgage and housing loan segment in 2003 and 2004:

	2004		2003
	millions	of Group total	millions
Income from financing activities before provision for doubtful debts	125	3.6	104
Operating and other income	57	2.6	60
Total income	182	3.2	164
Provision for doubtful debts	78	8.9	29
Operating and other expenses	65	1.6	62
Income from ordinary operations before taxes	39	4.9	73
Net income	12	2.1	42
Return on equity	1.8%		6.6%
Average balance of liabilities	2,298	1.7	2,362
Average balance of assets	9,850	6.9	9,548

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 225, including positions of employees directly related to the segment and positions of staff members at various levels whose employment costs are charged to the segment.

NEW PRODUCTS

Discount Mortgage Bank offers its customers a wide range of mortgage products. New products are added to the range from time to time in accordance with the changing requirements of customers.

In 2004, Discount Mortgage Bank brought out two new products, 'the accommodating mortgage' and 'recycling of mortgages.'
The "accommodating mortgage" allows the customer to select the option of linkage to the Consumer Price Index with interest at a known and predetermined rate – relatively low in the initial period and higher in the second period. This product meets the requirements of customers who have been hurt by the harsh economic climate, but who expect to enjoy an improvement in their income in the future.

COMPETITION

Operations in the mortgage banking industry are carried out by specialist mortgage banks, commercial banks and insurance companies.
The specialist mortgage banks operating today are Bank Leumi Mortgage Bank, the First International Mortgage Bank (incorporating Bank Atzma'ut), the Bank of Jerusalem (which is also a commercial bank), Bank Adanim and Discount Mortgage Bank. Recently, two other mortgage banks, Tefachot and Mishkan, merged with their respective parent companies, the United Mizrachi Bank and Bank Hapoalim.
The competition between banks is principally reflected through the rates of interest charged on loans.

GOALS AND BUSINESS PHILOSOPHY – DISCOUNT MORTGAGE BANK

The bank intends to continue operating in the same sectors in which it has previously operated, whilst moving its center of gravity in the direction of retail operations, and continuing the 'recycling of mortgages' campaign, which is offered to customers of all the banks.
In the first quarter of 2005, in accordance with the joint policy determined by the Supervisor of Banks and the Supervisor of Insurance (see above), Discount Mortgage Bank set up a subsidiary to act as an insurance agency.

ORGANIZATIONAL CHANGES AT DISCOUNT MORTGAGE BANK

Discount Mortgage Bank is currently implementing changes to its organizational structure. In the current structure, there are two separate marketing and credit departments, which service respectively the business segment and the retail segment. Under the new structure, there will be a retail department specializing in marketing and sales, and a business department specializing in credit management.

GOALS AND BUSINESS PHILOSOPHY – MERCANTILE DISCOUNT BANK

Under its business plan for 2005, Mercantile Discount Bank will act to continue the growth in its mortgage operations.

CREDIT CARD OPERATIONS SEGMENT

SEGMENT DEFINITION

This segment includes the credit card operations of the Bank's customers, and includes credit-financing income from transactions carried out by credit card and various commissions relating to credit card activity. The operations are principally conducted through Israel Credit Cards Ltd.

GENERAL INFORMATION ON SEGMENT OPERATIONS

The income of Israel Credit Cards Ltd. increased by 30% in 2004, from NIS 73 million in 2003 to NIS 95 million in 2004. The increase in income was mainly attributable to an increase of approximately 10% in credit cards issued (mainly due to the end of the recession and the increasing use being made of credit cards), and to higher credit balances. As against this

favorable trend, the commission charged by credit card issuers to businesses (the cross commission) has decreased from 1.25% to 1.21% and affected the profitability of the company.
The company's operations are concentrated in two particular areas, **issuing** and **clearing**. With regard to the company's issuing operations, credit facilities are made available to its customers.

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

Net income of the segment in 2004 amounted to NIS 47 million.
The return on equity in 2004, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 23.1%.
In accordance with the directive of the Supervisor of Banks, the segment has been charged with expenses relating to the encouragement of early retirement of segment employees who have retired, and of staff members at various levels whose salaries are attributed to the segment. Disregarding these expenses, segment's net income would amount to NIS 48 million and the return on equity would have been 23.8%.
Provision for doubtful debts in this segment amounted to NIS 8 million.
As stated above, it was only in 2004 that the Bank's information system for the management of its segment profit centers reached the degree of development and implementation required to permit the presentation of data relating to the operations of the Discount Group by segments. Accordingly, the Bank is unable to present comparative data for 2003, and analyses and explanations with respect to changes that occurred in the data for 2004 in comparison with that for 2003.

Following are the principal data relating to the operations of the credit card segment in 2004:

	In NIS millions	As percentage of Group total
Income from financing activities before provision for doubtful debts	82	2.3
Operating and other income	531	24.1
Total income	613	10.8
Provision for doubtful debts	8	0.9
Operating and other expenses	419	10.4
Income from ordinary operations before taxes	186	23.4
Net income	47	8.5
Return on equity	23.1%	
Average balance of liabilities	760	0.6
Average balance of assets	1,604	1.1

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 968, including positions of employees directly related to the segment and positions of staff members at various levels whose employment costs are charged to the segment.

REGULATIONS, LEGISLATION AND ARRANGEMENTS

Commissioner of Restrictive Trade Practices. The company is in contact with the Commissioner of Restrictive Trade Practices with respect to the structure of competition and the entry of MasterCard into this competitive market (for further information, see Note 34 B to the financial statements).
Supervisor of Banks. The Supervisor of Banks recently issued Proper Banking Management Directive No. 470, the purpose of which is regulating the charge card operations of credit

card companies. ICC does not believe that the directive will have any material effect on the results of its operations.

CRITICAL SUCCESS FACTORS

- The existence of recruiting platforms: banks and customer clubs (direct recruiting);
- Intelligent management of the credit field, risk management;
- The existence of sophisticated, customized computer systems.

OBSTACLES TO MARKET ENTRY

The principal obstacle to market entry is the existence of a solid, credible information system for billing management. In addition, the existence of a critical mass of customers recruited at the various recruiting platforms is crucial for success.

ALTERNATIVE PRODUCTS

The most readily available alternative products to those of ICC are checks and cash. With the growth in credit transactions, the most appropriate alternative product to credit cards is bank credit.

NEW PRODUCTS

A new product recently launched by ICC is the 'designer card'. The product allows the customer to select the design of his card from a range of one hundred different designs. This is an innovative and groundbreaking product designed to reinforce the image of the company in the eyes of the customer.

CUSTOMERS

The company's customers are mostly customers of the recruiting banks. In view of this fact, certain dependence exists in the relationship between ICC and the banks.

MARKETING AND DISTRIBUTION

Two avenues of distribution and marketing are open to the company: distribution through the banks to which the company is tied through a series of arrangements, and direct distribution through customer clubs (e.g., PowerCard, H&O etc.).
The reduction of the share of the banks with whom ICC is tied by a number of issuing agreements (especially the owner-banks), in the retail sector will have a direct influence on the company.

COMPETITION

In the issuing field, the company is in competition with the other credit card companies, which also initiate approaches to the banks' customers. In the clearing field, the company is in competition with LeumiCard, operating under the 'Visa' brand name.
At the present time, there are two other credit card companies operating in Israel in direct competition with ICC. Both of the competitors are wholly owned by banks:

- IsraCard Ltd., wholly owned by Bank Hapoalim, is the exclusive issuer and acquirer of the IsraCard, MasterCard and American Express credit cards. As of the end of 2004, the estimated market share of IsraCard was 48%.
- LeumiCard Ltd., wholly owned by Bank Leumi Ltd., issues and clears Visa credit cards, and, to a limited degree, also issues MasterCard credit cards. As of the end of 2004, the estimated market share of LeumiCard was 25%.

ICC issues and clears Visa and Diner's Club credit cards. The company has exclusive rights to the issuing and clearing of Diner's Club credit cards. In addition, the company issues MasterCard credit cards to a limited degree. As of the end of 2004, the estimated market share of ICC Ltd. was 27%.

SEASONAL FACTORS

The company's operations are affected by certain seasonal factors related to patterns of consumption; in the periods immediately prior to religious festivals and during the summer months, the company experiences an increase in its operations.

GOALS AND STRATEGY

ICC has adopted the goal of continuing to work for the development of the provision of consumer credit.

EXPECTATIONS FOR DEVELOPMENT IN THE COMING YEAR

ICC expects to capture a further increase (7%-8%) of the credit card market, whilst viewing the intensification of the competition from the independent issuers (with the approaches to customers of all bank), and the competition in clearing operations.
This discussion includes forward-looking information, which is based on the best evaluations of the Bank and ICC as of the date of these financial statements. Changes in the a priori assumptions may lead a reduction in the above debt.

CAPITAL MARKET SEGMENT

SEGMENT DEFINITION

This segment includes securities activity (excluding activity for the Bank's own account), portfolio management, mutual funds, supplementary training funds, provident funds and severance pay funds. The segment includes the activity of the Bank's securities and capital market departments, as well as the operations of specialized subsidiaries: Tachlit, Ilanot Discount, Discount Management of Provident Fund and Kahal. In addition, the segment includes the equivalent segment of Mercantile Discount Bank.

OPERATIONAL STRUCTURE OF SEGMENT

The Asset Management Division of the Bank, which is responsible for the operations of the segment, is comprised of the following units and investee companies:

- Securities department;
- Capital market department;
- Tachlit Discount – Investment Counseling Management Co. (subsidiary);
- Discount Management of Provident Fund (subsidiary);
- Ilanot Discount (subsidiary);
- Discount Trust (subsidiary) (the operations of this company are included in the financial management segment);
- Kahal – Employee's Supplementary Training Fund Ltd. (affiliated company).

TREND OF EVENTS AND DEVELOPMENTS IN THE MACRO-ECONOMIC ENVIRONMENT

Non-financial activity. Expectations for 2005 include an increase in disposable incomes stemming from an increase in the real-term wage, a decrease in the rate of unemployment, and a decrease in tax rates. The increase in disposable incomes, supported by low real interest rates, is expected to lead to continuing transfers of funds to the capital market.
Nominal environment. The expected devaluation in 2005 is estimated at 2.5% on account of the contracting interest gap, the comparison of tax rates and the increase in the current account deficit. Inflation is estimated at 2.5%. It is estimated that interest rates will rise to a level of about 5.5%, i.e., that real short-term interest rates will rise to about 3%.
Intensifying investment operations of overseas entities. The maintaining of a consistent restrained economic policy combined with a stable security situation will lead, it is felt, to increased investment activity in Israel on the part of overseas entities, whether this be through the capital market or through the making of non-financial investments (It may be

that, as a result of the stability described above, there may even be a move to improve the credit rating of Israel).

Increase in returns on bonds. It is felt that the increase in U.S. interest rates will lead to an increase in returns on bonds to a level of 5.5% (shekel interest). The return on linked bonds for similar maturity periods will rise to a level of approximately 4.5%.

Comparison of tax rates. The reduction of tax rates from 35% to 15% on capital gains flowing from the disposal of foreign securities will lead, it is felt, to a gradual transfer of investments to overseas markets (shares and bonds).

Possible implications of the above on investment policies of customers:

- Transfer of investments in shares and bonds to overseas markets;
- Investment in foreign bonds in the wake of expectations of an increase in dollar interest rates;
- Transfer of funds towards the share market;
- Expansion of investment in basket certificates on account of mutual funds.

This discussion constitutes forward-looking information, which is based on the best evaluations of the Bank and its segment subsidiaries as of the date that these financial statements were prepared. There can be no certainty that the above predictions will indeed be realized.

LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SEGMENT

The main restrictions that are expected to affect segment operations are those that will be applied to banks under the recommendations of the Bachar Committee. For further information relating to Government decisions concerning provident funds and proposed legislation concerning ownership of provident funds, and the Bachar Committee recommendations concerning changes in the structure of the capital market, including the question of relations of ownership and control as between the banks and the companies managing provident and mutual funds, see 'Government decisions concerning the banking industry and proposed changes in the structure of the capital market' and Note 33 to the financial statements.

It should be noted that, as part of the Bank's experiment to introduce innovative procedures for improvement of service and for improvement of the market, steps had been taken towards the signing of distribution agreements with the managers of various funds. In light of the recommendations of the Bachar Committee, it has been decided, at this stage, that the agreements should be suspended.

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

Net income of the segment in 2004 amounted to NIS 87 million.

The return on equity, which is calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, cannot be calculated, because no risk assets were allocated to this segment.

In accordance with the directive of the Supervisor of Banks, the segment has been charged with expenses relating to the encouragement of early retirement of segment employees who have retired, and of staff members at various levels whose salaries are attributed to the segment. Disregarding these expenses, segment's net income would amount to NIS 94 million.

As stated above, it was only in 2004 that the Bank's information system for the management of its segment profit centers reached the degree of development and implementation required to permit the presentation of data relating to the operations of the Discount Group by segment. Accordingly, the Bank is unable to present comparative data for 2003, and analyses and explanations with respect to changes that occurred in the data for 2004 in comparison with that for 2003.

Following are the principal data relating to the operations of the capital market segment in 2004:

	In NIS millions	As percentage of Group total
Income from financing activities before provision for doubtful debts	17	0.5
Operating and other income	485	22.0
Total income	502	8.8
Provision for doubtful debts	-	-
Operating and other expenses	330	8.2
Income from ordinary operations before taxes	172	21.6
Net income	87	15.6
Return on equity	-	
Average balance of liabilities	8	-
Average balance of assets	47	-

DATA RELATING TO THE SCALE OF OPERATIONS IN DIFFERENT AREAS:

Investment portfolio management. On December 31, 2004, Tachlit was managing 1,368 investment portfolios, which together were valued at approximately NIS 1,640 million, as compared to 957 portfolios valued in total at approximately NIS 1,116 million as at December 31, 2003. The above data point to an increase of 42.95% in the number of portfolios managed and to an increase of approximately 47% in the monetary value of the managed portfolios.

In addition, Mercantile Discount Bank, through a subsidiary of that bank, manages investment portfolios for its customers. On December 31, 2004, the total monetary value of managed portfolios was approximately NIS 602 million, an increase of approximately 17% in comparison with the situation as at December 31, 2003.

Mutual fund management. On December 31, 2004, Ilanot Discount was managing 59 mutual funds, as compared to 53 such funds as at the end of 2003. As of the end of 2004, the total value of mutual funds managed amounted to approximately NIS 12.3 billion, as compared to approximately NIS 10.2 billion as of the end of the previous year, an increase of approximately 20%. The share of Ilanot Discount in the mutual fund industry fell from approximately 12.3% as of the end of 2003 to 12.1%as at December 31, 2004.

Provident funds. As of December 31, 2004, the total value of provident fund assets amounted to NIS 16.2 billion, as compared to NIS 15.2 billion as of December 31, 2003, an increase of approximately 6.9%.

The number of provident fund accounts as of the end of 2004 was approximately 557,000, as compared to 572,000 as of the end of 2003, a decrease of approximately 2.6%.

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

- Three funds for the self-employed and salaried employees – “Tamar”, “Gefen”, and “Rothschild-Discount Overseas”. “Rothschild-Discount Overseas” is a new fund that commenced operations at the end of December 2004, and invests its funds overseas;
- Two funds for the self-employed 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 severance pay fund – “Hadas”;
- A multi-channel provident fund – “Eshkolot”, for both the self-employed and salaried employees alike.

The real-term returns achieved by these provident funds in 2004 were as follows: “Tamar” –

8.32%, "Gefen" – 8.34%, "Shikma" – 7.96%, "general severance pay fund" – 8.12%, "Toar" – 8.71%.

"Hadas" affords a unique investment track for each employer, and accordingly, it is not possible to publish a return for this fund.

The multi-channel provident fund, "Eshkolot", achieved positive returns on all its investment tracks at rates ranging between 3.12% and 15.70%, with the single exception of the foreign currency track, for which a negative real return of 0.34% was recorded.

Employees' Supplementary training funds. "Kahal" – Employees' Supplementary Training Fund Ltd. and "Kahal Maslulim" are jointly held by the Bank and Bank Leumi Le-Israel Ltd. In addition, Mercantile Discount Bank manages, both directly and through its subsidiary, eight additional provident funds, including severance pay funds and an supplementary training fund. As of December 31, 2004, total fund assets amounted to approximately NIS 3.1 billion, as compared to approximately NIS 2.8 billion as of the end of 2003, an increase of 11.1%. The number of members was approximately 115,000, an increase of approximately 2.0% in comparison with the number of members as of December 31, 2003.

HUMAN CAPITAL

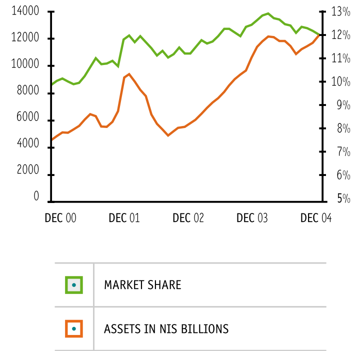
In 2004, the average number of positions in the segment amounted to 602, including positions of employees directly related to the segment and positions of staff members at various levels whose employment costs are charged to the segment.

SEGMENT DEVELOPMENTS

During the course of 2004, all the units operating within the segment were required to implement efficiency and specialization measures. These measures were required in order to ensure that staff were capable of meeting the competitive challenges in the capital market (changes with respect to personnel, computerization and perception).

- In the securities department, organizational changes and professionalism were implemented, including setting up a consulting department for the purpose of establishing an expert unit on the subject of securities, which could support the Bank's array of investment advisors. Improvements were also made to the computer system, and an Internet site was set up.
- At Discount Management of Provident Fund Ltd., organizational changes were made, efficiency measures were implemented, and an agreement was signed for the purchase of a new computer system for the management of members' accounts. At the end of the year, a new fund, "Rothschild-Discount Overseas", was set up. This fund invests its resources in overseas markets, as part of the plan to transfer investment moneys overseas in the wake of the equalization of tax rates applicable to foreign securities.
- At Ilanot Discount Ltd. (mutual funds), personnel changes were made to company management. In addition, prior to the impending equalization of tax rates on foreign securities, two new funds – Templeton Global Fund and a corporate bond fund, were set up, and the number of units in the Ma'of Strategy Fund was increased.
- At Kahal Employees' Supplementary Training Funds Ltd., personnel changes were made to company management.
- At Tachlit, the procedure commenced whereby the company intends to change its status from that of a portfolio management company to that of an investment house. The company also issued basket certificates and debt certificates.
- At Discount Trust Ltd., a managing director was appointed and a focused procedure was adopted in order to lead to an expansion of operations.
- The capital market business department has concentrated on the implementation of transactions involving complex and innovative financial products, a significant increase in operations involving brokerage and securities lending, and an intensive customer recruitment campaign.

ASSET VALUE AND MARKET SHARE OF ILANOT DISCOUNT 2000-2004



ANTICIPATED DEVELOPMENTS IN SEGMENT MARKETS

Mutual fund market

- Overseas developments (connections with investment houses, overseas investment products, overseas funds for investment in Israel, taxation of globalization, F.O.F).
- New instruments in new and innovative niches (real estate funds, special bonds, hedge funds, etc).
- Increasing rates of turnover influenced by two parallel processes, viz., domestic interest rates remain relatively low, a fact that drives the public to the market; and globalization accompanied by political stability makes investing in Israel an acceptable proposition for foreign investors.
- The public and the capital market – it is reasonable to assume that the processes that influenced the U.S. market in the past will also influence the market in Israel. The most important of these is the transparency and openness of the capital market to the public, both from the standpoint of the products and from the standpoint of the marketing specialists/managers. As a result of these processes, it may be expected that the public will increase its holdings in liquid and negotiable assets.
- Mutual funds – in tandem with the increasing interest of the public in the products of the capital market, it is forecast that the public's portfolios will contain an increasing quantity of fund assets, as these assets constitute the most convenient and accessible investment tools for entry into the capital market. The funds would contact fund managers and investment managers overseas, the mutual funds would improve, portfolio management would find a place within mutual funds, and this would be an answer to basket certificates (ETF), which compete with index funds.

This discussion constitutes forward-looking information, which is based on the evaluations and plans of the Bank and its subsidiaries as of the date on which these financial statements were prepared. Changes in the capital markets and other factors may lead to changes in public taste, which would, in turn, lead to the non- realization of the above evaluation.

NEW PRODUCTS

Basket certificates. In July 2004, Tachlit Dollar Worldwide issued debt certificates rated by Ma'alot at AAA rating. Tachlit Dollar Worldwide is a company owned jointly by Tachlit Discount and Synergatica, a company belonging to the Michael Davis Group.
Tachlit TA 100 and Tachlit TA 25 basket certificates have been issued by Tachlit Index, a company owned jointly by Tachlit Discount and Synergetics, a company belonging to the Michael Davis Group.

New mutual funds:

- Templeton Global Fund – a fund composed of foreign shares, and managed by Templeton Ltd;
- Global Shares Fund – a fund composed of shares, and managed by Templeton Ltd;
- Strategic Shekel Fund – a shekel-denominated fund, and managed by Gidurim Ltd. The fund operates in the derivatives market through various commercial strategies;
- "Pamach Liquid" – a dollar-denominated fund.

New provident fund – Edmond de Rothschild-Discount Overseas – a provident fund, in partnership with, and under the management of the Edmond de Rothschild Investment House, which is situated overseas. The fund invests in a variety of spheres in overseas markets.

MARKETING AND DISTRIBUTION

The distribution of products and services is undertaken by segment employees through the use of the Bank's existing distribution apparatus, the branch network, investment centers,

private banking centers, staff units and the Bank's subsidiary companies.
Although there is no inter-dependency within the marketing channels, attention should be drawn, in this connection, to the restrictions that are expected to apply if and when the recommendations of the Bachar Committee are implemented (see 'Government decisions concerning the banking industry and proposed changes in the structure of the capital market' and Note 33 to the financial statements).

Competition

The competition in this segment of operations is concentrated in two markets – the mutual funds market and the provident funds market.
These markets are today characterized by the fact that they are controlled by the banks. Nonetheless, the trend that began in 2003, to transfer funds from the bank-controlled provident and mutual funds to private bodies, gathered momentum in 2004 and is still continuing with little abatement today. In consequence of this trend, the Bank's share of these markets has declined.

Market share data regarding mutual and provident funds

Provident funds. As of January 2005, the total net funds accumulated in the provident funds and the supplemental training funds amounted to approximately NIS 178 million. This sum was distributed as follows: 41% was recorded in the private funds, 35% was recorded with other bodies (sectorial and enterprise funds), and approximately 13% was recorded with the funds controlled by the banks.

Following is the total assets held by the funds, published as of February 17, 2005 (in NIS billions):

Controlling entity*	Total assets	Rate
Banking corporations	150.0	71.0%
Private entities	9.0	4.2%
Pension funds	3.7	1.7%
Insurance companies	1.9	Negligible
Other entities	46.3	21.8%
Total	211.5	100.0%

* Source – the Ministry of Finance

The provident funds of Discount Bank comprise approximately17.3% of all the bank-controlled provident funds, and approximately 12.3% of all the provident funds. The competing provident funds are the funds controlled by the four other major banks.

Mutual funds. The beginning of 2005 was again marked by the gathering trend of reducing market share of the banks in favor of private brokers. The market share of the private brokers rose to approximately 16.7% of all the funds.
The mutual funds of Ilanot Discount comprises approximately 11.6% of all the funds, and approximately 12.1% of the bank-controlled funds.

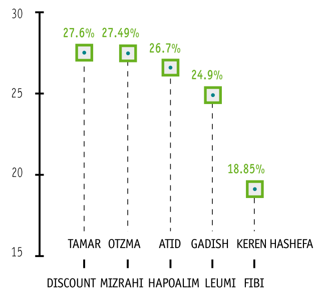
Following are the present market share, data as has been received from Meitav Ltd.:

Controlling entity	Market share forFebruary 2005
Bank Hapoalim Group	33.6%
Bank Leumi Le-Israel Group	28.3%
Israel Discount Bank Group	12.1%
United Mizrachi Bank	4.4%
First International Bank	3.7%
Union Bank of Israel	0.7%
Investec and Bank of Jerusalem	0.5%
Private fund managers (*)	16.7%

(*) The funds with market share in excess of 2% are: "Afikim", "Analist", "Meitav" and "Betucha".

YIELDS IN REAL TERMS AMONG THE LARGEST PROVIDENT FUNDS

ACCUMULATED YIELDS IN 2000-2004



MEETING THE COMPETITION

The competition is being met on two different plains, as under:

A. Empirical improvement of the results achieved by the various funds by upgrading human and technological resources

B. Formation of an intelligent market in which objectively good products are distributed by the maximum number of distributors.

GOALS AND BUSINESS STRATEGY

- Developing the Bank's retail business, whilst seeing the client at the center, including the construction of a procedure for the development of new products, reviewing the public response to products both in Israel and abroad, and examining the manner in which those products were launched by the Bank
- Preparing for the implementation of the recommendations of the Bachar Committee;
- Preparing for operations of Bank as a 'supermarket of financial products';
- Preparing for the expected changes in operations in the wake of the equalization of tax rates on foreign securities, including fostering cooperation with overseas investment houses, acquiring specialization in foreign securities, improving presentation techniques vis-à-vis overseas brokers and developing specific relevant computer aids;
- Preparing the Division for the pension fund reforms – reducing the designated bonds component from 70% to 30% including persuading pension funds to become customers of the Bank, providing professional and competitive brokerage services and developing sophisticated products;
- Developing cooperation with entities providing pension consulting so as to enable the Bank to dispense comprehensive counseling to customers in all areas of investment and saving, both in the field of financial assets and in the field of pension assets;
- Developing operations for arbitrage players and capital market players, including the improvement of the computer system and adjusting the credit model for these customers;
- Forming a subsidiary of Tachlit for mutual fund management purposes, as part of the procedures for transforming the operations of Tachlit to those of an investment house.

This discussion constitutes forward-looking information, which is based on the evaluations and plans of the Bank as of the date on which these financial statements were prepared. These evaluations may change in the light of changes in market conditions, commercial opportunities, regulatory restrictions etc.

NON-FINANCIAL COMPANIES SEGMENT

SEGMENT DEFINITION

This segment includes the Group's operations with respect to non-financial investments. The greater part of the segment's operations relate to investments of the Bank in Harel Ltd., and investments undertaken by a subsidiary, Israel Discount Capital Markets and Investments Ltd. (hereinafter: "DCMI"), as well as direct investments by the Bank itself.

LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SEGMENT

The Bank operates within the framework of laws, regulations and regulatory directives applicable to the banking sector in Israel as promulgated by various supervisory bodies, viz., the Supervisor of Banks, the Commissioner of the Capital Market, Insurance and Savings, the Commissioner of Restrictive Trade Practices, the Securities Authority etc. The principal restrictions applicable to this segment are briefly described hereunder.

Section 23 A of the Banking (Licensing) Law, specifies that the amount of any means of control held by a banking corporation in non-financial corporations shall not exceed the following proportions of the capital of the banking corporation, as shall be determined for this purpose in rules prescribed by the Governor, after consultation with the Advisory Committee and with the approval of the Minister of Finance –

(1) Up to fifteen per cent of its capital – in any non-financial corporation;

(2) Up to a further five per cent of its capital – provided that it does not hold in corporation more than five per cent of a certain class of means of control and it is not entitled to appoint a director;

(3) Up to a further five per cent of its capital – in non-financial corporations which are foreign corporations that do not conduct any material and continuing business operations in Israel.

As of December 31, 2004, the amount of the Bank's investment in non-financial corporations was considerably less than the amount of the above restriction.

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

Net income of the segment in 2004 amounted to NIS 114 million.

The return on equity in 2004, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets was 235%.

As stated above, it was only in 2004 that the Bank's information system for the management of its segment profit centers reached the degree of development and implementation required to permit the presentation of data relating to the operations of the Discount Group by segments. Accordingly, the Bank is unable to present comparative data for 2003, and analyses and explanations with respect to changes that occurred in the data for 2004 in comparison with that for 2003.

Following are the principal data relating to the operations of the non-financial company segment in 2004:

	In NIS millions	As percentage of Group total
Income from financing activities before		
provision for doubtful debts	(22)	0.6
Operating and other income	51	2.3
Total income	29	0.5
Provision for doubtful debts	-	-
Operating and other expenses	11	0.3
Income from ordinary operations before taxes	18	2.2
Bank's equity in income of		
Affiliated companies	66	
Extraordinary income on the sale of investments	32	
Net income	114	20.5
Return on equity	235%	
Average balance of liabilities	-	-
Average balance of assets	573	0.4

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 6 positions of staff members at various levels whose employment costs are charged to the segment.

PRINCIPAL AREAS OF OPERATION IN SEGMENT

The investments of the Discount Group in non-financial companies are divided into two principal categories, as under:

- Investment in companies: the principal investment in this field is the investment in Harel Insurance Investments Ltd. (see below, 'Principal investee companies');
- Investments in venture capital funds. The greater part of the investments in this field are made through the subsidiary DCMI, through the subsidiary of Mercantile Discount Bank, and directly by the Bank itself.

REVIEW OF THE VENTURE CAPITAL MARKET IN ISRAEL IN 2004

During the course of 2004, approximately 65 "Exits" were implemented in Israel, twelve of them by way of IPOs and the others by way of mergers or acquisitions (with six of these being in amounts in excess of US$ 100 million). The biggest realizations were of Agis Industries (1983) Ltd., which was acquired by the Perrigo Co. for US$ 852 million, of AST – Advanced Stent Technologies Inc., which was acquired by the Boston Scientific Corporation for US$ 500 million, and of P-Cube Inc., which was acquired by Cisco Systems for US$ 200 million.

Lipman (Nasdaq:LPMA) is in fourth place in the list of big realizations after a share issuance of approximately US$ 130 million on the Nasdaq – incidentally, while making dual listing.

During 2004, an amount of approximately US$ 1.46 billion was raised by 428 Israel hi tech companies, an increase of 45% in comparison with the funds invested in Israel hi-tech companies in 2003.

The Israeli funds invested about US$ 665 million of the above sum, with 46% of the sum being invested by way of initial investments in the companies and the rest by way of subsequent investments. The average amount of an initial investment was US$ 2.2 million, whilst the average amount of a subsequent investment was US$ 1.1 million (as compared to US$ 1.6 and US$ 0.7 million in 2003, respectively).

The rate of investment in the life sciences arena has been rising persistently since 2000. In that year, the life sciences took 8% of capital raised as compared to 22% in 2004.

This awakening is also evident from the number of companies involved and the size of the investments, both at the initial seed stage and also at the subsequent mid-stage: 54 companies at the seed stage raised about US$ 108 million (constituting about 8% of the total investment in hi-tech companies in 2004), as compared to about US$ 58 million invested in seed stage companies in 2003 (about 6% of hi-tech investment in that year). 196 companies at the mid-stage raised about US$ 819 million in 2004, about 56% of total investments in that year, compared to about US$ 493 million raised in 2003 (about 49% of total investments).

INVESTMENTS OF GROUP IN VENTURE CAPITAL FUNDS

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

First Israel Mezzanine Fund (FIMI) – in conjunction with foreign investors. The size of the fund is US$ 91 million. DCMI's share in the fund will reach US$ 16 million, of which US$ 13.1 million had already been invested by December 31, 2004.

The Israel International Fund, which was established jointly by Hambros Bank (UK) (since acquired by Investec) and DCMI, specializes in export-oriented projects. Amongst the investors in the fund is a group of Japanese investors headed by the Nomura company. The size of the fund is US$ 50 million, and DCMI's share is due to reach US$ 8.1 million. As of December 31, 2004, DCMI had invested US$ 7.7 million in this fund. The fund has concluded its investment program and realized holding in some of its investments.

Vertex Venture Management (III) Capital Fund (hereinafter: "the First Vertex Fund"). This fund's size is US$ 35 million, and DCMI's share is US$ 5 million. The fund has concluded its investment program and has realized some of the holdings obtained through its investments. The fund has repaid the entire investment amount to the investors and has now begun distributing profits.

Following the success of the First Vertex Fund, the **Vertex Israel II Venture Capital Fund** was established. The size of the fund is US$ 160 million, and is due to reach US$ 15 million. As of December 31, 2004, DCMI had invested US$ 9.4 million.

Vertex Israel III Fund is expected to reach a size of between US$ 150 and US$ 200 million, and DCMI's share will reach US$ 13.5 million. As of December 31, 2004, no funds had yet been invested in the fund.

Vitalife Fund. DCMI has initiated the establishment of a venture capital fund for investment in the field of the life sciences. Following the completion of the initial capital raising, the Fund will reach a size of US$ 50.3 million, of which DCMI's share will amount to US$ 10 million. As of December 31, 2004, DCMI had invested an amount of US$ 6.9 million in this fund.

DCIM, together with Foresight Ltd. established the **Golden Gate Bridge Fund,** which engages in providing bridge financing for hi-tech start-up companies. The size of the fund is US$ 6 million. DCMI's share is due to reach US$ 2 million, of which US$ 1.2 million had already been invested by the end of 2004. The Golden Gate Bridge Fund is now jointly managed with the Plenus Technologies Fund.

Plenus Venture Lending II Fund is planning to engage in providing bridge loans and lines of credit to technology companies. DCMI has undertaken to invest up to US$ 5 million in the fund. As of December 31, 2004, no money had been invested in the fund.

DCMI jointly with Bezeq and others, established the **Stage One Venture Capital Fund**, which is to invest in companies engaged in communications and information technology fields. The size of the fund is US$ 30 million. DCMI's share is due to reach US$ 10 million, of which US$ 7.6 million had been invested by the end of 2004.

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

Fortissimo Capital Fund. Following the completion of the initial capital raising the size of the fund stands at US$ 63 million, out of total planned capital raising of US$ 100 million. DCMI has undertaken to invest US$ 5 million in the fund, of which US$ 1 million had been invested by the end of 2004.

DCMI has invested in **"Menif" – Financial Services Ltd.**, together with Mivtach Shamir Finances, Clali Investments & Properties, Walter Rosenthal Ltd. and Edmond Chacheg. "Menif" engages in complementing equity capital of building contractors as required by banks financing building projects in a closed project format. Complementing the equity capital is effected by way of providing guarantees in favor of the project in consideration for a share 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, 2004, DCMI provided guarantees in a total amount of NIS 11.6 million.

DCMI holds 70% of **Forsight Ltd.**, a company engaged in economic consulting, research, and investment banking in the fields of communications, software and the Internet.

DCMI has invested US$ 1 million in **tecc-Is**, which is traded on the London AIM Exchange. tecc-Is invested in Israeli hi-tech companies. The controlling interest in the company has changed hands, and the company has, in consequence, now changed its name to Serviced Office Group (SVO).

Additional investment in funds. In addition to the investment in funds through DCMI, the Bank has made a direct investment in FIMI Opportunity Fund. The size of this fund is US$ 114 million. The Bank's share in the fund is due to reach US$ 23 million, of which US$ 7 million had been invested by December 31, 2004. The Bank has also undertaken to make a

direct investment in FITE – First Israel Turnaround Enterprise Fund. The size of the fund is US$ 129 million, and the Bank's share is due to reach US$ 12.5 million. Up to December 31, 2004, the Bank had invested US$ 250,000 in the fund.
Furthermore, Mercantile Discount Bank is committed to an investments in five venture capital funds. As of December 31, 2004, the investment of Mercantile Discount Bank in these funds amounted to NIS 8.8 million. As of December 31, 2004, the maximum commitment for the future investments in these funds amended to NIS 11 million.

FINANCIAL MANAGEMENT SEGMENT

SEGMENT DEFINITION

This segment includes activities that are characterized as banking operations, but do not involve customers of the Group (except for the dealing room). These activities are mainly comprised of for their own account operations of the Bank and Mercantile Discount Bank involving securities and other banks, as well as exposure management (the Consumer Price Index and foreign exchange) and dealing room operations, including those involving financial sectors. This segment also includes the Bank's share in the income of the First International Bank and its share in the income of its affiliated companies which operate in a supporting capacity.

NEW PRODUCTS

The department that deals with the development and management of financial products has responsibility for the development of new products that are then marketed and sold by the other segments. In 2004, the following new products were offered to customers:
Savings scheme linked to S&P Index. A non-linked shekel deposit carries a bonus that is linked to the US dollar at a rate determined by the increase in the S&P index. The principal is guaranteed. The scheme was operated intermittently for short periods of time and for varying periods of deposit. At the present time, the scheme is closed to deposits.
Inverse deposit. A non-linked shekel deposit for a period of three years, bearing interest as follows: for the first year – the interest is fixed and guaranteed; for the second and third years – the interest rate is fixed in advance with the average prime rate deducted therefrom and a guaranteed minimum interest rate of 0%. The interest is paid once a year. The scheme was operated for a short period and is today closed to deposits.
Dollar deposit. US dollar deposit for ten years, bearing interest as follows: for the first year – the interest is fixed and guaranteed; for all subsequent years – a guaranteed fixed interest rate with a deduction equivalent to twice the six-month LIBOR and a guaranteed minimum interest rate of 0%. The interest is paid every six months. The scheme was operated for a short period and is today closed to deposits.

SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

Net income of the segment in 2004 amounted to NIS 127 million.
The return on equity in 2004, calculated on the capital allocated to the sector on the basis of the average value of segment risk assets, was 20.6%.
As stated above, it was only in 2004, that the Bank's information system for the management of its segment profit centers reached the degree of development and implementation required to permit the presentation of data relating to the operations of the Discount Group by segments. Accordingly, the Bank is unable to present comparative data for 2003, and analyses and explanations with respect to changes that occurred in the data for 2004 in comparison with that for 2003.

Following are the principal data relating to the operations of the financial management segment in 2004:

	In NIS millions	As percentage of Group total
Income from financing activities before provision for doubtful debts	278	8.0
Operating and other income	48	2.2
Total income	326	5.7
Provision for doubtful debts	-	-
Operating and other expenses	275	6.9
Income from ordinary operations before taxes	51	6.4
Bank's share in operating income of affiliated Companies	69	
Net loss from extraordinary items	(8)	
Net income	127	22.8
Return on equity	20.6%	
Average balance of liabilities	7,420	5.5
Average balance of assets	34,469	24.2

HUMAN CAPITAL

In 2004, the average number of positions in the segment amounted to 318, including positions of employees directly related to the segment and positions of staff members at various levels whose employment costs are charged to the segment.

DEALING ROOM

The dealing room desk attends to the activities in derivative financial instruments, shekel and foreign currency deposits, foreign currency trading, foreign securities traded on stock exchanges around the world and overseas investments. The dealing room responds to the needs of sophisticated and competitive customers, investors, companies and institutional entities. In the dealing room, transactions are carried out in complex financial instruments, hedging transactions are proposed against the risk of exposure to currency and interest rate fluctuations, and unique customized solutions are offered to customers.

Advanced technology and a computer system connected to the big financial centers around the world facilitate service that is prompt, accurate and reliable.

In the dealing room, structured products based on foreign currency interest rates were successfully marketed.

The dealing room also handles on-call credit and trading transactions based on shekel and foreign currency interest rates.

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, 2004, amounted to NIS 5.9 billion, compared with NIS 5.6 billion on December 31, 2003.

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(*)	
	2004	2003	2004	2003
Banking Activity:				
Commercial banks:				
In Israel - the Bank (including branches overseas)	104	148	85	54
- Consolidated company	103	86	103	86
- Affiliated company	65	(130)	65	(130)
Overseas - Bank offices	143	(45)	161	49
Mortgage Bank	(23)	18	(23)	18
Other Activities:				
Credit cards	33	24	33	24
Other financial services	109	76	109	76
Total operating (gain) loss	534	177	534	177
Income (loss) from extraordinary operations	22	(23)	22	(23)
Net gain (loss)	556	154	556	154

(*) 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 2004, the shekel was appreciated in real terms as against the US dollar by 1.6%, compared with a devaluation of 7.6% in 2003. In 2004, the shekel was devalued in real terms against the Swiss Franc by 7.2%, compared with a devaluation of 3.9% in 2003. The said devaluation/appreciation resulted in a decrease in the Bank's net operating income after tax in Israel by NIS 19 million, compared with an increase of NIS 95 million in net operating income in 2003. Concurrently, there was a decrease/increase in the positive contribution by overseas extensions to the results of the Bank.

MAIN INVESTEE COMPANIES

At the end of 2004, 18.9% of all assets in the consolidated balance sheet were assets of consolidated companies in Israel, and 27.3 % were assets of overseas consolidated companies and branches. The contribution to the net results by the consolidated companies in Israel totalled NIS 150 million in 2004 (2003: NIS 116 million). The contribution to the net results by overseas consolidated companies totalled NIS 143 million in 2004 (2003: a loss of NIS 45 million), and the contribution to the net results by affiliated companies totalled NIS 135 million in 2004 (2003: NIS 121 million).

The total contribution by both domestic and overseas investees companies to the net results of the Bank amounted to NIS 426 million in 2004, compared with NIS 192 million in 2003, an increase of 121.9%. Disregarding the effect of the coverage of the investment in overseas subsidiaries, net of the tax effect, the contribution of both domestic and overseas investees to the net results of the Bank in 2004, would have been NIS 445 million, compared with 287 million in 2003, an increase of 55.1%.

DISCOUNT BANCORP, INC.

Discount Bancorp, Inc. ("Bancorp") is fully owned by the Bank. Bancorp fully owns and controls 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 legend to this effect appears on the share certificate of IDB New York.

Total assets at the end of 2004 amounted to US$ 8,410 million, compared with US$ 7,716 million at the end of the preceding year, a rise of 9.0%.

Total credit at the end of 2004, was US$ 2,481 million, compared with US$ 2,214 million at the end of the preceding year, an increase of 12.1%.

Total deposits stood at US$ 5,019 million as at the end of 2004, compared with US$ 4,594 million at the end of the preceding year, an increase of 9.3%.

Shareholder's equity totalled US$ 537 million at the end of 2004, compared with US$ 520 million at the end of 2003, an increase of 3.3%.

At the beginning of 2003 Bancorp distributed a dividend of US$ 45 million out of earnings of 2002. In September 2003, Bancorp distributed a dividend of US$ 15 million, in March 2004, Bancorp distributed a dividend of the same amount to its shareholders, and in December 2004, Bancorp distributed a dividend of US$ 20 million.

The ratio of capital to risk assets was 12.5% as at December 31, 2004, compared with 13.5% at December 31, 2003.

Net income in 2004 totalled US$ 50 million, compared with US$ 38 million in the preceding year, an increase of 31.6%.

Return on equity was 9.6% in 2004, compared with 6.85% in 2003.

The contribution of the Bank's investment in Bancorp to the net results of the Bank was NIS 138 million in 2004 (after deducting a provision for additional taxes of NIS 44 million that applies to the Bank in Israel), compared with a loss of NIS 39 million in 2003 (after deducting provision for additional taxes of NIS 81 million that applies to the Bank in Israel).

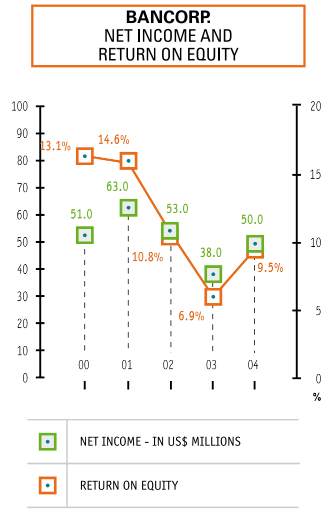
The said contribution is comprised of Bancorp's net income in 2004 (after deducting the provision for tax as aforesaid) of NIS 172 million with the addition of real term exchange rate differentials on the investment of NIS 34 million, compared with net income of NIS 83 million (after deducting a provision for taxes as aforesaid) and with the addition of real term exchange rate differentials on the investment of NIS 122 million in 2003.

Together with exchange rate differentials on the said investment, the Bank in Israel recorded financing expenses in 2004 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.

In 2004, IDB New York reclassified bonds in a total amount of US$ 1,303 million from the securities available for sale portfolio to the securities held to redemption portfolio.

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

Correction of an error in the financial statements as of December 31, 2003, by way of a restatement. In the course of the preparation of the financial statements of IDB New York as of December 31, 2004, it transpired that in the period from October 2002 to July 2003, IDB New York had issued non-callable step-up deposit notes, in respect of which IDB New York had no right of call at the interest change dates.



IDB New York had accrued interest on the said deposit notes at the current contractual interest rate, while according to US generally accepted accounting principles (EITF 86-15) and the directives of the Supervisor of Banks in Israel, interest should be accrued on the said deposit notes at the effective rate at each deposit period, which takes into account the rise in interest rates until the termination of the deposit period.
The overall effect of the said error on the financial statements of IDB New York amounts to US$ 12.5 million, gross, of which US$ 6.5 million, gross, in respect of 2003 (an amount after tax of 35%, of US$ 4.2 million), and the balance is in respect of 2004. In view of the above, the net earnings of Bancorp Inc. for 2003 amount to US$ 38 million, compared with US$ 42 million as previously reported.
It should be clarified, that the net effect on the financial statements of the Bank in Israel is smaller than the net effect on the financial statement of IDB New York, in view of the fact that according to an agreement with the Tax Authorities in Israel the Bank pays additional taxes in Israel in respect of the earnings of IDB New York. As the earnings for 2003 of IDB New York were reduced following the correction of the error, the taxes payable in Israel by the Bank will be reduced accordingly.

MERCANTILE DISCOUNT BANK LTD.

Mercantile Discount Bank Ltd. ("Mercantile Discount") is a wholly-owned subsidiary of the Bank.
At the end of 2004, Mercantile Discount Bank operated through 62 branches.
Total assets at the end of 2004 amounted to NIS 15,771 million, compared with NIS 15,067 million at the end of 2003, a rise of 4.7%.
Total credit granted to the public at the end of 2004 was NIS 12,697 million, compared with NIS 12,293 million at the end of 2003, a rise of 3.3%.
Total deposits from the public at the end of 2004 amounted to NIS 13,894 million, compared with NIS 13,265 million at the end of 2003, a rise of 4.7%.
Shareholder's equity at the end of 2004 amounted to NIS 952 million, compared with NIS 898 million at the end of 2003, a rise of 6.0%.
The ratio of capital to risk assets was 10.6% as at December 31, 2004, compared with 10.8% as at December 31, 2003.
In 2004, the Mercantile Discount Bank raised secondary capital of NIS 40 million, by way of an issue of subordinate capital notes, compared with NIS 81 million in 2003.
Net income was NIS 103 million in 2004, compared with NIS 86 million in 2003, a rise of 19.8%.
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, 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 and an increase in the provision for doubtful debts.
Return on shareholders' equity in 2004 was 11.5%, compared with 11.0% in 2003.
The General Meeting of Shareholders approved on December 28, 2004, a dividend distribution of NIS 50 million, which was paid on January 3, 2005.
As to details regarding the cancellation of the Government decision in the matter of the sale of the shares in Mercantile Discount Bank held by the Bank, see Note 33 to the financial statements. Following the said cancellation there was no further need for the provision for taxes in the amount of NIS 33 million, in respect of the Bank's share in the earnings of Mercantile Discount Bank recorded in the past. This provision was reversed in 2004.
Correction of a mistake in the classification of problematic debts as of December 31, 2003. A credit audit performed by the Supervisor of Banks at Mercantile Discount Bank disclosed a mistake, which this bank has always been doing, of not classifying problematic

MERCANTILE
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debts relating to loans secured by a mortgage (not comprising housing loans), the outstanding balance of which at September 30, 2004 amounted to NIS 214 million, of which NIS 131 million relates to the period ended December 31, 2003 (out of total credit managed by the mortgage division of Mercantile Discount Bank amounting to NIS 2 billion). Most of the unclassified amounts, as stated above, comprise loans, which have been rescheduled and which according to directives of Bank of Israel, had to be classified by the bank as "reorganized" problematic debts. The said directive states that such a classification requires automatically the creation of "a supplementary provision for doubtful debts", at a certain rate of the debt in question. Amendment of the balance of problematic debts as of December 31, 2003, was made by way of a restatement. Due to materiality considerations, the supplementary provision for doubtful debts, required as a result of the amendment of the problematic debts as of December 31, 2003, in the amount of NIS 3 million, as stated, was recognized as an expense in 2004.

See Note 19 C to the financial statements, articles: 15.1.3 and 15.2 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) and in the matter of a share hiking affair.

DISCOUNT MORTGAGE BANK LTD.

Discount Mortgage Bank is a subsidiary of the Bank. As of December 31, 2004, 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 2004 amounted to NIS 9,746 million, compared with NIS 9,534 million at the end of 2003, an increase of 2.2%.

Total credit granted to the public amounted at the end of 2004 to NIS 9,519 million, compared with NIS 9,377 million at the end of 2003, an increase of 1.5%.

Shareholder's equity amounted to NIS 783 million at the end of 2004, compared with NIS 818 million at the end of 2003, a decrease of 4.3%.

Net loss totalled NIS 35 million in 2004, compared with net income of NIS 27 million in 2003.

The deterioration in the business results in 2004, as compared with 2003, resulted mostly from an increase in the provisions for doubtful debts, which rose from NIS 70 million in 2003 to NIS 165 million in 2004, an increase of 135.7%.

At the same time, Discount Mortgage Bank recorded a deferred tax asset in respect of the carryforwards tax losses and the deduction for inflation in the amount of NIS 18 million.

Return on shareholders' equity in 2004 was a negative rate of 4.3%, compared to a positive rate of 3.4% in 2003.

The ratio of capital to risk assets was 10.5% as at December 31, 2004, compared with 11.6% as at December 2003.

The Bank's share in the net loss of Discount Mortgage Bank in 2004 totalled NIS 23 million in 2004, compared with a share in net income of NIS 18 million in 2003.

See Notes 19C 16.3 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 in the matter of the regulation of the continued activities of mortgage banks in the property insurance and borrowers' life assurance business while providing housing loans; and several requests to the Courts to approve actions against mortgage banks, including Discount Mortgage Bank, as class action suits, in the matter of insuring property for amounts exceeding its reinstatement value and in the matter of collecting excess stamp duty; and Note 15.4 to the financial statements in the matter of charging commission in respect of life assurance and property insurance of borrowers.

Changes in the treatment of the provision for doubtful debts based on the period in arrears system. In accordance with the directives of Proper Banking Procedure No 314 concerning the treatment of problematic debts, a mortgage bank is required to compute the specific provision using the system of provision based on the period in arrears, in respect of housing loans the outstanding balance of which is lower than a determined ceiling, and for such a group only. The provision based on the period in arrears is a minimum provision, and where the bank's management has information that such a provision is insufficient, it has to increase the specific provision.

In assessing the required specific provision, Discount Mortgage Bank implemented of its own choice, the system of provision based on the period in arrears also in respect of two additional groups – housing loans in excess of the said ceiling and general loans secured by a mortgage on a dwelling unit, except in specific cases.

In the course of 2004, in view of the continued crisis in the real estate market, the additional slowdown in both the private housing and commercial property markets, the continued slowdown in economic activity, Discount Mortgage Bank conducted an in-depth survey and examination of all problematic debts in all segments of activity of this bank.

Within the framework of this survey of problematic debts, Discount Mortgage Bank decided in the second quarter of 2004, to change to a computation of a specific provision in respect of the said two groups. This transition required great effort and the allocation of considerable manpower. Discount Mortgage Bank did so believing that this is the fair treatment, which complies with the directives of Proper Banking Procedure. Discount Mortgage Bank continued this treatment also in the third quarter of 2004. Accordingly, the provision based on the period in arrears was reduced in the second and third quarters together, by an amount of NIS 29 million, and the specific provision was increased by NIS 21 million. In total, the provision was decreased by NIS 8 million.

On October 25, 2004, Bank of Israel published a draft directive expanding and clarifying the provision system based on the period in arrears. In this respect several discussions were held between Bank of Israel and the mortgage banks.

The said draft clarifies and determines that even though a mortgage bank is entitled to implement the period of arrears system with respect to certain additional groups of borrowers, in addition to the housing loan group up to a ceiling, once a specific provision based on the period of arrears has been established in respect of a certain loan, it cannot be reduced unless as a result of debt amounts collected in cash.

Once Discount Mortgage Bank had learnt of the draft directive, which requires a different treatment than that applied by the bank, it approached the Bank of Israel, of its own volition, requesting clarifications. In response to this approach, Discount Mortgage Bank has been informed that the Bank of Israel position is that the treatment applied in the financial statements as of June 30, 2004 and September 30, 2004 was not in accordance with written and oral instructions given to mortgage banks in recent years. The Bank of Israel also reiterated its position in a letter sent to the mortgage banks on November 14, 2002.

Accordingly, the Bank of Israel instructed Discount Mortgage Bank to amend in accordance with its above instructions, the provisions for doubtful debts made in the second and third quarters of 2004, and to present this amendment, giving the quarterly details, in the annual financial statements of Discount Mortgage Bank.

Discount Mortgage Bank acted according to the requirements of the Bank of Israel, while emphasizing that its treatment in the second and third quarters of 2004 were in accordance

with the instructions of Proper Banking Procedure, and that it understood that the prohibition as to the reduction in the provision based on the period in arrears, unless by way of cash collection of the amounts in arrears, as was reflected in the Bank of Israel letter of 2002, applies only to the group to be treated according to the period in arrears per the instructions of Proper Banking Procedure.
The amendment increased the specific provision based on the period in arrears, for the second and third quarters of 2004, by NIS 29 million.
It should be noted that the said amendment has not affected the comparative figures as at December 31, 2003, and for periods ended on that date, and its effect is reflected in the restatement of the interim financial data for June 30, 2004, and September 30, 2004, and for the periods ended on those dates.

ISRAEL CREDIT CARDS
NET INCOME AND
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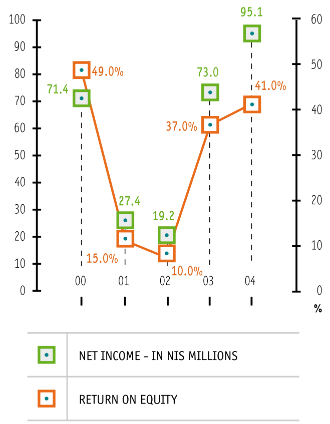

FIRST INTERNATIONAL BANK OF ISRAEL LTD.

The First International Bank of Israel Ltd. is an affiliated company of the Bank. As of December 31, 2004, 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 2004 totalled NIS 65 million, compared to a loss of NIS 42 million in 2003.
Return on shareholders' equity in 2004 was 6.9%, compared with 4.8% in 2003.
The ratio of capital to risk assets stood at 11.2% on December 31, 2004, compared with 10.6% at the end of 2003.
Provision for impairment in value. See Note 6 D 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.
On December 22, 2004, the transaction was completed in which the First international Bank acquired the full ownership (100%) in Investec (Israel) Bank Ltd., at a total cost of US$ 102 million.
For details regarding certain legal actions filed against the First International Bank in the matter of line entry commissions, and in the matter of life assurance commissions and property insurance in contravention of the law and regarding requests to approve them as class actions, see Note 19 C, 19.1 and 19.2 to the financial statements.

ISRAEL CREDIT CARDS LTD.

Israel Credit Cards Ltd. ("ICC") is a subsidiary of the Bank. As of December 31, 2004, the Bank owned 51% of the equity and 63% of the voting rights in ICC and in Diners. 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 Diners. These shares were previously stated in the financial statements as available-for-sale securities.
The said shares, which are intended for sale, were classified as such since their acquisition from Leumi Holdings in view of the fact that from the beginning they were purchased and held for the purpose of sale.
In his letter dated June 17, 2004, the Supervisor of Banks informed the bank that in view of the long time that had passed since their acquisition, he feels uneasy with the said continued classification, therefore, if, until the date of publication of the financial statements as of September 30, 2004, a draft agreement for their sale is not reached, or

alternatively, an offer for sale of the said shares is not published, then, as from the financial statements of September 30, 2004, onwards, the bank will have to state all its holdings in ICC and Diners by the equity value method. The bank implemented the said instruction in its financial statements as of September 30, 2004, which had no material effect upon the financial statements.

Following are data taken from the consolidated financial statements of ICC:

Total assets amounted, at the end of 2004, to NIS 1,597 million, compared with NIS 1,582 million at the end of 2003, an increase of 0.9%.

Total capital resources amounted, at the end of 2004, to NIS 275 million, compared with NIS 246 million at the end of 2003, an increase of 11.8%. In 2004, ICC distributed to its shareholders a dividend amounting to NIS 65 million.

The ratio of equity to risk assets at September 30, 2004, was 9.9%, similar to the end of 2003.

Total income amounted in 2004 to NIS 532 million, compared with NIS 464 million in 2003, an increase of 14.7%.

Net earnings amounted in 2004 to NIS 95 million, compared with NIS 73 million in 2003, an increase of 30.1%.

Return on equity reached 40.9% in 2004, compared with 37.0% in 2003.

The share of the Bank in the net earnings of ICC in 2004, amounted to NIS 33 million, compared with NIS 26 million in 2003.

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.

On January 30, 2005, the Supervisor of Banks issued a Proper Banking Procedures Directive, intended to regulate the overall activity of credit card companies – both in the risk management field and in the various consumer fields. In the risk management field the Supervisor applied to the credit card companies further instructions, such as “The Board of Directors”, “Risk Management”, “Embezzlements and Fraud by Employees”, “Banking Insurance”, etc. In the consumer field, the Directive suggests the regulation of several major issues, including: rules for the issue of credit cards, their delivery, renewal and cancellation, the information provided as part of the monthly statement, rules regarding marketing drives by way of points/stars, rules for the conversion of transaction in foreign currencies to Israeli currency, and so forth.

For details regarding changes in the arrangements concerning credit cards in Israel, see Note 34B. to the financial statements.

As for details regarding changes in arrangements concerning the credit card field in Israel, see Note 34B. to the financial statements. For details regarding pleas for approval of legal actions filed against ICC as class actions in the matter of the rate of business houses commission (an action, the submission of which as a class action had been approved and the Supreme Court admitted the appeal against such approval), and in the matter of collection of certain commissions (an action, in which the claimant has asked the Court to dismiss the action and the Court requested the opinion of the Attorney General), see Note 19C., paragraphs: 15.3.1 and 15.3.2 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 15.89% interest in the equity and in the voting rights of Harel.

Until May 31, 2004, the share capital of Harel was composed of ordinary shares of NIS 1 each and ordinary shares of NIS 5 each, each share having one voting right at the shareholders meetings of Harel. On May 31, 2004, the shareholders meeting of Harel adopted a resolution to equalize the voting rights of the shares without compensating the holders of the ordinary shares of NIS 1 each, and also to convert each share of NIS 5 into five ordinary shares of NIS 1 each.

On June 16, 2004, the Bank sold on and off the market 870,500 ordinary shares of NIS 1 each of Harel, comprising 4.11% of the equity, for total consideration of NIS 128 million. The said sale contributed an amount of NIS 32 million to the income of the Group.

The said reduction in the holdings in Harel does not affect the rights of the Bank in accordance with the agreement between the Bank and the Hamburger Group, which regulates the relationship between them as shareholders of Harel.

Harel is a holding company that primarily engages in the various insurance areas and in additional areas, such as the capital markets, real estate and communications. Holding means of control in Harel is a strategic investment which diversifies the Bank's sources of income.

Net earnings in 2004 amounted to NIS 406 million, compared with net earnings of NIS 401 million in 2003, an increase of 1.2%.

The return on equity in 2004 was 28.6%, compared with 37.1% in 2003.

The contribution of Harel to the net earnings of the Bank amounted in 2004 to NIS 63 million, compared with NIS 73 million in 2003.

With regard to motions for approval of actions against Harel and its consolidated subsidiary, Harel – Insurance, as class action suits, see Note 19 C 18.1 and 18.2 to the financial statements, to which the auditors drew attention in their opinion on the financial statements.

Regarding the uncertainty relating to the changes in the capital market structure that the Ministry of Finance is contemplating, including the issue of ownership and control of insurance companies by banks, see "Government decisions regarding the banking industry and proposed changes in the structure of the capital market" and Note 33 to the financial statements.

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, 2004 amounted to NIS 229 million, compared with NIS 208 million at the end of 2003, an increase of 10.1%.

Net income in 2004 amounted to NIS 21 million, compared to a loss of NIS 21 million in 2003. The improvement in the business results of Israel Discount Capital Markets and Investments Ltd. in 2004 derives mainly from realization margins and dividends compared with provisions for the impairment in value of investments, amounting to NIS 31 million in 2003.

Cumulative effect of change in accounting method (in 2003). 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 directed that the provision for impairment in value of an investment in a venture capital fund be 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 directive, 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 directive reduced earnings by NIS 17 million.

Return on equity in 2004 reached a rate of 18.2%, compared with a negative rate of 16.9% in 2003. Disregarding the cumulative effect, the return on equity in the corresponding period last year would have reached a negative rate of 3.3%.

In 2004, DCMI participated in the underwriting of 5 public issues of debentures.

As to an indictment filed against DCMI and against two of its former employees, see Note 19 C 16.4 to the financial statements.

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 1,368 investment portfolios with assets totaling NIS 1,640 million, compared with 957 portfolios with assets of NIS 1,116 million as at December 31, 2003.

Tachlit Dollar Olami Ltd. Tachlit together with Synergetica Ltd. established Tachlit Dollar Olami Ltd. (hereinafter – "Tachlit Dollar") a special purpose company (SPC), the sole purpose of which is to issue up to two series of marketable debt notes linked to foreign currency, which are convertible in accordance with the terms to be detailed in prospectuses that Tachlit will publish from time to time, this on the basis of various indices of foreign currencies published by recognized bodies, as well as carrying out all the operations required for the issue of the notes, their conversion and redemption, reducing the exposure of Tachlit Dollar and coverage by various assets in order to honor the liabilities of Tachlit Dollar as stated in the prospectuses. Tachlit owns 20% of the issued equity capital of Tachlit Dollar.

On July 11, 2004, Tachlit Dollar issued for the first time registered debt notes (Series "A") of a par value of NIS 1 each, with a total par value of NIS 222,222 (out of a series of a total volume of up to NIS 3,500,000). The units were issued to the public and sold at a price of US$ 100 per each unit of NIS 1 par value.

Tachlit has agreed with Synergetica and Tachlit Dollar, that it will transfer from time to time to Tachlit Dollar, funds not to exceed a cumulative amount of US$ 1 million (hereinafter – "the amount of liability") to enable Tachlit Dollar to honor its liabilities towards the note holders and to cover its current operating expenses.

To secure the liabilities of Tachlit, the Bank is to provide a letter of indemnity in respect of the said liability of Tachlit to provide funds, by way of the Bank indemnifying Tachlit Dollar in respect of its liabilities towards the note holders and for covering its current operating expenses, in a total amount not to exceed the amount of the liability.

Management of additional investment portfolios. Mercantile Discount Bank, through one of its subsidiaries, manages, in addition, investment portfolios of customers. As of September 30, 2004, the customer portfolio managed amounted in total to NIS 602 million, an increase of 17% as compared with December 31, 2003.

ILANOT DISCOUNT LTD.

Ilanot Discount is a subsidiary of the Bank. As at December 31, 2004 the Bank held 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.
Ilanot Discount engages in mutual funds management. 59 mutual funds were managed by Ilanot Discount at December 31, 2004, compared with 53 mutual funds at the end of 2003. The value of the mutual funds managed by Ilanot Discount amounted to NIS 12.3 billion at the end of 2004, compared with NIS 10.2 billion at the end of 2003. Ilanot Discount's share in the mutual funds market decreased from 12.3% to 12.1% at December 31, 2004.
Pursuant to an agreement, dated September 1999, between the Bank and Ilanot Batucha Investment House Ltd., according to which the Bank acquired control of Ilanot Discount Ltd., Ilanot Batucha (or whoever succeeds it) has been granted the option to sell to the Bank the remaining balance of its holdings in the shares of Ilanot Discount, in consideration for their value as determined in a valuation to be performed at the date of exercise of the option by an agreed independent assessor, based on the principles set out in the agreement. This option is exercisable within nine months from the date of closing of a transaction in which controlling core of the Bank will be sold for the first time.

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 5,264 in 2003 to 5,180 in 2004, a decrease of 84 employees on a monthly average, 1.6%. The Bank had 4,009 tenured employees at the end of 2004, compared with 4,111 tenured employees at the end of 2003, a net decrease of 102 employees. The total number of the Bank's employees at the end of 2004 was 5,215, compared with 5,180 employees at the end of 2003, an increase of 35 employees.
There were 5,242 employees in full-time positions in the Bank in Israel at the end of 2004, compared with 5,264 at the end of 2003, a decline of 0.4%.
The average direct cost per employee position in the Bank in Israel in 2004 was NIS 193 thousand, compared with NIS 173 thousand in 2003, an increase of 11.7%.
The average direct cost per employee position in the Bank of Israel, disregarding an appreciation bonus and a provision for a bonus with respect to the sale of the Bank, would have amounted to approximately NIS 179 thousand, compared with NIS 173 thousand in 2003, an increase of 3.5%.
The total average cost per employee position in the Bank in Israel, not including voluntary early retirement expenses, in 2004, was NIS 297 thousand, compared with NIS 264 thousand in 2003, an increase of 15.7%. The increase in the total cost per employee position results mainly from the increase in direct salary as detailed above.
The total average cost per employee position in the Bank in Israel, not including voluntary early retirement expenses and expenses of appreciation bonus and the Bonus in respect of the sale of the Bank, in 2004, was NIS 279 thousand, compared with NIS 256 thousand in 2003, and an increase of 8.7%.
The average monthly number of employees in full-time positions in the Group, both in Israel and abroad, at the end of 2004, was 8,544, compared with 8,562 at the end of 2003, a decline of 0.2%.
There were 8,655 full-time positions in the Group at the end of 2004, compared with 8,551 at the end of 2003, an increase of 1.2%.
The average overall payroll cost per employee of the Group in Israel and abroad, excluding the change in the salary tax expense, amounted in 2004 to NIS 294 thousand, compared with NIS 264 thousand in 2003, an increase of 11.1%.

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

	As of December 31		Monthly average in	
	2004	2003	2004	2003
The Bank in Israel	5,242	5,264	5,180	5,264
Domestic subsidiaries	2,502	2,382	2,458	2,399
Group total in Israel	7,744	7,646	7,638	7,663
Overseas branches	31	31	31	29
Overseas subsidiaries	880	874	875	870
Group total overseas	911	905	906	899
Group total overseas and Israel	8,655	8,551	8,544	8,562

RETIREMENT OF EMPLOYEES

In the years 2000-2004, the Bank encouraged early retirement of employees, directed at an employee population having defined characteristics, in respect of which a focused effort was made to encourage their early retirement at beneficial terms.

175 employees retired during 2004, of which 131 employees took early retirement. 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, 1,057 employees retired from the Bank in the period 2000-2004, of which 754 were under the early retirement plan.

Among those who retired in 2004 were 48 managers (27% of all retirees in this year), compared with 47 managers in 2003 (26% of all retirees in the year).

DEVELOPMENT OF HUMAN RESOURCES

Employee development and the treatment of the human resource are defined as one of the primary targets of the Bank's Management.

As part of this target, emphasis was made during the year on the strengthening of the line manpower and the enhancement of their **professional level**, as part of the effort to improve the level of the Bank's customer satisfaction. This is achieved by identifying the professional level of the staff as one of the principal parameters affecting customer satisfaction. A continuous improvement in the professional level of the staff would enable it to lead a human and personal service experience to Bank customers.

Knowledge management in an organization has been identified as vital and critical for the improvement of the professional level of the staff, and in the course of 2004, the Internet system became a central tool for the management of the organization's knowledge. The portal serves as a tool for knowledge management, which provides relevant, available and up-to-date information on a daily basis. The website is connected to the activity of the business core and to the central organizational processes and as such supports the professional level required from the staff.

Management of the professionalism of the staff in the organization is designed to respond to several central challenges:

- The transfer of the center of knowledge from the head office to the field. This is achieved by gathering knowledge and intelligence from the field and distributing it in a structured and orderly manner.
- Turning hidden knowledge into open knowledge and managing the existing knowledge by sharing it and by the studying others.
- Curtailing the response time and providing the required information to the staff in the

quickest and most effective manner.

- Updating the presentation of the professional level of the organization.
- The identification of a managerial focusing by measuring the knowledge and professionalism of the staff, while presenting alternatives for attaining professional targets.
- Improving performance and attaining business targets of the organization.

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, a development program was formed and implemented, focusing on three central levels:

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

A framework of development that focuses on the managerial line has been developed on a personal level. This emphasizes the core duties that relate to the business activity of the Bank. 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 and a reserve course for branch management were implemented; and groups for qualifying investment consultants were trained.

On the organic level, a multi-disciplinary approach is being implemented, 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.

In the system level a managerial toolbox for the empowerment of managers by the cross-organization method was developed. Within this framework, implementation of the following projects has continued in 2004: 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; and more.

Also in 2004, the Bank continued to encourage the staff to acquire higher education, which included the participation in tuition fees for 181 employees. 24 employees completed their studies for a Bachelors Degree in 2004, and 14 employees completed their studies for a Masters Degree.

ABSORPTION OF THE SERVICE CULTURE IN THE BANK

The service field at the Bank is defined as a primary target in the strategy of the Bank. This decision stands at the base of cross-organization action programs for the enhancement and improvement of service, which became a significant landmark in the organization. A revolution in the service culture of Discount Bank takes 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.

The service strategy at Discount Bank has been "translated" into an operative plan – the service improvement model. At most of the Bank's branches and at all Head Office units, a local project of some kind is being conducted in respect of service improvement. In total, some 250 projects are being conducted at the Bank for the improvement of service to external and internal customers.

Already at the selection and recruitment of staff, discerning measures were structures, which clearly identify a high level of service perception, as an essential acceptance requirement.

A new employee spends a practical-experiencing orientation day, in the course of which, he "connects" to the values of the organization and to its obligation to quality service.
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.
As part of the absorption of the service improvement process and the assimilation of the service as a value in the organizational culture, service surveys are being conducted, which constitute a tool for the examination of service quality in the organization as well as a management tool for the improvement of service processes in the various units. The service control procedures conducted at the Bank (a telephonic service survey and a "guest customer" survey) create an integrative situation presentation as to the level of service at the Bank and the level of improvement in service over time. Marking the service of the different units within the Bank is derived from parameters measured within the framework of the said surveys: professionalism, initiative, personal service, telephone service. The marks of the different units within the Bank over the year in accordance with the said parameters, at predetermined weights, reflect the service mark of each unit and the Bank as a whole and comprise a management tool for constant improvement.
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 2004 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 continues to improve the existing training methods by 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 enables 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 2004 was 25,487, compared with 30,259 days in 2003.
Alongside the system for knowledge and learning management, additional varied internal communication channels exist: "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. After watching it, the staff of the unit/branch hold an open discussion regarding the topics shown.
Investment in training. The Bank's investments in training and in the development of human resources amounted to NIS 10.7 million in 2004. The amount includes the training of employees on the subjects of service, sales, general and financial issues, the training of management, absorption of the "Ofek" project and development of knowledge management

in the organization. The amount also includes the cost of financing academic studies for Bank employees as well as expenses for professional training, seminars, etc. The amount does not include indirect expenses for instructors' fees and rent of premises. Also the amount does not include the development of training materials for the "Ofek" studies. Furthermore, for the purpose of conducting the training, the Bank appoints mentors and training partners who are employees of the Bank and who, in addition to their regular work, assist in training and in the preparation of training material. The cost in this respect is not included in the above amount.

LABOR RELATIONS

Labor relations at the Bank for over three years have been characterized by factual cooperation and consents, part of which have materialized into collective agreements.
On March 11, 2004, with the intention of M.I. Holdings to renew the process for the sale of control in the Bank in the background, the General Federation of Labor announced a labor dispute in the matter of "The demand for a special collective labor agreement securing the rights of the employees in regards to the process for the sale of control of the Bank". As part of this dispute, sanctions were adopted and a meeting of employees was held.
On May 10, 2004, the representatives of the employees declared a labor dispute in the matter of the demand for a special collective labor agreement for the selective advancement of employees for 2003. On May 20, 2004, a special collective agreement was signed, which provide for the payment of an additional selective advance for the years 2003-2004 at the average rate of 5% of the scheduled salary. The agreement concluded the salary demands for 2003 of the employees' representatives and determined that the negotiations regarding the rate of final selective increment for 2004 shall be deferred to June 2005, the employees' representatives undertaking to maintain industrial peace on this matter.
On July 22, 2004, the National Employees Committee announced that it is adopting sanctions as part of a labor dispute regarding the privatization of the Bank, and in this respect on July 21, 2004, instructed all employees of the Comptrollers Division not to process the information submitted by the Bank's subsidiary and related companies and/or any other reporting for the preparation of the consolidated statements of the Group.
In order to be able to present the said statements on August 12, 2004, the Bank applied to the Regional Labor Court in Tel-Aviv Yaffo as a party to a collective dispute, for the issue of an injunction instructing the employees to terminate forthwith the sanctions adopted. The Regional Labor Court decided against issuing of the temporary injunction and fixed the next hearing for September 27, 2004.
On August 31, 2004, the Bank requested the National Labor Court for permission to appeal the decision of the Regional Labor Court. The National Labor Court allowed the appeal and, following hearings, decided, on September 26, 2004, to permit the appeal and to issue an injunction ordering the cessation of the sanctions and ordering the Employees' Committee to instruct the employees to carry out the duties required in order to enable the Bank to present its financial statements as required by law.
On October 25, 2004, the employees' representative body declared a labor dispute in the matter of a demand for a special collective labor agreement regulating the employees' rights regarding the increase in workload.
On November 9, the national Employees Committee instructed the employees at the Comptrollers Division not to accept, process, consolidate and prepare any data for the financial statements of the Bank that is received from subsidiary companies, and not to provide the Bank of Israel and to the management of the Bank any data relating to the daily liquidity of the Bank.
The Bank referred this matter to the Labor Court, and on November 17, 2004 the Regional Labor Court decided in the matter of the plea filed by the Bank, that the sanctions adopted

at the Bank should be stopped forthwith and that the parties conduct negotiations and report to the Court on November 23, 2004. On November 24, 2004, following the hearing held on November 23, 2004, the Regional Labor Court decided that the said temporary order is to become a provisional order to remain in force until another decision is given.
For details regarding agreements as to the termination of the labor dispute at the Bank, cooperation in any matter or actions required for completing the transaction for the sale of control of the Bank, and the obligation to mutually maintain "industrial peace", see Section "employees agreement" hereunder.

BANK BRANCHES

Merger of Branches
As part of the reorganization of the branch system, in 2004 the Bank merged the operations of four branches. This is in addition to the merger of six branches in 2003, twelve branches in 2002 and eight branches in 2001.
During the process of the merger, the absorbing branches were organized to receive 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.
Relocation of Branches
As part of the reorganization of the Bank's branch deployment, three branches: Beit Shemesh, Zfat and Kiriyat Motzkin were relocated in 2004 to new premises.
Opening of New Branches
In March 2004, the first in a series of "Discount your way" (a shopping center contact point) branches was opened at the Avnat Mall. The branch serves as a point of service and sales to the population that visits the Mall. The branch is adapted to the consumer environment of the Mall and focuses on providing exceptional service to customers of the Bank and in attracting new customers.
An additional branch in the series "Neighbourhood Branch" was opened in September 2004 in Modi'in. The branch is adapted to customers residing in a "bedroom community" and provides exceptional service, such as: hours of operation from 10 AM to 8 PM and a play corner for children.
In December 2004 the Raanana branch started a unique concept of a swift banking area with no partitions between the banker and customer. The service is provided by the bankers with the aid of advanced technology between the hours 8 AM and 8 PM.
At the end of 2004, the Bank operated 124 branches across the country.

CONVERSION OF THE CENTRAL COMPUTER SYSTEM

BACKGROUND

In the 1970's the Bank decided to base its electronic data processing (EDP) systems on the computers of the Burroughs Company (which later merged with Unisys). It should be mentioned that at that time and at points of decision in the 1980's, all other banks in Israel decided to base their EDP systems on IBM computers.
Over the years since the 1970's, various processes have taken place in EDP in general and in bank EDP in particular, which changed considerably the status and concept of EDP as well as the status of equipment suppliers.
Following are the main changes:
EDP systems at banks became the backbone on which the activity of banks is based. The basic systems turned into the "system core" on which were based hundreds of additional systems located on the central computer or on subsidiary computers, all these systems being inter-connected for the transfer of data.
a. Differences in the implementation concept for the different systems as well as the

technology, accompanied by the "aging" of the basic systems and the increasing shortage of skilled staff with expertise in the systems, turned the EDP system of the Bank over the years into a most complex system as far as understanding and maintenance were concerned. As difficulties and complexities increased so did human resources involved in operating the system (implementation staff, operation/infrastructure systems staff, computer operators, development staff, organization and systems staff, user assistance staff, data security staff, EDP audit staff, quality assurance staff, acceptance tests staff, etc.). As a result, the process of introducing changes to existing systems or introducing new systems at the Bank became a very long one, extremely expensive and requires maximum attention, in order that the change would not destroy the texture of the systems and the delicate and fragile equilibrium existing among them. The cost of maintenance of the EDP systems also increased over the years.

b. The number of large business entities that based their EDP systems on Unisys computers declined gradually. At the present day, the Bank remained the only place in Israel where business activity is based on Unisys computers.

c. IBM established itself as the principal supplier in the world for mega-computers supporting large enterprises, where some 90% of the major banks in the world use IBM computers.

THE CONDITION OF THE EDP SYSTEMS AT THE BANK

Over the years, the Bank has developed effective, efficient and stable EDP solutions for all fields of its activity. The solutions developed compete well with solutions developed by other banks in Israel. These systems may continue and serve the Bank for many more years, provided the necessary maintenance measures are applied.

DECISION OF THE BANK TO DEPART FROM UNISYS

At the end of the 1990's only a few large enterprises in Israel remained with Unisys computers, one of which had already decided at the beginning of the 90's to change to another main computer.

The belief that the Bank is to remain the only customer of this technology in Israel, a matter that in itself presents a risk, induced the Board of Directors, still in 1998, to adopt a strategic resolution of changing from Unisys to IBM.

Electing the IBM computers stemmed rather from the lack of another practical alternative, considering also that this alternative serves all the major banks in Israel.

THE PROJECT OF CONVERTING THE BANK'S SYSTEMS TO IBM

A consolidated subsidiary of the Bank – "Badal" Computer and Management Services Ltd. – entered, into an agreement on May 26, 1998 with IBM Israel Ltd. ("IBM") whereby Badal would purchase IBM computers and peripheral equipment, and that IBM would convert the central computer system of the Bank to IBM computers, on a "turnkey project" basis.

The consideration for this engagement was US$ 18 million (excluding VAT), of which US$ 8 million had been paid by June 30, 1999.

The project was supposed to automatically convert the systems of the Bank to the IBM platform, using a system by which the systems would be converted "as is", with no change in their behavior or in the data they manage. This was unsuccessful, and in June 1999, the consolidated subsidiary of the Bank informed IBM of the termination of the engagement between them as the format for executing the conversion was found to be inapplicable.

BIRTH OF THE OFEK PROJECT

Following the failure of the trial to convert to IBM computers, the Bank has formed a workplan for the execution of a project, the essence of which is the renovation of the Bank's central EDP system infrastructure, while replacing the existing operating system with that

of IBM's 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.
The Bank went through a systematic and orderly process of identifying alternatives and the election of a product that will serve as a basis for conversion, being assisted by Gartner, Tower Group and Data Monitor consulting companies.
After examining several alternatives, the Bank elected to base the conversion on the Alta Mira product, which at the time was in operation at about 80 banks all over the world, with the assistance of Accenture Consulting Company, which specializes in projects of this nature, for the execution of the project itself.
The Alta Mira project has been defined as a basic product, on which modifications are to be made by the "Buy and build" method.
In October 2001, the Bank entered into an agreement with Accenture Ltd. (an Israeli corporation) and with Alnova Technologies Corporation SL, both of the Accenture International Group, for the purchase of the "Core Banking" system for the providing of services, and for the modification of the system to the needs of the Bank as well as for its absorption at the Bank.

THE OFEK PROJECT

The Ofek Project was started at the end of 2001, relying on the work methods of Accenture. The first stage in the development of the system acquired was the definition of the modification processes required for its adaptation to the Bank (PDP). In this respect and alongside the detailed examination of the different modules, the required software changes, the order of development and the solutions for the "co-existence" period have been defined. Based on the differences that had been mapped, and the experience of Accenture in conducting similar projects in other countries, a work plan was devised for the whole project, including principal milestones, as well as a budgetary framework for the execution of the project. Management and the Board of Directors have approved the result of the PDP process as well as the work plan and the budgetary framework. The original budgetary framework stood at US$ 116 million (excluding VAT).
Besides Accenture, which leads the project together with the Bank, several leading Israeli software companies participate in the project, amongst which are: Matrix, Ness Technologies, Teldor, Tescom, TessNet and IBM.

THE FIRST ROLL OUT

The first stage of the project has been defined as a pioneer stage, at the end of which a conclusion will be drawn regarding the manner of execution of the project and the work plan will be updated accordingly.
The execution of this stage – roll out No.1 – met with many difficulties, both because of external factors (the Intifada and the Iraq War) and because of the difficulty of the Bank to come to grips with such an enormous and complex project (professional, administrative and other difficulties).
The first roll out included infrastructure systems and the customer management system. At the end of October 2003, the first stage of the system was installed in all branches of the Bank and is operating successfully.
The difficulties described above caused a delay of five months in the launching of the first stage of the project (even though, as stated, it was very successfully launched), and the delay appearing with respect to future roll outs was getting longer.
The conclusions drawn from the first roll out. Following the delay in the time schedule, as well as the increase in costs, the Bank executed at the end of 2003 a process of inquiry and the drawing of conclusions.
Following this process, the Bank has made organizational changes for the execution of the

project; certain adaptations were made to the contents of the project, while increasing the contents in certain areas and reducing it in other areas. The Board also approved an expansion of the budgetary framework of the project as well as a delay in the time schedule for completing the project, which, at the time, was estimated at one additional year (namely, completion of the project by the end of 2006). Following the update, the budget for the project has increased to US$ 155 million (excluding VAT). This budget includes the direct cost of the project, but not indirect expenses in respect of the project and in respect of its effect on the current conduct of the Bank. In addition, the project was divided into seven stages instead of ten.

SECOND ROLL OUT

During the second half of 2004, additional systems were installed within the framework of the second roll out, including a significant system concerning deposits that was launched successfully in December 2004. Following the launching of this system, several failures have been discovered (most of them repaired), including the non-presentation of data relating to deposits in foreign currency at the automatic service machines (though this data was recorded in the central EDP system), and a failure as a result of which notices to customers have not been issued in time regarding deposits entries made and notices as to future maturities of deposits.

Towards implementation of the second stage in which, as stated, the leading system was the deposit management system at the Bank, the Bank upgraded the professional and administrative abilities of the project, and indeed, as stated, the second stage was launched successfully in December 2004. However, this stage was also not implemented according to the set time schedules (as updated) and also deviated from the updated budget.

The conclusions drawn from the second roll out. Examination of the reasons for the deviation from the time schedule and from the budget utilization shows that the deviations stemmed from two main reasons:

a. Increasing the demands from the system well in excess of those mapped at the PDP stage (this increase in demands resulted mostly from new regulatory requirements that demanded EDP preparations)
b. A professional difficulty, greater than expected in executing such a large and complex project (this stage handled for the first time the core banking systems, therefore only then was the whole complexity and fragility inherent in banking systems exposed in full).

As a result of the conclusions drawn from the second roll out, the third roll out has been re-planned (as was the execution of all projects relating to the fourth roll out). Following this, Management of the Bank has prepared an update of the budget required for the second roll out (based on the actual cost) and of the budgets for the third and fourth roll outs. An update for the fifth roll out will be made, if necessary, with the progress of the project and the preparation of a detailed planning of these roll out.

This budgetary update has recently been discussed by the Computerization Committee of the Board, which decided to recommend to the Board that the budget be increased to US$ 185 million, excluding VAT (namely: US$ 216 million including VAT). The Board of Directors is to deliberate this issue in one of its its coming meetings.

An amount of US$ 92.8 million has been invested in the project by December 31, 2004 (for details of software development costs that were capitalized, and the amortization of costs so capitalized in respect of systems put into operation, see Note 7).

CONTROL OF THE BANK

In consequence of the crisis on the shares market in October 1983, with respect to the "regulation" of this market, and as part of the measures taken to confront the situation that had occurred, The Government of Israel, on behalf of the State of Israel, entered into a series of agreements that created an arrangement to finance the acquisition from the public of the shares in each of the banking groups that were involved in the crisis.

In accordance with the Bank Shares in Arrangement (Temporary Provision) Law, 1983, (hereinafter – "the Bank Shares in Arrangement Law"), the shares of the Bank were transferred to the ownership of the State of Israel on October 31, 1983, which as from that date became the controlling owner of the Bank, due to its holdings of the shares of the Bank.

According to the Bank Shares in Arrangement Law, use of the voting rights attached to the shares held by the State of Israel shall be exercised by the Committee for the shares of the Bank for and on behalf of the State of Israel.

As of date of this report the State holds 559,870,403 Ordinary "A" Shares of NIS 0.1 each par value of the Bank, comprising 57.09% of the outstanding capital of the Bank and of the voting rights therein. This, after two offers for sale by the State of the Bank shares made in 1996 and 1997 to the public and to the employees of the Bank, in accordance with Prospectuses published by the State and the Bank, and after a private placement of the Bank's shares made to institutional investors in 2001.

Concerning the agreement for the sale of a controlling interest in the Bank signed on February 1, 2005, see hereunder in the Section "Sale of the Bank" and in Note 37 to the financial statements.

TRANSACTIONS IN THE BANK'S SHARES

On July 29, 2003, IDB Holding Company Ltd. sold, in an off-market transaction, 54,867,427 ordinary "A" shares of NIS 0.10 par value each of the Bank, comprising 5.6% of the outstanding capital of the Bank, for a total consideration of NIS 200 million. The per share quotation for this transaction was 364.5 points.

On October 30, 2003, IDB Holding Company Ltd. sold, in an off-market transaction, 29,000,000 ordinary "A" shares of NIS 0.10 par value each of the Bank, comprising 2.96% of the outstanding capital of the Bank, for a total consideration of NIS 103 million. The per share quotation for this transaction was 357.0 points. Following this sale, IDB Holding Company Ltd. ceased to be an interested party of the Bank.

As detailed in the section "Agreement for the sale of a controlling interest in the Bank", an agreement was signed on February 1, 2005, for the sale of the controlling interest in the Bank. On March 9, 2005, the Bank approached M.I. Holdings Ltd. for details of the sale so that the effective price per share could be disclosed in this Report. Only in the late hours of March 27, 2005 (towards midnight), did the Bank receive additional details, as stated in subsection "Credit Agreement" hereunder, and representatives of the Bank were invited to review the credit documents at the offices of the representatives of M.I. Holdings Ltd. In view of the time schedule for the publication of the Annual Report for 2004, the Bank had insufficient time to examine the issue of the calculation of the effective price or review the documents mentioned above. The Bank will publish the effective price per share immediately after the said data will be made available to it.

SALE OF THE BANK

THE SALE PROCESS IN THE YEARS 1998 – 2000

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-market 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.

THE SALE PROCESS IN THE YEARS 2004 – 2005

On May 5, 2004, the Accountant General and M.I. Holdings Ltd. issued a statement informing that the Government of Israel is considering the sale, by way of a private offer, of the shares that it owns in the Bank. The State's holdings in the Bank that are being considered comprise between 26% and 51% of the outstanding capital of the Bank.
According to the said statement, those interested in the transaction were invited in the first stage, to offer their application to M.I. Holdings. Following a preliminary screening and depending on its results, M.I. Holdings Ltd. may invite certain of the applicants to submit their offer for the purchase of the shares. The last date for submission of the applications was July 20, 2004, and to the best knowledge of the Bank, five applications had been submitted to M.I. Holdings Ltd. up to the said date.
It should be noted that the Bank was not a party to the process of the sale of the Bank's shares.
For details regarding a labor dispute announced by the New Histadrut Federation of Labor in the matter of "The demand for the signing of a special collective labor agreement securing the rights of the employees in regard to the process for the sale of control of the Bank", see "Labor relations" above.
An Information Room was opened on October 14, 2004, for use by the representatives of the approved applicants and by representatives of M.I. Holdings Ltd. performing a "Due-Diligence" review. On November 22, 2004, another Information Room was opened in New York for use of the said examiners in performing a Due Diligence review of Bancorp. The Information Room in New York had been open for several days. The Information Room in Israel was closed on January 14, 2005.

AGREEMENT FOR THE SALE OF A CONTROLLING INTEREST IN THE BANK

On February 1, 2005, the Bank was informed by the State of Israel and by M.I. Holdings Ltd., that on that date an agreement was signed between M.I. Holdings and the Government of Israel (hereinafter: "the Government") on the one hand, and a corporation, which to the best knowledge of M.I. Holdings and the Government is controlled by the Bronfman Family and others, and another corporation, which to the best knowledge of M.I. Holdings and the Government is controlled by Mr. Rubin Schron (hereinafter together: "the Buyers") on the other hand, for the sale of a controlling interest in the Bank (hereinafter – "the Agreement for the Sale of a Controlling Interest in the Bank").
According to the information provided to the Bank, the terms of the Agreement for the Sale of a Controlling Interest in the Bank are as follows:

- The Buyers will purchase shares of the Bank comprising 26% of the outstanding capital of the Bank, and will also receive an option, for a period of three years from the completion of the transaction, to purchase additional shares comprising up to 25% of the outstanding capital of the Bank.
- Arrangements between the Government and the Buyers will be prepared for coordinating their manner of voting and for exercising control of the Bank, and for cooperation and limits which will be imposed with regard to the future sale of shares of the parties in the Bank.

- In consideration for the shares and option as aforesaid, the Buyers will pay approximately NIS 1.3 billion (comprising approximately NIS 5.1 per share). In the event that the option is exercised, the Buyers will pay an exercise price that might reach an additional sum of approximately NIS 1.25 billion (in the event of the full exercise of the option). Interest will be added to the consideration of the sale according to the date of completion of the transaction.
- The consideration of the sold shares and the consideration for the exercise of the option will be paid mainly (81.25%) in cash, the balance will be paid on credit terms which were agreed, for a period of up to three years from the sale of the shares or the exercise of the option, as the case may be.
- An additional consideration of up to NIS 156 million might be paid by the Buyers to the State according to the return on equity of the Bank.
- The completion of the transaction is subject to conditions which were determined, including receipt of various regulatory approvals in Israel and overseas.
- The Employees Agreement, as defined hereunder, was annexed to the Agreement for the sale of a Controlling Interest in the Bank. Pursuant to the Agreement for the Sale of a Controlling Interest in the Bank, if the Bank will not enter into the Employees Agreement or into another arrangement with the employees, which will be in a form not significantly different from the Employees Agreement, and subject to the terms agreed in this matter in the Agreement for the Sale of a Controlling Interest in the Bank, then each of the parties to the Agreement for the Sale of a Controlling Interest in the Bank would be entitled to notify the other parties of the cancellation of the transaction.
- Concurrently with signing the Agreement for the Sale of a Controlling Interest in the Bank, the Buyers and the Government entered into an agreement providing interim finance for the State Grant to employees in respect of that part of the option, which may not be exercised by the Buyers (see hereunder for details of the "State Grant to Employees" provided in the Employees Agreement). According to the said agreement, in the event that the Buyers would not exercise the option in full, they are committed to finance that part of the State's grant due to the employees in respect of the unexercised shares, and the Government shall refund this amount to them out of the consideration to be received by it from future sale of the shares of the Bank or at the end of eight years.

CREDIT AGREEMENT

The Buyers shall be entitled to pay the balance of the consideration on dates and under terms detailed bellow, subject to the signing at date of closing of an Annex to the Sale Agreement, which will includ provisions for assuring the payment of the balance (hereinafter – "the Credit Agreement"):

- Subject to that stated hereunder, the balance of the consideration shall be paid until the end of 36 months from date of closing of the transaction (hereinafter – "the First Period").
- As from January 11, 2005, and until the closing date of the transaction, the balance of the consideration shall bear interest at an annual rate equal to a four month US dollar LIBOR interest rate, as published at 13:00 hours on January 10, 2005, (namely: 2.69%)
- Upon the closing of the transaction, the balance of the consideration together with the interest accrued thereon as above, shall be translated into New Israel Shekels (NIS).
- As from the closing date and until the balance of the consideration is paid in full, the outstanding balance still unpaid shall be linked to the CPI and shall bear interest at an annual rate of 4%. Accrued interest as above shall be paid annually.
- As collateral for the fulfilment of the Buyers obligation to repay the debt to the Government, the Buyers are to pledge in favour of the Government, by way of a first degree fixed pledge, unlimited in amount, shares of the Bank comprising 6% of its

outstanding capital, as well as the earnings on such shares (hereinafter – "the Pledged Shares"). At the end of the first period and under the circumstances determined, the pledge on a certain quantity of the shares shall be removed in a way that the pledge shall apply to shares comprising a total of 5% of the outstanding capital of the Bank.

- In addition, the Buyers shall provide the Government and M.I. Holdings on the closing date, personal letters of guarantee in an agreed text and in a total amount of US$ 10,800,000.

  The right of recourse to the Buyers, over and above the collateral mentioned above, is subject to the permit of the Bank of Israel.
- Under certain conditions the Buyers shall be entitled to make an early repayment of the outstanding balance of the consideration, in whole or in part. Furthermore, in the event that the Bank would distribute dividends, then the Buyers will have to make an early repayment up to certain determined amounts.
- In the event that an early repayment has been made following the distribution of dividends by the Bank as above, then under certain conditions, the Buyers may request the granting of new credit in the amount of the early repayments made by them.
- The Buyers shall be entitled to defer the last date for the payment of the balance of the consideration until the end of 36 months from the end of the first period, subject to certain conditions, including:
- The option has been partly or fully exercised by the end of the exercise period. If only a part of the option is exercised then the last date for the payment of the balance of the consideration will be deferred only as regards a proportion of the outstanding balance of the consideration in accordance with the ratio of the number of shares exercised to the total number of shares covered by the option.
- Until the end of the first period, the shares comprising the controlling interest in the Bank that are not pledged has to reach a rate of 26% of the outstanding capital of the Bank.
- On the date on which the Buyers request a deferment of the last date for the payment of the consideration, the collateral as stated above, has to meet with the determined ratio of collateral to debt.
- So long as a debt as detailed above exists, the Buyers shall be subject to certain limitations, including limitations on transactions in the pledged shares, on the distribution of dividends, on the registration of an additional pledge on the shares acquired through the exercise of the option, and limitations on various actions regarding the Bank, which may affect the value of the collateral, without the prior consent of the Government. In addition, the Buyers will have to abide by a certain ratio of the collateral to the outstanding debt (a ratio of the amount of the personal guarantees plus the market value of the pledged shares, according to a determined calculation, or the value of other collateral provided by the Buyers, to the balance of the debt).
- In addition, the Credit Agreement determine agreement violation events and other circumstances in which the debt will become immediately payable.

EMPLOYEES AGREEMENT

On February 1, 2005, concurrently with the signing of the Agreement for the Sale of a Controlling Interest in the Bank, an agreement was signed between the New Histadrut Federation of Labor (hereinafter: "the Histadrut"), the Representative Committee of Discount Bank Employees and the Accountant General of the Ministry of Finance (hereinafter – "the Employees Agreement"), which among other things, is subject to the approval of the Bank. The Employees Agreement is intended to settle several demands raised on behalf of the employees of the Bank in connection with their rights in light of the sale of the controlling interest in the Bank by the State.

Setout below are the provisions of this Agreement:

- The Histadrut, as the organization representing the workers, conceded, on behalf of the employees, their right to purchase the balance of 10% of the shares of the Bank which are held by the State, at a 25% discount, and to a subsidized loan by the Bank to finance this purchase, as is customary in privatization of banks being part of the "Share Arrangement".
- In exchange for the concession, as above-mentioned, the employees will receive from the Government cash amount equivalent to a value of 30% of the value of the 10% of the Bank shares which were not offered at a discount to the employees. In the Employees Agreement it was declared that the value of the benefit for conceding the purchase of the shares as aforesaid is NIS 120 million (hereinafter – "the State Grant to Employees").
- The employees would be entitled to receive from the Bank a bonus on account of 2004, of one salary to each employee (hereinafter – "the Bonus for 2004"), as well as a special grant with regard to conceding of the right to receive a subsidized loan for which they would have been entitled as is customary for the privatization of the banks being a part of the "Share Arrangement" (hereinafter – "the Special Grant").
- The total value of the Special Grant and the Bonus for 2004 is approximately NIS 130 million (hereinafter together: "the Bank Grant to Employees").
  It should be clarified that in a conversation held between the President & CEO of the Bank and the Deputy Accountant General at the Ministry of Finance, it was made clear to the Bank that the amount of the Bank Grant to Employees (amounting as stated above to NIS 130 million) reflects the total cost to the Bank as the employer of these employees. The content of this discussion has been put in writing in a letter sent by the Bank to the Deputy Accountant General.
  Amounts in excess of the said NIS 130 million, will be paid by the Government.
- The State Grant to Employees and the Bank Grant to Employees (hereinafter – "the Total Grant") amount to NIS 250 million. The Total Grant shall be paid to the employees subject to the closing of the Agreement for the Sale of the Controlling Interest in the Bank, and on dates determined in the agreement.
- The employees entitled to the Total Grant are those who at date of closing are employees of the Bank, of Mercantile Discount Bank and of the wholly owned subsidiaries in Israel, and who are tenured and permanently employed, and also those employed under personal employment agreements, which at closing date have been with the Bank for at least one year.
  The Employees Agreement clarifies that the share in the total bonus relating to the employees of Mercantile Discount Bank shall be paid by the Government and the Bank subject to the signing of a separate agreement with these employees.
- The power of the Labor Charter as a collective labor agreement at Discount Bank, shall be extended for a period of five years, namely until December 31, 2009. At the end of this period, the parties shall act with regards to the power of the Labor Charter, in accordance with Section 3 to the Charter.
- The Agreement for the Sale of a Controlling Interest in the Bank is to include a provision that in the event that the control of Discount Bank of New York is sold, then the full cash proceeds of such a sale will be transferred to the Bank, and that no dividend shall be distributed out of such proceeds in the period of five years from date of signing the Agreement for the Sale of a Controlling Interest in the Bank, unless otherwise agreed with the Representative Committee of the Employees.
- The labor dispute announced on March 11, 2004, with regard to the privatization of the Bank, shall be terminated immediately upon the approval of the Employees Agreement.
- Immediately following the approval of the Employees Agreement, the employees will cooperate in any matter or action required for the closing of the transaction for the Sale

of the Controlling Interest in the Bank, and for the sale of the balance of the shares remaining in the hands of the State, and in any other required process, if at all. (In this respect it has been clarified that that the term "employees" in relation to the above, excludes the employees of Mercantile Discount Bank).

- Subject to the approval of the Employees Agreement, the parties to the Employees Agreement have mutually committed that in the period until the closing date of the transaction or until September 30, 2005, whichever is later, they will mutually maintain "industrial peace". No one-sided actions will be taken or one-sided organizational changes made by any of the parties that are not compatible with the Labor Charter. No strike or closing-down measures, in part or in full, will be taken, neither will anything that might impair labor relations and orderly work procedures be brought into effect.

The Employees Agreement is subject to the approval of the authorized organs of the Bank. On February 7, 2005, the Audit Committee of the Bank and the Board of Directors of the Bank approved the Bank joining the Agreement. The resolution emphasized that the total cost to the Bank (employer's cost) will be NIS 130 million (and shall not exceed that amount). Joining the Agreement is also subject to approval of the General Meeting of Shareholders of the Bank. A general meeting was convened for April 5, 2005.

The Employees Agreement is also subject to the approval of the Finance Committee of the Knesset. The Employees Agreement provides that the Government shall request the approval of the Finance Committee to this Agreement together with the request for approval of the transaction for the Sale of a Controlling Interest in the Bank as one package.

THE ACCOUNTING TREATMENT OF THE EMPLOYEE AGREEMENT

The financial statements for 2004 include a provision in respect of the bonus for 2004, to the tune of one salary, based on the assessment that in view of the results for the year 2004, the Bank and its other relevant subsidiaries in the Group would have in any case paid such a bonus to their employees. The amount of the said bonus is NIS 73 million.

The provision in respect of the balance of the Bank Grant to Employees in the amount of NIS 57 million, comprising the said special bonus, will be reflected in 2005, in the financial statements for the quarter in which the conditions precedent in the Employees Agreement are fulfilled, and in particular the closing of the transaction for the sale of a Controlling Interest in the Bank.

As to the State Grant to Employees, the Bank was informed by the Supervisor of Banks that the Grant to be paid by the State (an amount of NIS 120 million, and under certain circumstances even higher, if the State will have to bear further amounts in respect of the addition of employer related costs) is considered "a transaction with a controlling party", therefore the grant paid by the State is to be recorded as part of payroll expenses against a capital reserve.

The expense regarding the State Grant to Employees will be recorded in the financial statements of the Bank, in accordance with the said directive of the Supervisor of Banks, at the time of recording the provision for the special bonus.

SPECIAL ARRANGEMENTS IN THE INTERIM PERIOD UNTIL THE CLOSING OF THE TRANSACTION FOR THE SALE OF A CONTROLLING INTEREST IN THE BANK

On February 21, 2005, the Minister of Finance approached the Chairman of the Bank's Board of Directors in view of signing the agreement for the Sale of a Controlling Interest in the Bank, and the expected time-table for the closing of the transaction, which may last for several months, mainly due to the need to obtain regulatory approvals for the transaction, both in Israel and abroad.

In view of the scope and materiality of the transaction on the one hand, and the long interim period that might pass from the date of signing of the agreement to the closing date of the transaction on the other hand, The Minister of Finance was of the opinion that it would be appropriate that measures should be taken so as to minimize, as far as possible (and subject to the provisions of the law), the changes that might take place in the business of the Bank in this period, unless after hearing the opinion of the representatives of the Buyers or after consulting with them, as follows.

Accordingly, the Minister of Finance asked that his opinion should be brought before the Board of Directors, as follows:

1. Until closing date of the transaction, any material transaction that is not within the ordinary course of business of the Bank, shall be effected only after the standpoint of the representatives of the Buyers has been brought before the Board;
2. Until closing date of the transaction the appointment of Senior Executive Officers of the Bank (from the position of Executive Vice President and above) would be made only after consultation with the representatives of the Buyers, unless it would be possible to remove the said Executive Officers from office after closing date, without the payment of indemnification in excess of that prescribed by Law, or if the terms of the agreement with that Executive Officers are similar to those existing in agreements of other Executive Officers, and which do not relate to the payment of any indemnification in respect of removal from office or retirement following the change of control in the Bank;
3. Until closing date of the transaction, the Board of Directors are to allow an observer, recommended by the Buyers and approved by the Chairman of M.I. Holdings Ltd. and by the Chairman of the Board of the Bank, and with the consent of the Supervisor of Banks, to participate in meetings of the Board of Directors of the Bank;
4. To the extent that the matter is within its control, the Bank shall act that the matters stated above will apply, mutatis mutandis, also to its branch and to its subsidiaries: Discount Bancorp Inc. (including IDB NY); Mercantile Discount Bank Ltd., Discount Mortgage Bank Ltd., Israel Credit Cards Ltd., Israel Discount Bank (Switzerland) SA, Israel Discount Bank Ltd. – London Branch.

In this respect, the Minister of Finance clarified that the representative of the Buyers is Mr. Shlomo Zohar, CPA, (so long as the Buyers have not notified about the appointment of another representative), subject to the consent of the Supervisor of Banks to the identity of this person, and subject to the identity of the observer recommended by the buyers (or other observers in the case of the various companies of the Bank's Group) being notified to the Bank following approval by the Supervisor of Banks.

In its meeting of March 15, 2005, the Board of Directors took notice of the said letter of the Minister of finance, and resolved that, subject to restrictions setout by law and subject to that discussed below as regards the overseas subsidiaries, the Board shall act taking notice of the Minister's opinion.

The Board instructed the Management of the Bank to seek guidance with the Supervisor of Banks as to whether an approach by the Bank to its overseas subsidiaries in which it requests their Board of Directors to enter on their agendas the letter of the Minister of Finance, would not create a situation where the Bank and/or its overseas subsidiaries will be deemed to have acted in contravention to the provisions of the law and/or regulation applying to such subsidiaries, and that the Supervisor of Banks instruct the Bank how to act in this matter. A letter in this respect was sent on March 17, 2005.

The letter of the Minister of Finance has been brought to the attention of Mercantile Discount Bank, Discount Mortgage Bank and Israel Credit Cards and these subsidiaries have been asked to enter the matter on the agenda of their next Board meeting. The letter was also brought to the attention of the Manager of the London Branch of the bank.

On March 17, 2005, the Bank received the approval of the Supervisor of Banks to the appointment of Mr. Shlomo Zohar as an observer to the Board of Directors of the Bank and to committees of the Board: Human Resources, Computerization and Financial Statements, as well as to the Board of Directors of the following subsidiaries of the Bank: Mercantile

Discount Bank, Discount Mortgage Bank, and Israel Credit Cards. Among other things, the approval of the Supervisor of Banks is subject to Mr. Zohar abiding by all the provisions regarding the conflict of interest included in Proper Banking Procedures in regard to the "Board of Directors" (Directive No.301), mutatis mutandis.

The consent of the Supervisor of Banks to Mr. Zohar acting also as the representative of the Buyers was also received on that date.

On March 22, 2005, M.I. Holdings and the Chairman of the Board of the Bank approved the appointment of Mr. Zohar as observer to the Board of Directors of the Bank, and to the Human Resources, Computerization and Financial Statements Committees of the Board, as well as his appointment as observer to the Board of Mercantile Discount Bank Ltd.

GOVERNMENT DECISIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE

GENERAL

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** was, inter alia, enacted. The law was designed to regulate the holding of such shares and the exercise of the voting rights attached thereto, and other ancillary matters.

Setout bellow are certain details pertaining to this law:

(a) By virtue of the law, 86.78% of the shares of the Bank were transferred into the ownership of the State on October 31, 1993. It has been stipulated however, that the Government Corporations Law,1975, will not apply to the Bank, and that the Bank will not be treated as a Government Corporation or a corporation under the management of the Government (for details of the holdings of the State of the Bank's shares at balance sheet date, see section "Control of the Bank" above and Note 22 G. to the financial statements. For details regarding the transaction for the sale of a controllinig interest in the Bank, see the section "Sale of the Bank" above and Note 37 to the financial statements.

(b) The law provides that the exercise of the voting rights attached to the shares be exercised on behalf of the State by the Committee for the Shares of the Bank, which was appointed for this purpose.

(c) Section 28 of the Bank Shares in Arrangement Law stipulates that the Minister of Finance, with the approval of the Government or with the approval of a ministerial committee empowered by the Government, will be entitled to instruct the Committee to summon a general meeting of the Bank and to attend such a meeting and to vote in accordance with his instructions, if required, in his opinion, in order to effect a sale of the shares, and other ancillary actions; to prevent or reduce the actual impairment, directly or indirectly, of the rights attached to the shares, the ability to sell them or adversely affect the consideration which will be received on the sale thereof; to effect structural changes, including the sale of significant assets of the Bank, or a reorganization of the Bank and companies under its control, which are required according to law, or on which the Government resolved prior to October 31, 1993; setting of a policy for the distribution of dividends; delegate the powers and authority on matters mentioned above to the general meeting.

(d) Section 34 of the Bank Shares in Arrangement Law prescribes that resolutions of a general meeting and their implementation as referred in Section 28 of this law, as well as

cooperation and the passing-on of information as required under Section 33 of this law, will not constitute grounds for a civil lawsuit, provided that implementation of the resolutions and the actions were carried out by the Bank, a company under the control of the Bank, an officer of either of them or one of their employees, as the case may be, at a level of skill at which a reasonable person of the same status and standing would have acted in the same circumstances, and in a manner which will to the extent possible, reduce damage to the Bank, to a company under the control of the Bank, or to a third party.
However, with regard to a claim based on a cause of action pursuant to the Securities Law, 1968, the. provisions of that law will apply.

Splitting-off other banking institutions and sale of blocks of shares: The Government decision of May 2, 1993, states that the Government and the Bank of Israel would "inter alia, work towards splitting off small and medium sized banks from the banks which hold them", and in relation to the Bank, it was decided on the separation of Mercantile Discount Bank (see hereunder). The Government decision also deals with the possibility of the "split-off of additional banking corporations, including the sale of blocks of shares which one bank holds in another", without any further clarification.

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 the financial statements issued by the Bank up to the date of the Government's decision as aforesaid, the Bank considered its investment in Mercantile Discount Bank as a fixed investment. Accordingly, prior to the Government's decision, no provision was recorded in the past for tax on the Bank's share in the retained earnings of Mercantile Discount Bank. As a result of the aforesaid Government resolution, the Bank no longer could treat the investment in Mercantile Discount Bank as a fixed investment and thus, the Bank recorded adequate provisions for tax in respect of its share in earnings of Mercantile Discount Bank.
On May 20 2004, the decision of the socio-economic cabinet received the authority of a Government decision to erase the first paragraph of section b(1) of the decision of May 2, 1993, regarding the separation of Barclays-Discount Bank Ltd. (in its present name of Mercantile Discount Bank Ltd.) from Israel Discount Bank Ltd. In view of the said decision, the provision for tax in respect of the Bank's share in the profits of Mercantile Discount Bank' created in the past and amounting to NIS 33 million, becomes superfluous, and its reversal is reflected in the financial statements as of December 31, 2004.
As regards the sale of Mercantile Discount Bank as well as the shares that Discount Bank had purchased from Barclays Bank PLC, and which the Governor of Bank of Israel instructed their sale until December 31, 1995, the Governor of Bank of Israel extended from time to time the date fixed for the sale of these shares. On July 1, 2004, the Governor of Bank of Israel granted the Bank a permit under Section 34 of the Banking Law (Licensing)-1981, to control and hold all the means of control of any sort whatsoever, in the Mercantile Discount Bank.

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 issued on February 20, 2000, the "Conclusions of discussions regarding the control by banks over provident funds and the provident fund draft bill", a

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. 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 conflicts between parties operating in this field, as well as to examine and propose ways of increasing fair competition and trading in the capital market. The recommendations of the team have not been accepted by the Government.

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.

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.

In August 2004, the Income Tax Regulations (Rules for the Approval and Management of Provident Funds)-1964, were extensively amended so that, inter-alia, they require provident funds to calculate the daily return, they regularize the specialized funds and they impose limitations on related party transactions and require the purchase of professional liability insurance. As part of these Regulations various duties were imposed on provident funds in respect of their members, including the duty to trace members, to provide notices and to facilitate the transfer of members' funds from one fund to another.

Most of the said instructions came into effect in September 2004, while certain of which will become effective in April 2005.

The subject of the holdings of banks in provident funds is among the principal issues discussed in the Bachar Committee Report, and of the law proposals tabled in its wake, as detailed hereunder.

SUGGESTED CHANGES IN THE STRUCTURE OF THE CAPITAL MARKET

In April 2004 the Minister of Finance formed a team, headed by the Director General of the Ministry, with the object of recommending measures for the actions required for basing a competitive structure in the capital market ("the Bachar Committee").

At the beginning of November, the Bachar Committee published its report, the principal recommendations of which are as follows:

- A banking corporation shall not be permitted to own means of control in a company managing provident funds, or in a provident fund, and in a company managing mutual investment trust funds, neither will a banking corporation or whoever controls it or is controlled by it be permitted to be an interested party in a provident fund or in a mutual investment trust fund or in a corporation that is an interested party in such an entity. The Committee suggested a timetable for the gradual application of this recommendation over a period of three years (in respect of provident funds) and four years (in respect of mutual investment trust funds).
- An underwriter shall not be qualified to act as a pricing underwriter in a public offer of securities if the outstanding cumulative balance of debt of the issuer or of the offeror and entities controlled by them to the banking group to which the underwriter belongs, exceeds NIS 5 million and such balance comprises over 10% of the total financial liabilities of the issuer or offeror.
- An underwriter shall not be permitted to sell over 5% of the value of the securities offered in the issue or in the offer for sale in respect of which he acts as an underwriter, to himself, and to all the institutional bodies and to customers of the portfolio

management companies that are controlled by him, control him or controlled by them

- A provident funds law should be enacted, which would regulate the control and enforcement principles regarding provident funds, including the rule that control and ownership at a certain percentage of the means of control in an institutional body will require receiving a permit.
- An acquisition of a provident fund or an insurer shall not be permitted if subsequent to the acquisition the market share of the purchaser, its controlling entities and entities controlled by them, will exceed 15% of the long-term savings market (i.e., the cumulative total amount of assets being managed by provident funds, new pension funds and the profit sharing portfolio of life assurance policies).
- An acquisition of a provident fund or an insurer shall not be permitted if subsequent to the acquisition the market share of the purchaser, its controlling entities and entities controlled by them, will exceed 20% of the mutual investment trust fund market.
- The legislation pertaining to the capital market is to define two occupations, which will require qualification and licensing, and which will be subject to regulation and supervision – consulting and marketing, both as regards financial products (including securities, mutual investment trust funds, structured bank deposits) and as regards pension products (including provident funds, profit sharing life assurance and pensions). A banking corporation the equity of the banking group to which it belongs exceeds NIS 10 billion, shall be required to complete the sale of all its holdings in mutual investment trust funds.
- A banking corporation shall not be permitted to engage in the marketing of certain financial products, in respect of which it will be permitted to provide consulting services only.
- On the other hand, a banking corporation shall be permitted to provide consulting services or to sell life assurance and pension products, after having completed the sale of all his holdings in provident funds and as long as it is not an interested party in an insurer (including a pension fund). A banking corporation the equity of the banking group to which it belongs exceeds NIS 10 billion, shall be required to complete the sale of all its holdings in mutual investment trust funds.
- Entities engaged in consulting, including a banking corporation, shall not be permitted to accept any consideration from the owner of the financial or pension instruments in respect of activities conducted in such products, including distribution fees.

In addition, the team desires to examine and form recommendations for the further intensification of competition in the capital market, by way of examination and general arrangements regarding commercial papers, Repo, Money Market Funds, distribution of mutual investment trust funds by non-members of the Stock Exchange, facilitating the movement of customers from one bank to another, deposit insurance, nostro investments, banks acting as market makers and implementing securitization schemes in the banking industry. Recommendation on these matters will be submitted to the Minister of Finance until June 30, 2005.

On November 14, 2004, the Government discussed the recommendations of the Committee and approved them. However, the Director General of the Prime Minister's Office and the Director General of the Ministry of Finance were assigned with the task to form a framework for the implementation of the recommendations of the Committee, after having examined the comments of the Government Ministers and of the public and after consulting with the members of the "Bachar Committee", and if required, suggest adjustments to the proposed Reform.

In February 2005, as a result of the recommendations of the Bachar Committee, the Ministry of Finance published three law proposal memorandums, which declared object is to bring about improvement of competition in the capital market, reduction of centralization and minimization of conflict of interests.

Following are the principal proposed amendments to existing legislation and the new proposed laws:

Banking laws (Banking Law (licensing), Banking Ordinance and Banking Law (customer service))

- Banks shall have to gradually dispose of their holdings in mutual funds and in provident funds over a period of 3 to 4 years.
- Restrictions are to be imposed on the holdings of banks in a corporation that holds provident funds, mutual funds or a corporation that manages investment portfolios of institutional bodies.
- Banks shall be allowed to provide pension advisory services, though material limitations are to apply in this respect.
- The consent of the Supervisor of Banks will have to be obtained for the formation of an auxiliary corporation for a bank.
- The Supervisor of Banks shall be authorized to impose monetary fines (civilian) on a bank that would violate certain provisions of the Banking Law (Licensing), the Banking Ordinance and the Banking Law (Customer service).
- The Supervisor of Banks shall be authorized by legislation to issue proper banking management directives.
- The Supervisor of Banks shall be authorized to pass on to other regulatory authorities information that reached him while performing his duties.

Legislating relating to the supervision of financial services (provident funds, insurance and financial products)

Amendments to the Supervision of Insurance Business Law are proposed, as well as two law proposal memorandums dealing with investment consulting, marketing of pension products and provident funds.

- The Supervision of Insurance Business Law – The power of those engaging in insurance brokerage are to be extended to include also pension consulting, and the authority of the Supervisor of Insurance Business is to be extended both as to the licensing of insurers and insurance agents and to the determination of rules as to insurers and, and also as to enforcement powers.
- The memorandum of the law proposal for the supervision of financial services (engagement in consultancy and in the marketing of pension products) determines the differentiation between consulting and the sale of pension products.

  A bank shall be entitled to provide consulting services as to pension products, with the exception of products managed by institutional bodies, where those who control them or are being controlled by them, are interested parties in the bank, and where they are connected with that body as far as operating management services are concerned.

  A bank shall not be allowed to market pension products.

  Pension consulting shall be provided exclusively at the branches of the bank, and it should not include pension consulting to an employer in respect of his employees.

  A bank shall not be permitted to receive a distribution commission from the manager of the pension product, but only from the customer.
- The memorandum of the law proposal for the supervision of financial services (provident funds) includes all the provisions existing at present in the Income Tax Regulations and regularizes also additional issues. As proposed, a provident fund is to be managed as a trust fund and the rights of the members therein will not be available for pledge or mortgage; the conditions for the establishment of a provident fund management company will be regularized as well as various other issues connected to the activity of such a company and the activity of its organs. The Minister of Finance shall be authorized to determine rules for the management of the fund's moneys, the transfer of the management of a provident fund to another company, merger, etc.

The Law for Regularization of Investment Consulting and Investment Portfolio

Management Business

The proposed amendment differentiates between an investment consultant and a marketer. Banks will not be permitted to market financial products. Therefore banks have been defined as consultants; in addition it is proposed that banks would not be permitted to engage in consulting if they hold 5% or more of an institutional body (including an insurer).

A bank holding a consultant license shall not be allowed to offer consultation as regards financial assets of an institutional body, which is controlled by the bank, which controls the bank or which is an interested party in the bank.

A holder of a consultant license shall not be permitted to issue basket certificates.

Banks shall be permitted to market structured products owned by it.

The engagement of a bank with an institutional body for the provision of banking services, which is not part of the ordinary course of business of the bank shall require approval of the Supervisor of Banks, the Chairman of the Securities Authority, and in the coming years also the approval of the Commissioner of Restrictive Trade Practices.

Portfolio managers would be allowed to provide investment consulting and market investments, however, a portfolio manager who is connected to a bank shall not be permitted to engage in marketing.

Anyone who is not a marketer shall not be allowed to receive benefits for consultation, except for fees and reimbursement of expenses from the customer.

Mutual Trust Investments Law

In this respect it is proposed that the Chairman of the Securities Authority would be authorized to approve the holdings of means of control in a fund manager, and restrictions would apply to the acquisition of such means.

A distributor would be allowed to receive a uniform distribution commission from various fund managers in accordance with the types of funds managed by them.

The Minister of Finance shall be authorized to determine the distribution commission that a distributor may charge the customer in the event that the distributor could not reach an arrangement with the fund manager.

The above law proposal memorandums include additional rules to those recommended by the Bachar Committee, and in many cases such rules are even stricter as regards the banks than the rules proposed by the Bachar Committee. The said proposals even increase the supervision and regulation of the operations of banks in a manner that certain of the business areas in which banks engage would require involvement and licensing by two or three Regulators.

It should be noted that at this stage there is no certainty that the said legislation will in fact be passed, and if so, in which format. The scope of the proposed legislation and the implications that changes in certain parts thereof might have, may be most significant to the analysis of the possible implications it might have on the Bank.

The damage to the Bank from detachment of the provident funds and mutual funds is mostly the loss of income and from the difficulty to receive an appropriate price under the constraints of a forced sale, in particular under the circumstances that might be created in the market when all banks would be forced to sell their holdings in provident funds and in mutual funds within a set period, and in view of the intention that holdings at certain rates would require the approval of various Regulators.

The distribution model devised by the proposed legislation is an innovative model that has not as yet been tried by other capital markets in western countries, and the implications that it might have on the income of the Bank and its volume of operations is unclear.

The proposed limitations to be imposed on the additional business in which the Bank may engage in, and which it is unclear whether they would in fact be adopted by legislation, make it difficult to assess, at this stage, the income that the Bank may earn as a result of the implementation of the proposed legislation, including the consideration to be received from the sale of ownership of the provident and mutual funds, the income to be earned from the new areas of operation on the one hand, and the loss of income from provident and mutual funds on the other hand.

Therefore, the Bank believes that the implementation of the Bachar Committee recommendations as well as the adoption of the legislation proposed in its wake, may have a material adverse effect on the business position of the Bank and on its results of operations. However, in view of everything stated above, the probability that all this will happen and the future implications of the implementation of the capital market reform on the business position and the results of operations of the Bank cannot be evaluated or quantified at this stage.

It should be noted in this respect that in addition to that stated above regarding a private law proposal regarding provident funds, a private law proposal was tabled before the Knesset on June 7, 2004, which forbids banks to control or to manage mutual funds. This law proposal passed its preliminary reading on July 28, 2004. A private bill was also tabled before the Knesset, the object of which is to preclude banks from acting, directly or indirectly, in the fields of underwriting and investment management.

As to the income of the Group from fees for the management of provident and mutual funds, see Note 26 to the financial statements.

LEGISLATION AND SUPERVISION

GENERAL

The Bank operates within the framework of Laws, Regulations and Directives, certain of which are exclusive for the banking industry, and others, though even not exclusive as above, do have an effect on certain sections of its operations.

The Banking Ordinance, various banking laws and the proper banking management directives issued from time to time by the Supervisor of Banks, constitute the central legal basis for the operations of the Bank Group.

These, among other things, define the limits of the operations of the Bank, the permitted operations of subsidiaries and companies related to the bank and the terms for owning and controlling them, the relations between the Bank and its customers, the use made of assets of the Bank, and the mode of reporting to the Supervisor and the public as to the Bank's said operations.

Alongside these, the Bank is subject to a wide legislation that regulates its capital market operations both on behalf of customers an on its own behalf (for example: investment and customer portfolio management consulting, mutual investments funds, the overall activities of provident funds, securities laws and restrictions on insurance business activity).

Additional legislation as regards special subjects imposes on banks, including the Bank, specific duties and rules. Thus for instance, the legislation relating to the prohibition of money laundering and the prohibition of financing of terror activities, the credit data law, legislating relating to housing loans, guarantees, etc.

In addition legislation exists, which because of its connection to the operations of the Bank, has a considerable implication on the way the Bank is being managed. In this respect it should be mentioned, among other things, the debt execution laws, liquidation and receivership laws, laws relating to specific economic sectors (local authorities, mortgagees, the agricultural sector) and various tax laws.

Following is a summary of legislation changes and relevant legislation initiatives during the reported period, which affect or might have a significant effect on the operations of the Bank.

LEGISLATIVE INITIATIVES AND NEW LEGISLATION

Abundance of legislation initiatives. The year 2004 saw an abundance of legislation initiatives. Many private law proposals have been tabled recently (part of which 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, restrictions on the payment and/or collection of interest, separation of provident funds from the banks, separation of mutual funds from the Banks, etc. These law proposals and other similar ones, if passed, might have a material adverse effect on the activities of the Bank and its subsidiaries and on their results of operations in the future. The Bank is not able to evaluate which of these law proposals will in fact be passed and what would be the scope of their effect.

LEGISLATION PROPOSALS AND ARRANGEMENTS REGARDING BANKING COMMISSIONS

In the course of 2004 various issues relating to commissions were debated publicly, including their rate level, classes and the nature of their disclosure. A team on behalf of the Economic Committee of the Knesset and a team on behalf of Bank of Israel (hereinafter: "the Regulating Bodies") as well as experts on behalf of the Union of Banks examined various aspects of these issues. All the said teams have submitted their recommendations.

In this respect several private law proposals have been tabled before the Knesset. These include limitations on the entitlement to increase the rate of commissions, limitation of the aggregate income from commissions and the prevention of commissions in respect of certain services, and a law proposal for the establishment of a fair business practice authority, which will take charge of various matters, including banker-customer relations.

At this stage it is unclear as to the way in which the said recommendations will be implemented. However, the trend that becomes apparent is the reduction in commissions. It is also unclear at this stage whether the said law proposals will in fact be approved in their present form.

In June 2004, the Commissioner of Restrictive Trade Practices informed the Bank that he is inclined to agree with the opinion that the level of competition in providing banking services of managing current accounts, and especially in commissions, is low and accordingly he is considering to act under the authority vested in him under the Restrictive Trade Practices Law, and to proclaim that five banks, including the Bank, form a concerted group. The Bank informed the Commissioner of its opposition to the said position.

Concurrently, in July 2004, the Economic Committee of the Knesset, issued a draft of a package deal plan concerning the issue of commissions and obstructions as to the transition of private customers/households from bank to bank, all this in light of the intention to regulate and reduce the commissions charged to households.

In September 2004, the Bank of Israel presented the Economic Committee of the Knesset with a draft law proposal in the matter of bank commissions. According to this proposal, the Supervisor of Banks will, inter-alia, be authorized to take part in determining the level of certain commissions, including the fixing of a maximum price for certain of which, and will be authorized to prohibit the collection of certain commissions. The Supervisor proposed also the imposition of a monetary sanction on a bank that unlawfully collects commissions. The Government has not as yet approved the said law proposal, and it is unclear whether it will be proposed in this form, whether it will be tabled before the Knesset and what will be its final form, if passed.

On August 25, 2004, the Bank, subject to certain qualifications, notified its consent to the proposal of the economic Committee of the Knesset.

On November 11, 2004, the economic committee of the Knesset received the response of the Commissioner of Restrictive Trade Practices to the said proposal and the terms determined by him for its acceptance, which relate mainly to the mode of determining the amount of commissions, the freezing of commissions and dealing with the lifting of obstacle on the transfer of customers from one bank to another. The Bank took exception to certain of the terms presented by the Commissioner.

Concurrently, the Commissioner issued a proposal for the amendment of the Restrictive Trade Practices Law dealing with the regulation of his authority with respect to a concerted group.
On February 28, 2005, the Supervisor of Banks announced that he takes exception to the "package deal" formed by the Economic Committee of the Knesset, in view of the difficulties encountered in its implementation, and suggested another alternative the essence of which is the abolition of the line entry commission in the account and the fixed commissions, and in its place suggested the fixing of commissions for specific services, including in respect of services for which no commission has yet been charged and the determination of a minimum monthly charge.
On March 20, 2005, the Supervisor informed that he requests the consent of the banks to that part of the "package deal" dealing with the removal of obstacles relating to the transfer of customer accounts from one bank to another. The Supervisor detailed the issues which he proposes to regulate, including the provision of a list of banking institutions to a customer who wishes to change banks, and allowing the other bank to make on behalf of the customer, the necessary arrangements for the transfer of his account.
For further details regarding the "package deal" formulated by the Economic Committee of the Knesset, regarding the alternative proposal of the Supervisor of Banks and regarding actions taken by the Bank in this respect, see the chapter "Activities of the Group according to principal segments of operation", in the Section "Retails sector – Household segment".
At this stage the bank is unable to assess the effect of the said processes, which of them will in fact become law and in what form.

LOCAL AUTHORITIES

In recent months, on the background of the deepening crisis in local authorities, several legislation processes were launched with the aim of distinguishing certain funds received by local authorities, so that they could not be pledged or forfeited:

a. On June 9, 2004, the Knesset passed the Budget Bases Law (Amendment No. 31 and Provisional Instructions) 2004, which determined instructions regarding local authorities and religious councils in financial difficulties. According to the Law, the said authorities and councils, in respect of which a restructuring plan has been approved, would be entitled to open special bank accounts for a period of six months and deposit therein current receipts to be used for specific purposes. Funds deposited in such accounts shall not be used for the repayment of loans taken prior to the opening of such accounts and they would not be available for pledge, forfeiture or assignment. The Law further determines that entities as above, in respect of which a restructuring plan would be approved until July 1, 2007, would be entitled to deposit certain funds, including State grants, in restructuring accounts, and such funds would also not be available for pledge, forfeiture or assignment.

   The said Law impairs the right of the banks to realize existing pledges, impairs their ability to reimburse themselves out of certain funds due to local authorities and religious councils and impairs current repayments of banking credit.

   On June 30, 2004, the Union of Banks appealed to the High Court of Justice requesting the annulment of the said legislation. Since then the Union of Banks is negotiating with the representatives of the State regarding certain understandings as to the way in which the Law will be implemented and as to its application.

   In between, the Accountant General, the Budget Controller at the Ministry of Finance and the Director General of the Interior Ministry declared their policy with respect to the implementation of the said legislative instruction and the granting of new credit by banks to local authorities. This declaration state, inter-alia, that the period of six month determined in the Law for the creation of the special account – which is protected as stated against pledges and foreclosure – shall not be extended. It has been determined that local authorities that require it shall be declared authorities in the process of

rehabilitation only until the end of 2004, and it has also been agreed that current interest charges and debts in arrears shall be paid out of the special account or out of the rehabilitation funds, respectively.
Following this declaration the plea was struck of without an expenses reimbursement order.

b. On August 4, 2004, the Water and Sewage Corporations Law (Amendment No.3) 2004, was passed. Among its instructions is the granting to a local authority in financial difficulties the right to maintain a separate bank account in which would be deposited income receipts and other funds relating to water and sewage only, such funds to be used , first of all, to pay the bills of the water supplier. Any balance remaining in that account would be transferred to the regular account of that authority. This Law grants priority to certain current debts of the authority over the repayment of banking loans.
c. In July 2004, the Interior and Environment Committee of the Knesset debated the Local Authorities Law Proposal (Designating Allocation Funds for Welfare Services Purposes) 2003, dealing with depositing allocation funds in special accounts designated only for welfare services purposes.

Management of the Bank believes that the effect of the legislation already passed by the Knesset and of the said law proposal, if approved, will not be material (for additional details see Note 4 B3 to the financial statements).

PROHIBITION OF MONEY LAUNDERING LAW AND PROHIBITION OF THE FINANCING OF TERROR ACTIVITIES

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 for 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 then a gradual reduction has taken place in blocked accounts.
It has been related, a few months ago, 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. It should be noted that even though the said Order has not yet been approved, ICC is preparing for the implementation thereof as regards new engagements with customers and business houses.

In August 2004, the Supervisor of Banks issued a clarifying and interpretation document on the subject of the prevention of money laundering, in view of the vagueness in the letter of the law as emerged among the banks themselves and between the banks and the authorities.

In December 29, 2004, the Knesset passed the Prohibition of the Financing of Terror Activities, 2004, which will come into force at the beginning of August 2005. According to this Law, anyone who takes action as regards assets of a person knowingly that such a person is active in terror activities or has been declared as such (according to a procedure determined in the Law) is committing a felony. It is also determined that a bank is obligated to report any attempt to act as above and/or or any such action actually taken, and that the non-reporting also constitutes a felony.

Regulations under the above Law have not as yet been published, and there are many ambiguities as to what is required from the banks under this Law.

The preparation for the implementation of this Law requires the Bank additional EDP preparations, intensive training of staff as to everything connected with this subject (which is not similar to money laundering activities) and for the promulgation of additional operating procedures.

Concurrently, the Supervisor issued an additional amendment to Proper banking Management Directives, which instructs banks to prepare, inter-alia, for the adoption of a group policy as regards these subjects and the supervision of its implementation, the management of an EDP system for supporting the monitoring and disclosure of unusual activity in customer accounts, for the determination of standards for the treatment of the risk involved in the deposit of checks.

The Bank is preparing for the implementation of the above matters.

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. Further to the hearing held in April 2004 by the “Committee for monetary sanctions” set up by law, the Committee imposed monetary sanctions on banks in the Discount Group, as follows: NIS 100 thousand on the Bank and NIS 350 thousand on Discount Mortgage Bank. No monetary sanction was imposed on Mercantile Discount Bank and the Committee was satisfied with the issue of a warning only.

In 2004, Bank of Israel performed an audit at Discount Trust Ltd. (the final results of which have not yet been detailed to the Bank) and is expected to perform an additional audit in 2005.

THE CREDIT DATA LAW, 2001

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 Law came into effect on August 5, 2004 after several postponements. The Finance Committee approved on March 23, 2004, the required Regulations for the implementation of the Law.
The Bank is ready to provide the data required by law (though at this stage the requirements have not as yet been agreed with license holders under the law and the data is still not provided).

REDUCING TAX RATES

On June 29, 2004, the Knesset passed the Income Tax Amendment Law (No.140 and Provisional Instructions) 2004, (hereinafter: "the Amendment").
The Amendment determines a gradual reduction in company tax rate from 36% to 30%, as follows: a tax rate of 35% will apply in the tax year 2004, a tax rate of 34% will apply in the tax year 2005, a tax rate of 32% will apply in the tax year 2006 and a tax rate of 30% will apply in 2007 and thereafter.
The reduction in company tax will result in a reduction in the aggregate (statutory) tax rate applying to banking corporations, as follows: 44.52% in 2004, 43.59% in 2005, 41.88% in 2006 and 40.17% in 2007 and thereafter.
See Note 29 F to the financial statements for the effect of the above change.

THE VALUE ADDED TAX LAW AMENDMENT BILL – 1975

On October 27, 2004, the Economic Policy for the Fiscal Year 2005 (Legislation Amendments) Bill – 2004 was tabled, in which it is proposed to amend the definition of wages in the Added Value Tax Law, to include also a grant payable upon retirement or death, and any amount paid by an employer to a supplementary training fund or to a provident fund which is not a central severance pay fund, even though under Section 3 of the Income Tax Ordinance it is not considered employment income at the time the payment is made to the severance pay fund or to the provident fund.
Many ambiguities exist as to the interpretation of the application of the Bill to the various components of payroll. At this stage the Bank is unable to assess the effect of the Bill on its financial position and results of operations.
The said Bill, if passed in the proposed form, will have an effect of the payment of payroll tax in respect of amounts payable by the Bank to its employees, and thus will increase the payroll expense of the Group, in an estimated amount of NIS 28 million.

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.

On June 17, 2004, the Commissioner extended the validity of the said exemption, under the same terms, for an additional period of three years.

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.

On June 17, 2004, the Commissioner extended the validity of the said exemption, under the same terms, for an additional period of three years.

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 then 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. On December 19, 2004, its validity was extended until December 30, 2005.

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.

THE BANKING LAW (LICENSING) AND THE BANKING ORDINANCE

In August 2004, the Knesset passed amendments to the Banking Law (licensing) and to the Banking Ordinance, according to which, inter-alia, the holding by a bank of the means of control in another bank has been restricted, including holdings by way of a pledge of means of control within the framework of the granting of credit; the permitted rate of holdings in a bank, over which approval by the Governor is required, was reduced; the Governor was authorized to change or cancel approvals and to issue instructions as to exceptional holdings; the Supervisor was authorized as to the prior approval of the appointment of directors and officers of a bank; reporting instructions were determined; A mechanism was set for the appointment of the required number of Board members where the shareholder authorized to appoint directors has not done so; etc. Transitional instructions were also added, and also a provision authorizing Bank of Israel to provide information to foreign regulatory authorities.

The Law that was passed has, inter-alia, certain implications as to the purchase of securities to customer accounts, to the holding of one bank in another bank, and to the management of securities of one bank held by another bank and its related companies. The Bank is not able to evaluate or assess the said implications.

As to further amendments that are planned for these laws following the Bachar Commission recommendations, see the chapter on "Government decisions with respect to the banking industry and expected changes in the capital market".

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 Supervision 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 and counsels of other banks and companies in the Group, examine once every quarter the pending actions and update, where necessary, the provisions created therewith in the light of developments.

During the past year, discussions continued with the Supervisor of Banks regarding the "accounting treatment of contingencies". In these discussions the Supervisor informed the banks orally as to guidelines and clarifications in this respect. As the process of approval of the draft is yet incomplete, the banks are supposed to base their treatment of contingencies in their financial statements as of December 31, 2004, on the said US Standard and related guidelines, and on the guidelines and clarifications of the Supervisor, based on the draft of the said Directive.

It has been determined in the draft directive that in evaluating the outstanding legal actions, the management of a banking corporation is to rely upon legal opinions of Counsel, which should determine the probability of the exposure to the risk involved in such actions materializing.

Claims have been classified according to the probability range for a risk exposure materializing, as follows:

1) Probable – probability of over 70%.
2) Reasonably possible – probability of over 20% and up to and including 70%.
3) Remote – probability of 20% or below.

According to the draft Directive only in rare cases a banking corporation is entitled to state in its financial statements that in its Management's opinion, based on Counsel's opinion, it is not possible to assess the prospects that a risk exposure would materialize in respect of an ordinary legal action and an action approved as a class action, and in four financial statements (including one annual report) to be published subsequently to the filing of an action together with a plea to have it approved as a class action suit. Such period is not to include the period in which the Court has stayed the proceedings in the matter. Note 19 states separately the outstanding claims, in respect of which a reasonable assessment of the exposure is not possible.

The banking corporations have been asked to determine for themselves a graded disclosure level relating to the classification of the proceedings according to the assessment of the risk involved therein. Accordingly, the financial statements as of December 31, 2004, include disclosure of material legal proceedings conducted against the Bank and Group companies, based on the following criteria: as a general rule, a material legal proceeding is one where the amount claimed is in excess of 0.5% of the equity capital of the Bank, and if it is not possible to assess the prospects of the risk materializing; of 1% of the equity capital if the prospects of the risk materializing are reasonably possible; and of 2% of the equity capital if the prospects of the claim are remote.

It should be noted that the change in the level of disclosure caused the non-disclosure of certain proceedings, which for the first time have been defined as "immaterial".

The banking corporations have also been asked to provide disclosure regarding the total exposure in respect of claims that have been assessed, in whole or in part (in respect of the relevant part), as "reasonably possible".

At this stage, such disclosure has been given only with respect to the Bank, as in view of the late date on which the guideline was given, certain of the subsidiaries had already received opinions that were not prepared according to the required format, therefore it was not possible to prepare for the required computation at the group level for the purpose of the financial statements for 2004.

It should be further mentioned that where the Bank is one of the defendants in an action, and the claimants have not attributed an amount to each of the defendants, the evaluation of the claim amount relevant to the Bank has been made to the best of ability, taking into account that consideration of the total amount might mislead and is

incorrect in the circumstances, and that the evaluation does not necessarily represent the allocation as finally determined by the Court.
See Note 19 C to the financial statements for details of legal actions pending against the Bank and against other companies in the Group; For details as to additional proceedings and claims settled during the year, see Section "Legal proceedings" hereunder.

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.

LEGAL PROCEEDINGS

OUTSTANDING CLAIMS AGAINST THE BANK

Various actions are pending against the Bank and its consolidated subsidiaries, including class action suits and pleas to approve actions as class action, brought against them by customers of the Bank and of its consolidated subsidiaries, past customers as well as various third parties, who consider themselves harmed or damaged by the actions of the Bank and its consolidated subsidiaries in the ordinary course of their business. Among other things, these actions raise allegations with regard to the unlawful debiting of interest and/or not in accordance with agreements, subjecting one service to another, the failure to execute instructions, applications for the confirmation of attachment orders in respect of attachments served by third parties as regards assets of debtors held, as alleged by them, with the bank, the unlawful debiting of accounts, mistakes in value dates, the invalidity of collateral security and the realization thereof, requests for injunction orders instructing the Bank to refrain from paying out of bank guarantees or documentary credit, as well as to provident funds, securities, construction loans, and applications for the removal of restrictions on an account pursuant to the Dishonored Checks Law, 1981. Management of the Bank believes, based inter-alia on Counsel's opinion and on the opinions of the managements of the consolidated subsidiaries of the Bank, which are also based on counsel's opinion, as the case may be, respectively, that adequate provisions have been included in the financial statements, if required.
Material actions outstanding against the Bank and its consolidated subsidiaries are described in Note 19 to the financial statements.

DEBT COLLECTION PROCEDURES

As part of the debt collection policy of the Bank and its consolidated subsidiaries, legal procedures are instituted in the ordinary course of business for the collection of debts from the borrowers or from guarantors for such debts, including the realization of collateral provided by the borrowers or by any third parties. Included in such procedures are procedures for receiverships, liquidations, the foreclosure of pledged assets, etc.

ADDITIONAL LEGAL PROCEEDINGS TO WHICH THE BANK IS A PARTY

1. A customer of the Bank appealed to the Tel-Aviv District court in August 2003, to enforce the Bank to fulfill an agreement according to which the Bank committed, still in March 1999, to provide that customer a credit facility of NIS 700 million (in values of that time) for the construction of the Carmel tunnels project. The Carmel Tunnels Authority (the State), the grantor of the concession to the project, was attached as a formal defendant to the action.

   The appeal was made to the Court after the Bank informed the customer in June 2003, that it does not intend to finance the project and that it does not see itself tied any longer by the agreement as a result of the conduct of the customer towards it, and in view of the developments that have taken place since the commitment for finance had been given.

   In March 2004, the Court issued an order enforcing the said agreement. In its decision, the Court dismissed he bank's arguments, according to which, inter-alia, certain conditions precedents have not been fulfilled so that the agreement was in fact not validated; the customer did not act in good faith in that it refrained from submitting vital information to the Bank; serious apprehension arose regarding the viability of the project, which justified the cancellation of the agreement.

   The Court admitted the arguments of the customer and the State according to which the Bank had no contractual right to require an update of the business plan, which was at the base of the financing agreement; the project is viable despite the changes that have occurred; even if the customer did not inform the Bank as to the full changes that had taken place or are expected to take place in the project, this does not constitute a breach of the agreement.

Accordingly, the Court also dismissed the alternative argument of the Bank that in the circumstances an enforcement order should not be issued, as its execution would require an unreasonable amount of supervision on the part of the Court.

In May 2004, the Bank filed an appeal against this verdict. The arguments of the parties have been submitted in writing and a date for voicing additional arguments orally has been set for May 2005.

2. In view of the fact that due to sanctions of the employees, the Bank was unable to submit in time the interim financial statements as of June 30, 2004 (see chapter "Labor relations" above), the Bank made several applications to the Israeli Securities Authority for extension of the period of submission of the financial statements in accordance with the power vested in it under Section 36(h) of the Israeli Securities Law. The Authority responded to the requests of the Bank and extended the period for submission of the report to September 21, 2004. However on that date the Authority informed the Bank of its refusal to grant any further deferment for submission of the report. It also rejected the bank's request for a review of its decision.

   On September 27, 2004, the Bank appealed to the Tel-Aviv District Court against the decision of the Authority under Section 14(a) of the Securities Law. The Court was asked to admit the appeal and instruct the Authority to extend the period for submission of the financial statements. The Court was also asked to hear the appeal at the earliest possible date, and alternatively, if this was not possible, to issue a provisional order for the extension of the said period until another decision is given after hearing of the case.

   On September 28, 2004 the Court decided to summon the parties for an urgent hearing of the case on October 1, 2004, before a judge on duty.

   At the hearing of the appeal of the Bank against the decision of the Authority, held on October 1, 2004, at the Tel-Aviv District Court, the Court issued a provisional order extending the period for the submission of the financial report of the Bank up to October 3, 2004 at 17:00, without pronouncing its opinion as to the matter itself. The financial statements were submitted in the late hours of October 2, 2004. The case was heard in December 2004.

   The parties submitted their summation in writing and are now awaiting the decision of the Court.

SIGNIFICANT LEGAL PROCEEDINGS SETTLED IN 2004

1. In January 2002 a customer of the Bank filed an action against the Bank together with a petition to have the action approved as a class action suit. The action concerns the manner of recording post-dated checks having the same future payment date, and respectively, the charging of commission in respect of these operations. The total amount of the claim for the reimbursement of all commissions paid as above, as estimated by the plaintiff, is NIS 43.5 million, of which the alleged loss to the plaintiff is NIS 5,685.

   On May 5, 2004, the Tel-Aviv District Court rejected the petition to approve the action as a class action suit. On June 20, 2004, the claimant filed an appeal against the said decision. On October 10, 2004, the appeal was dismissed on grounds of the non-deposit of a guarantee covering the expenses of the Bank.

2. In February 2004, an action was filed against Mercantile Discount Bank together with a petition to approve it as a class action suit. The action was filed by a local authority within its boundaries one of the branches of this bank has been in operation until

February 19, 2004 (subsequent to this date, the operations of the branch were merged with another branch of the Bank operating in an area of a neighbouring local authority). According to the claimant, the bank has undertaken in the past to operate a branch within its boundaries, so that the action taken by the bank constitutes a prima facie breach of this undertaking and adversely effects the quality of banking services provided to customers of this bank residing within the said area. The amount stated in the petition for approval of a class action suit in respect of the alleged damage caused to the claimants is NIS 86 million.

On May 13, 2004, the Haifa District Court rejected the petition for approval of the action as a class action suit.

3. In September 2002, an action was filed against Mercantile Discount Bank together with a petition to have the action approved as a class action suit, was filed by a customer who claimed that the Bank charged him with excess interest based on an erroneous computation. On March 23, 2003, the Haifa District Court dismissed the said action and petition. On May 15,, 2003, the claimant appealed to the Supreme Court against this decision. The claimant withdrew the said appeal on March 18, 2004.
4. Alongside the appeal of the Bank against the decision of the Israeli Securities Authority not to grant the Bank a deferment for the submission of its financial statements as of June 30, 2004, the Bank appealed to the Tel-Aviv District Court against a decision of the Tel-Aviv Stock Exchange of September 26, 2004, to suspend trading in the securities of the bank as from October 3, 2004.

   On September 28, 2004 the Court decided to summon the parties for an urgent hearing of the case on October 1, 2004, before a judge on duty.

   At the hearing held on October 1, 2004, the Bank and the Stock Exchange reached certain agreements, which were granted the power of a Court decision. In view of the said arrangement, there was no further purpose for the appeal and the Court removed it.
5. Fort details regarding proceedings adopted by the Bank following the sanctions on the part of the employees as part of the labor dispute declared in connection with the privatization of the Bank, see “Labor relations” above.
6. For details regarding significant legal proceedings that were settled at the beginning of 2005, see Note 19C., sections 15.1.1 and 15.3.1.

PROCEEDINGS REGARDING AUTHORITIES

1. For details regarding various proceedings conducted by the Commissioner of Restrictive Trade Practices concerning the Groups activities in the credit card field, see Note 34 to the financial statements.
2. For details regarding various proceedings conducted by the Commissioner of Restrictive Trade Practices concerning the “Principles of Conduct Document”, see the chapter “Legislation initiatives and new legislation” above.
3. On December 1 and 2, 2004, investigators of the Restrictive Trade Practices Authority arrived at units at the Bank and seized a large number of documents and computer material. The search order presented by the investigators was a very wide one and indicated an investigation concerning “binding arrangements”. Management of the Bank has no knowledge of the suspicions being investigated or as to the progress of the investigation, and accordingly it is unable to evaluate the results of the investigation.

THE INTERNAL AUDIT IN THE GROUP

GENERAL

The Israel Securities Authority published in October 2004 a guideline under Section 36A(b) of the Securities Law –1968, in the matter of "Disclosure regarding the internal auditor of a reporting corporation" (hereinafter – "the Authority's Guideline"). In January 2005, the Supervisor of Banks issued a provisional instruction in the matter of the disclosure in the Directors' report of a banking corporation regarding the internal auditor, in which the Supervisor applied, *mutatis mutandis*, the Authority's Guideline to the banking corporations, and specified several subjects pertaining particularly to the banking industry, which should be addressed when implementing the Guideline.

DETAILS REGARDING THE INTERNAL AUDIT IN THE GROUP IN 2004

The internal auditor of the Bank is Mr. Shlomo Pitchon, who heads the internal audit operation at the Bank. Mr. Pitchon, who entered office on September 1, 1994, is an economist and a certified public accountant, and has internal audit experience in a banking corporation for over thirty years.

The internal auditor is an officer of the Bank ranking as Senior Executive Vice President, he is fully employed, heads the internal audit operation of the Bank and of the Group, and attends also to complaints submitted by the public.

From the organizational aspect, the Chairman of the Board of Directors is in charge of the internal auditor of the Bank.

In addition, as from February 1, 1994, Mr. Pitchon serves also as the internal auditor of certain subsidiaries of the Bank, as follows:

Discount Mortgage Bank Ltd., Discount Provident Fund Management Ltd., Israel Discount Capital Market and Investments Ltd., Tachlit Discount – Investment, Counselling & Management Co. Ltd., Discount Trust Ltd., Discount Leasing Ltd., BDL Computer and Administration Services Ltd., Beth Lamed Daleth Ltd., Provident Fund of BDL Employees Ltd.

He serves as internal auditor of Ilanot Discount since November 1, 2001, of Manpikim Issuance Company of Discount Bank Ltd. since April 1, 1999, and of Manpikim Financial Operations Ltd. since December 8, 2004.

In addition, he serves as internal auditor of the following subsidiaries: Nidbach Ltd., Har Halevi Properties Ltd., Smadar Nominee Company Ltd., Raanan Nominee Company Ltd., Tzir trading Company Ltd. BDL Nominee Company Ltd.

During the reported period, the average number of positions subject to the internal auditor was 92.5, divided as follows: 76.5 positions of internal audit at the Bank, 11 positions at the Bank's public complaints unit, and 5 positions at the consolidated subsidiaries, in which the internal auditor of the Bank serves as their internal auditor. At consolidated subsidiaries, which employ internal auditors of their own – Mercantile Discount Bank Ltd., Israel Credit Cards Ltd., Foresight Ltd. (a subsidiary of Israel Discount Capital Market and Investments Ltd.), Bancorp Inc. IDB New York, Discount Bank Latin America, Discount Bank (Switzerland) SA – the number of positions during the reported period was 43.

The annual and multi-annual work programs are devised on the basis of the following considerations:

- An internal model based on risk matrix, which includes criteria and weights adjusted according to the unit or subject being audited. According to this model, an audit is performed once every 18 months in each unit having a high-risk level. An audit is performed once every 24 to 36 months in each unit having a medium-risk level, while all other units are audited at least once every 48 months;
- A survey mapping operational risk centers;
- Bank of Israel instructions;
- Accepted professional standards;
- Number of audit staff.

The multi-annual work program is being reviewed annually and is updated as required.
The planned work programs for the material subsidiaries, at which the Bank's internal auditor serves also as their internal auditor, are combined with the annual work program for the internal audit of the Bank, while addressing each subsidiary separately. The scope of the work program for each subsidiary as above, is discussed by the Audit Committee of each subsidiary, and/or by the Board of Directors.
Audit reports relating to subsidiaries at which Mr. Pitchon serves as internal auditor, are submitted to the Chairman of the Board of the respective subsidiary, to the Chairman of the Audit Committee (where one exists) and to the CEO of that subsidiary.
In respect of subsidiaries that have their own internal auditor, the internal auditor of the Bank reviews once every year the performance of the internal auditor in each such subsidiary.
The internal audit at the Bank and at its subsidiaries is being performed in accordance with the professional guidelines of the Institute of Internal Auditors in Israel and with the obligatory professional instructions of Bank of Israel.
Each audit report is submitted by the internal auditor to the Chairman of the Board and to the President and CEO of the Bank. Each report with respect to head office units and a management summary of audit report regarding the Bank's branch offices is submitted to the Chairman of the Audit Committee of the Board.
Within about 45 days from the end of each quarter, the internal auditor submits a quarterly report, which covers all the activities of the internal audit during the respective quarter. The quarterly report details extensively all the audit reports that had been submitted during that quarter, includes details of the response of the audited units to the audit findings, as well as monitors prior quarterly reports and matters raised in them, the treatment of which has not yet been concluded.
The quarterly report is submitted to the President and CEO, to the Chairman of the Board and to all Board members, so that at each quarter they have a very detailed picture as to the findings of all audits performed by the internal auditor, the response to these findings and the manner in which audit findings had been treated. The Audit Committee of the Board discusses the quarterly report.
In addition, the Audit Committee of the Board discusses specific audit reports regarding the Bank's units, in cases where the internal auditor, the Chairman of the Committee and/or the Chairman of the Board consider that the findings in these reports or the significant issues which they raise require special attention.
Once a year, the internal auditor submits to the President and CEO, to the Chairman of the Board and to all Board members an annual report (in addition to the four quarterly reports). This report details the principal matters that were audited during the year, the manner in which the findings and recommendations were treated, as well as a special section regarding significant issues that have been pending for a long time and not yet concluded. The annual report is being submitted within 75 days from the end of the year to which it relates, and is being discussed by the Board and by the Audit Committee of the Board.
The quarterly reports in respect of 2004 were submitted and discussed by the audit Committee of the Board, as follows: First quarter report – submitted on May 16, 2004 and discussed by the Audit Committee of the Board on June 20, 2004; Second quarter report – submitted on August 11, 2004 and discussed by the Audit Committee of the Board on September 12, 2004; Third quarter report – submitted on November 11, 2004 and discussed by the Audit Committee of the Board on December 26, 2004; Fourth quarter report – submitted on February 6, 2005 and discussed by the Audit Committee of the Board on March 13, 2005.
The annual report for 2004 was submitted on March 6, 2005 and has not yet been brought up for discussion. The Audit Committee of the Board also discussed in 2004 the annual audit report for 2003 (submitted on March 11, 2004 and discussed on May 17, 2004 by the Audit

Committee of the Board and on June 30, 2004 by the Board) and the report for the fourth quarter of 2003 (submitted on February 10, 2004 and discussed on March 11, 2004).
The internal auditor of the Bank is allowed free access to every information or document required by him or by the internal audit staff for the purpose of the audit, including continuous and direct access to the information system of the Bank and its subsidiaries in which he acts as internal auditor, including financial data.
The Board of Directors is of the opinion that the work program of the internal auditor and the manner and continuity of his operations are most reasonable, and that they accomplish the targets of the internal audits at the Bank and at the Group.

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 2004 in the culture and arts field, providing sponsorship, "Tzalash" activities in the branches and donations.
The total volume of activities of Discount group in 2004, including the Lema'an Project, amounted to NIS 3,460 thousand.
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 2004, the Bank continued the trend of supporting children and youth in various states of distress, and Art seeking youth.

"TZALASH" LOCAL ACTIVITY

This activity is been 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.
Following are several examples of the event that took place in 2004:
Discount Bank in aid of the "Erez" Battalion soldiers. The Bank held two moving events in aid of the fighting men of the "Erez" Battalion engaged on the Gaza-Rapha axis.. The first event was initiated by the Ashkelon Branch of the Bank, which had won an allocation for a joint outing and decided to donate the full amount for the welfare of the soldiers serving in the area near to the Branch. The soldiers were served dinner and enjoyed the performance by the singers Maya Buskilla and Einat Saruf as well as the entertainer Nadav Abuksiss. Present at the event was the President and CEO of the Bank, the Head of the Banking Division and managers from the Jerusalem and Southern Region. Among the guests were the Mayor of Ashkelon with his two deputies, executives of the Association for the Welfare of Soldiers in Ashkelon and of course soldiers of the Battalion and their commanders. As, because of location and budgetary constraints, it was possible to entertain in the first event only about one half of the Battalion men, the Bank organized a second event financed by Management of the Bank, to which were invited the remainder of the Battalion men.
"Hanukka happening at Discount Bank". Members of Management participated in the Hanukka candle lighting ceremonies held at several branches of the Bank all over the country. Present at these ceremonies were branch customers and town dignitaries. The

ceremonies took place at Bat-Yam, Kfar-Saba, Hod hashron, Akko, Hadera and Givat Tal.
Entertaining new immigrants at "Tu B' Shvat" tree planting. The Ashkelon Branch of Discount Bank entertained a group of 50 immigrant families from France who settled in Ashkelon. The immigrants experienced "Tu B'Shvat" tree planting for the first time in their lives. In cooperation with the JNF they were honored with tree planting and later were served with traditional "Tu B'Shvat" refreshments. Present at the ceremony were the Branch manager, the manager of the Jerusalem and Southern Region and the Mayor of Ashkelon and his deputies.

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 Discount Bank Art Collection" Selected works from the art collection of Discount Bank were on show at an exhibition at the Tel-Aviv Museum from December 8, 2003 to April 25 2005. 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.
Sponsorship for "Our country's landscapes" exhibition at the Haifa University Art Gallery. The Bank supported the exhibition **"Our country's landscapes"** - Comments on landscape painting in Israel, held at the Haifa University Art Gallery. The exhibition, which mostly included works from the art collection of the Bank, was open to the public for three months, and served as part of the effort to acquaint the public with the art collection of the Bank.
A grant to art seeking youth. The Bank granted scholarships to ten art seeking young people, who study at the Tel-Aviv Art Museum. The scholarship enables talented youth, who are financially incapable, to acquire education in this field.
Drawings exhibition by juvenile diabetes afflicted children – Tel-Aviv Main Branch. As part of the Donations Day for the Juvenile Diabetes Association, the Bank hosted a children-drawing exhibition "My Dream" - juvenile diabetes afflicted children draw. An official opening ceremony was held with the participation of the President of the Bank, Mr. Giora Opher, the children artists and their families, representatives of the Juvenile Diabetes Association and Bank employees. The exhibition was open to the public and later was transferred to the Children Museum in Washington DC.
Individual exhibition of the young artist Eitan Ben-Moshe – at the entrance hall of the Discount House, 160 Herzl Street. The Bank has responded to an approach by a student of "Bezalel" –Art and Design Academy, who asked for permission to setup for a period of time in the hall of a financial institute or public building, his graduation work, in order to expose the statue to the public and to art critics. The location selected was the entrance hall of Discount House, at 160 Herzl street. The exhibition was open for three month and was visited by the heads of "Bezalel", students and the public at large.

SPONSORSHIPS

Sponsorship is provided to entities that promote significant social targets.
"Face to face" – Art exhibition by sick children from the Schneider Medical Center. Among the sponsorships granted by the Bank in 2004, should be mentioned the sponsorship granted to a unique exhibition, which summed up a year of activity in cooperation with the Ministry of Education and with the Schneider Medical Center for Children in Israel. The exhibition presents the works of children hospitalized at the Schneider Medical Center. The exhibition was opened at the Suzan Dallal Center on October 28, 2004, with the blessing of the Education Minister, Mrs. Limor Livnat and in the presence of the President of the Bank. The exhibition

was open for five days, in which youth and school children, school headmasters, senior representatives of the health services, and customers of Discount Bank, visited it.

THE "LEMA'AN" PROJECT – DISCOUNT EMPLOYEES FOR THE COMMUNITY

This project was launched at the end of March 2002. The project constitutes the joint effort of management and the employees' committee, whereby Bank employees volunteered for activities for the community. In the course of 2004, the number of employees volunteering for community work was 870.

In 2004, 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. It should be noted that the Chairman of the Board of the Bank serves also as the Chairman of the Public Committee of "Yad Sarah"

"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.

In addition to the current voluntary activity within the framework of "Elem", two "Night Mobile Units" were launched in the first quarter of 2004, under sponsorship of the Bank, one in Holon and the other in Acco.

In addition to the current voluntary activity in the framework of "Elem", two "Night Mobile Units" were launched in the first quarter of 2004 under sponsorship of the Bank, one in Holon and the other in Akko.

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 "Warm Winter at Discount" drive – a drive conducted at the beginning of 2004, intended for the collection of warm items for the winter for distribution to needy families. Some 4000 especially large cardboard boxes were collected during this drive and were distributed to 12 associations all over the country and to the welfare departments of several local authorities.

"Kimcha D'Pascha" drive – the collection of food stuff for Passover, to be distributed to needy families. Also in this year the drive was conducted in cooperation with Bank customers. Some 1,500 cardboard boxes were collected during this drive, containing a variety of products. The drive helped some 20 various associations and local authorities to increase the number of food baskets distributed to needy families.

Haifa "Helping Hand to a Friend" Association – Within the framework of the "LeMa'an" project, the Association has been granted a donation of NIS 18 thousand as assistance for the acquisition of a vehicle to be used for transporting school children from schools to the "Children House" (a club for children of families in distress) and transporting them back home at the end of their activities.

The Hebrew "Reali" Secondary School, Haifa – The school operates a project the goal of which is to grant students originating from Ethiopia fair prospects in competing as equals in the community. Two pupils were adopted as part of the "LeMaan" project, and a grant of NIS 20 thousand was given to the school to finance one year of their study.

"Give lovingly for a Happy New Year" drive. According to the tradition created at the

Bank, a drive for the collection of foodstuff for the High Holidays was conducted also in 2004, in order to expand the scope of the assistance to associations supporting the needy. Jointly with the “Latet” organization, which supports some 100 various associations all over the country, a “Give lovingly for a Happy New Year” drive was conducted. Also this year, the Bank employees and customers participated in the drive, which collected thousands of containers laden with food products. In addition to the collection activity conducted in the Bank branches, Management of the Bank contributed an amount of NIS 300 thousand to “Latet” Organization, for the purchase of thousands of meals and their distribution to needy families.

Children clubs. The Beer-Sheva Branch staff initiated an activity supporting the **children of the Beer-Sheva Abused Children Club**, and in this framework the Bank provided presents for distribution to the children. In Haifa, female staff of the Bank, who are members of the Haifa Ladies Basketball Team, and who do voluntary work during the year at the **Haifa Children Club** organized a school year-end party for the children. During the summer vacation the Bank assisted the coordinator of the **Tel-Aviv Shapiro Quarter Children Club** in organizing outings for the children and provided them with transportation, this in addition to voluntary work of the staff of the Bank throughout the year. Pocket dictionaries were distributed to the children of the **Tel-Aviv Neve Opher Children Club** at a school year-end party. Volunteer Bank employees support this club throughout the year.

In Haifa, female staff of the Bank, who are members of the Haifa Ladies Basketball Team, and who do voluntary work during the year at The **Haifa Blind House**, organized a “fun day” for the blind at the House.

“MAALEH” – BUSINESS SECTOR OBLIGATION TOWARDS SOCIETY IN ISRAEL

The Bank joined the “Maaleh” Organization in the first quarter of the year as part of the leadership group of “Maaleh” for 2004. It is important to note that the business companies that belong to the leadership group of “Maaleh” see in their organizations companies of merit, which are among the leaders of social change in Israel

“Maaleh” Index for Social Responsibility. On February 13, 2004, the Tel-Aviv Stock Exchange Ltd. launched the “Maaleh Index for Social Responsibility, which is to include the first twenty companies in the “Maaleh” rating for social responsibility, that comply with the threshold conditions of the TA 100 Index. The Bank is included among the 20 companies covered by the Index at the date it was launched.

The criteria for the rating reflect the concept of “Maaleh” that social responsibility does not constitute mere financial contributions, but also business conduct of the company as part of overall social responsibility. Accordingly, the criteria include the total amount (in NIS) of donations, The ratio of donations to earnings or to turnover (according to earnings) and the conduct of the company in the course of transacting its business based on criteria of working environment, investment in the community and environment quality.

“THE MARCH OF THE LIVING”

In April 2004, a delegation of Discount Bank employees participated for the second 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, numbered 160 bank and subsidiary companies employees. This continued a tradition started on 2003, of participation of a Discount Group delegation in the “March of the Living”, the Bank and the Employee Union participating in the cost thereof. In addition, 35 young persons from development towns join the delegation, the Bank and the Employees Union bearing the cost of their travel to Poland. A delegation numbering 120 of the Bank’s and the Mercantile Discount Bank staff is expected to participate in 2005 in the “March of the Living”. Some 35 youth from various development towns, whose travel to Poland is financed by the Bank and the Employees Union, will join the delegation.

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,			
	2004	2003	2004	2003
For Auditing[3]**:**				
To the joint auditors[5]	8,531	6,867	3,988	3,659
To other auditors	3,228	*3,260	-	-
Total	11,759	10,127	3,988	3,659
For Other Services:				
Audit related services[4]:				
To the joint auditors	591	450	537	251
To other auditors	446	*62	-	62
Taxation Services[5]:				
To the joint auditors	2,932	1,570	2,170	886
To other auditors	1,065	1,660	-	-
Other Services:				
To the joint auditors	766	436	201	287
To other auditors	-	882	-	8
Total	5,800	5,060	2,908	1,494
Total Auditors' Remuneration	17,559	15,187	6,896	5,153

* Reclassified

Footnotes:

(1) The auditors' remuneration includes payments to partnerships and corporations under their control and also includes payments pursuant to the VAT law.

(2) Includes remuneration that has been paid and remuneration that has been accrued.

(3) Auditing annual financial statements and reviewing interim financial statements.

(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

in NIS thousands:

	Salary and bonuses*	Employer's provisions(1)	Supplemental reserves(2)	Total salary and related expenses**	Loans given on beneficial conditions(3) Balance	Average repayment period (in years)	Benefit given during the year	Loans given on usual conditions
2004								
Arie Mientkavich	(4)(6)2,574	(7)3,082	229	5,858				
Giora Offer	3,024	(8)598	323	3,945	18	0.71	1	96
Dr. Amnon Goldschmidt	1,275	317	155	1,747	3	0.08	-	-
Reuven Spigel	1,271	319	57	1,647	-	-	-	50
Shlomo Pitchon	1,167	288	177	1,632	-	-	-	233
Michael Fokschaner	(10)2,072	149	132	2,353	11	-	-	-
2003								
Arie Mientkavich(5)	(4)1,588	521	67	2,176	-	-	-	-
Giora Offer	2,233	(6)1,457	9	3,699	35	1.10	2	110
Dr. Amnon Goldschmidt	1,074	327	42	1,443	14	0.58	-	6
Shlomo Pitchon	952	306	64	1,322	9	0.58	-	264
Dr. Ehud Kaufman	975	317	7	1,299	-	-	-	117
Michael Fokschaner	(10)1,559	138	54	1,751	11	0.58	-	6

* Not including the allocation of a provision in respect of the "Employee agreement" (see the section "Sale of the Bank" above).

** 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 on October 5, 1999, and on June 14, 2004.

(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 the general meeting to approve 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, who chaired, at that time, 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 notice of Mr. Mientkavich requesting that the discussion regarding his remuneration should be deferred once again to a different date, was also on the Agenda of the General Meetings of Shareholders for the years 2000, 2001 and 2002.
At the General Meeting of Shareholders for 2003, held in June 2004, the said remuneration increment and grant were approved. The Bank has provided in the past, the amounts pertaining to the above resolutions, but as these were not included in the data presented in the past in this table, the data presented for 2003 has now been restated in order to reflect the remuneration increment.

(6) The Board of Directors in its meetings of August 2004 and October 2004 (after receiving the approval of the Audit Committee) decided to approve a remuneration increment of 6.5% and a grant equal to seven monthly salaries to the Chairman. These subjects have not as yet been brought before the General Meeting of Shareholders of the Bank, though they are however included in the above remuneration data.

(7) Including a provision for a payment to the Chairman of the Board in the event of his retirement from office due to change in ownership of the Bank as a result of change of ownership. According to the decision of the Board of Directors of May 2004 (following the approval of the Audit Committee) the Chairman would be entitled to a payment of an amount equal to 15 full monthly salaries, in addition to the amounts due to him in accordance with the personal employment agreement with him, subject to the conditions specified in the resolution. This subject was on the agenda of the General Meeting of Shareholders held in June 2004, however it was not debated at that date.

(8) Including adjustment grant.

(9) In 2003 the Board of Directors of the Bank decided that if the President & 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.

(10) 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.

MISCELLANEOUS

Provisional instructions regarding the description of the business of a banking corporation and forward looking information in the report of the board of directors. In June 2004, Amendment No. 23 to the Securities Law, 1968, was published, in he spirit of the principles recommended by the Barnea Committee. In September 2004, amendments were published to the Securities Regulations (Details of a Prospectus, its Structure and Form), 1969, and to the Securities Regulations (Periodic and Immediate Reports), 1970.

In recent months discussions were held with the Supervisor of Banks in the matter of adapting the reporting requirements determined in Regulations by the Israeli Securities Authority to the reporting requirements to be applied to banking corporations. The Supervisor of Banks intends to apply the extended disclosure requirements to banks by way of a Provisional Instruction. At this stage a draft of the Instruction has been distributed and the Bank acted in accordance therewith in preparing this Report.

The principal adjustments included in the Provisional Instruction compared with the Addendum to the Securities Regulations, are:

- The Provisional Instruction omitted certain articles in respect of which, the Supervisor of Banks was convinced that they were not relevant to the activity of banking corporations;
- Certain articles in the Provisional Instruction were marked "for discussion in 2005". These articles will be discussed in 2005 in the light of their actual implementation in the reports to be published by other public companies in Israel and according to the accepted practice of disclosure in their respect in the financial statements of the banking industry in the United States.;
- A specific transitional instruction for 2004 has been determined with respect to certain matters.

Declarations as to disclosure in financial statements. Following the accounting scandals exposed in recent years in the United States, the Sarbanes-Oxley Act of 2002 was passed with the intension of improving the accuracy, reliability and transparency of reporting by corporations, in order to restore public trust in them.

In the spirit of Section 302 of the said Act and the instructions published in accordance therewith by the SEC in the United States, The Supervisor of Banks issued an Instruction regarding a declaration as to disclosure in quarterly and annual reports of banking corporations. This instruction is to be applied first in the financial statements for the second quarter of 2005, which are to be published by the end of August 2005.

In accordance with the said Instruction, the President and CEO and the Chief Accountant of a banking corporation have to personally declare as follows:

- That they have reviewed the financial statements and based on their knowledge, the statements does not include an incorrect presentation of a material fact and that the statements reflects fairly the financial position, results of operations, changes in shareholders' equity and cash flows;
- Controls and procedures have been instituted as regards reporting and disclosure of financial information processes, in particular in the course of the period of preparation of the financial statements;
- They have evaluated the effectiveness of the controls and procedures as to disclosure in the financial statements;
- That they have disclosed in the financial report any material change occurring in the internal control of the bank that has implications on the reporting and disclosure in the financial statements.

The Bank and its banking subsidiaries in Israel have engaged an independent firm of Certified Public Accountants, who are not the Auditors, to provide consulting, support and guidance and also accompany the bank in its preparations towards the signing of the required declaration.

BOARD OF DIRECTORS AND MANAGEMENT

GENERAL

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.

REPORT ON DIRECTORS HAVING ACCOUNTING AND FINANCIAL EXPERTISE

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 expertise" (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 expertise" 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, to remove any doubt, that 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 expertise, 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. It should be mentioned that according to the reporting requirements of Bank of Israel, against each name of a Director it is stated whether he is a member of the Finance Committee of the Board dealing with the Bank's financial statements and/or a member of the Audit Committee of the Board.

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. Until recently served as Director of Harel Insurance Investments Ltd. Mr. Mientkavich serves as a member of the Finance Committee.

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 and Academic Studies, member of the Administrative Committee of the Veteran Pension Funds and member of the Audit

Committee of the Israeli 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 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 heading 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. Mr. Arbel serves as Chairman of the Audit Committee.

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, other public entities. In this period served as a director of Government companies, including Bank Tefahot, TA'AS and Beit Shemesh Engines. In the period 1979 - 1983 served as Chairman and President of Rural and Suburban Settlement Company Ltd. (Rassco) 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. Mr. Baruch serves as Chairman of the Finance Committee.

Joseph Singer – Bachelor of Economics and Business Administration and Master of Business Administration. Serves as a Director and Managing Partner of Giza, Singer and 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, in Midroog Holdings Ltd., Giza, Singer and Even Finance Ltd., and in Singer & Even and Kraizberg Holdings Ltd. Serves as an external director of Edmond de Rothschild Mutual Funds Management Ltd. and served as an external director of Otzarit Mutual Funds Management Company Ltd. Served for over a decade as Managing Director of Singer and Even Ltd., economic and business consulting firm. Mr. Singer serves as a member of the Finance Committee and the Audit Committee.

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. Serves as director of companies including Carmel Investment Group, Tassnet Software Testing and Elbit Systems. In the period 1994 to 2002 served as Chairman of companies Hamasbir Latzarchan, Israel Military Industry, Spectronics, Dor Chemicals and Dor Energy, DorGas, Foreign Trade Risk Insurance Company and as Director in Frotarum Industries and Dankner Investments. In the years 1992 – 1994 served as Executive Vice President in charge of credit at 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 Defence. Mr. Lifshitz serves as a member of the Finance Committee.

Yehuda Milo - Bachelor of Economics and Statistics. Serves as director of companies, including Menorah-Gaon Investments Ltd., Menorah-Gaon Capital Markets Ltd., Menorah-Gaon Investment House Ltd., Menorah-Gaon Netivei Gemel, Menorah-Gaon Underwriting and Investments Ltd., Arkal Filtration Systems Ltd., Arkal Plastic Products Ltd., Netivei Pensia Ltd. 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 Company.

In the period 1970 – 1975 served as CEO of Maskit Ltd. 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 Capital Market, Insurance and Savings. At the same time, served as director of M.I. Holdings Ltd. In the years 1996 – 1998 served as a member of the Israel Securities Authority. Ms. Samet serves as a member of the Audit Committee.

Dr. Arieh 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 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., the Israel Petrochemical Industries Ltd., Carmel Ulpinim Ltd., Tadiran Communications Ltd., Hadar Ltd. Mehadrin Ltd. Served as a member of the Israel Securities Authority between the years 1981 – 1996, as a member of the Israeli Accounting Standards Institute between the years 1998 – 2001. In the years 1996-1999 served as CEO of Dubek Ltd. Concurrently served at various times as company director including Dubek Ltd., Koor Industries Ltd. Dr. Ovadia serves as a member of the Finance Committee.

David Schlacht – Bachelor of Chemical Engineering and Master of Business Administration. Serves as CFO of Syneron Medical Ltd. Managing Partner and director of BIOCOM Management and Investments (2002) Ltd. Serves also as company director of Harel Capital Markets Ltd., Poalim Capital Markets & Investments Ltd., United Studios Ltd., “Taya” Investment Company Ltd., Pharmos Ltd., Proseed Venture Capital Fund Ltd., Compugen Ltd. and as External Director of Adgar Investments & Development 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 Manager 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 director of 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., Taldor Computer Systems Ltd. (External Director). Mr. Schlachet serves as a member of the Finance Committee.

Tida Shamir – Bachelor of Law and Master of Business Administration from the European Institute INSEAD in France. Practicing attorney, specializing, inter-alia, in the area of commerce. Serves as an External Director in Gazit Globe (1982) Ltd. Served as a director from the public of the Tel-Aviv Stock Exchange (1996 – 2002). Ms. Shamir serves as a member of the Audit Committee.

MEETINGS OF THE BOARD AND ITS COMMITTEES

In 2004, the Board of Directors held 25 meetings. In addition, 61 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.

Arie Mientkavich
Chairman of the Board
of Directors

March 29, 2005

MANAGEMENT REVIEW

04

SCHEDULE A - CONSOLIDATED BALANCE SHEET - MULTI-PERIOD DATA

	As at December 31				
	2004	2003	2002	2001	2000
	Reported amounts[1]	Adjusted amounts[1]			
	In NIS millions				
Assets					
Cash and deposits with banks	17,751	16,888	18,878	24,510	22,606
Securities	40,068	38,774	36,581	30,457	25,952
Credit granted to the public	77,508	(2)76,464	74,334	74,110	72,262
Credit granted to the Government	271	367	552	546	559
Investments in affiliated companies	1,320	1,238	1,282	1,316	977
Buildings and equipment	1,978	(2)2,102	1,955	1,881	1,802
Other assets	4,155	(3)(2)3,869	3,692	2,960	2,673
Total assets	143,051	(3)139,702	137,274	135,780	126,831
Liabilities and Shareholders` Equity					
Deposits from the public	121,692	(3)119,953	119,734	118,981	110,993
Deposits from banks	5,078	5,097	4,051	3,622	3,748
Deposits from the Government	144	171	166	189	258
Debentures and subordinated capital notes	4,809	4,223	3,787	3,766	3,404
Other liabilities	4,493	(2)3,819	4,023	3,212	2,453
Total liabilities	136,216	(3)133,263	131,761	129,770	120,856
Minority interest	449	484	449	445	429
Shareholders` equity	6,386	(3)5,955	5,064	5,565	5,546
Total liabilities and shareholders` equity	143,051	(3)139,702	137,274	135,780	126,831

Footnotes:
(1) See Note 1 B.
(2) Reclassified.
(3) Restated - see Note 1 X.

SCHEDULE B - CONSOLIDATED STATEMENT OF INCOME - MULTI-PERIOD DATA

	As at December 31				
	2004	2003	2002	2001	2000
	Reported amounts[1]		Adjusted amounts[1]		
	in NIS millions				
Financing Income					
Income from financing activities before provision for doubtful debts	3,489	(2)2,983	2,879	2,866	2,815
Provision for doubtful debts	880	845	896	990	740
Income from financing activities after provision for doubtful debts	2,609	(2)2,138	1,983	1,876	2,075
Non-Financing Income					
Operating commissions	1,745	1,648	1,508	1,516	1,559
Net income (loss) on investment in shares	103	9	(11)	20	36
Other income	352	434	243	352	263
Total non-financing income	2,200	2,091	1,740	1,888	1,858
Non-Financing Expenses					
Salaries and related expenses	2,511	2,264	2,183	2,404	2,431
Maintenance and depreciation of buildings and equipment	632	636	596	573	511
Other expenses	870	705	785	836	827
Total non-financing expenses	4,013	3,605	3,564	3,813	3,769
Operating income (loss) before taxes in reported amounts	796	624	159	(49)	164
Erosions and adjustments[1]	-	30	-	-	-
Operating income (loss) before taxes	796	(2)654	159	(49)	164
Provision for taxes on operating income	342	(2)371	207	246	292
Operating income (loss) after taxes	454	(2)283	(48)	(295)	(128)
Bank's share in operating income (loss) of affiliated companies, net of tax effect	135	117	(1)	56	78
Net operating income (loss) before minority interest	589	(2)400	(49)	(239)	(50)
Minority interest, after taxes, in the operating income of consolidated subsidiaries	(56)	(60)	(25)	(34)	(76)
Net operating income (loss)	533	(2)340	(74)	(273)	(126)
Net cumulative effect as of the beginning of the year of change in accounting	(1)	10	-	-	-
Net income (loss), before extraordinary income (loss) after taxes	532	(2)350	(74)	(273)	(126)
Provision for impairment in value of investment in affiliated companies	-	(173)	(8)	-	-
Net gain (loss) from extraordinary items, net of taxes	24	(23)	44	6	15
Net income (loss)	556	(2)154	(38)	(267)	(111)

SCHEDULE B - CONSOLIDATED STATEMENT OF INCOME - MULTI-PERIOD DATA (CONTINUED)

	As at December 31				
	2004	2003	2002	2001	2000
	Reported amounts[1]		Adjusted amounts[1]		
			in NIS millions		
Earnings (loss) per NIS 1 Nominal Value of Share Capital (in NIS)[1]					
Net operating income (loss)	5.44	[2]3.47	(0.75)	(2.90)	(1.35)
Net gain (loss) from extraordinary items, net of taxes[3]	0.23	(1.90)	0.36	0.06	0.16
Net income (loss)	5.67	[2]1.57	(0.39)	(2.84)	(1.19)
Weighted nominal value of share capital used in the above calculation (in NIS thousands)	98,064	98,064	98,064	94,173	93,394

Footnotes:
(1) See Note 1 B.
(2) Restated - see Note 1 X.
(3) December 31, 2004: Including net cumulative effect as of the beginning of the year of change in accounting.
December 31, 2003: Including a provision for impairment in value of investment in an affiliated company and the net cumulative effect as of the beginning of the year of change in accounting.
December 31, 2002: Including a provision for impairment in value of investment in an affiliated company.

SCHEDULE C – INCOME AND EXPENSE RATIOS OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES[1]

REPORTED AMOUNTS **

	2004				*2003			
			Rate of income (expense)				Rate of income (expense)	
	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]
	in NIS millions		%		in NIS millions		%	
Non-Linked Israeli Currency:								
Assets[4][5]	43,083	2,822	6.55		40,073	3,622	9.04	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	-	-			-	-		
Embedded derivaties and ALM	6,690	226			7,230	590		
Total assets	49,773	3,048		6.12	47,303	4,212		8.90
Liabilities[5]	(43,975)	(1,519)	(3.45)		(42,377)	(2,657)	(6.27)	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	-	-			-	-		
Embedded derivaties and ALM	(4,333)	(145)			(3,777)	(353)		
Total liabilities	(48,308)	(1,664)		(3.45)	(46,154)	(3,010)		(6.52)
Interest margin			3.10	2.67			2.77	2.38
Israeli Currency Linked to the CPI :								
Assets[4][5]	22,795	1,530	6.71		25,424	1,130	4.44	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	-	-			-	-		
Embedded derivaties and ALM	562	26			691	101		
Total assets	23,357	1,556		6.66	26,115	1,231		4.71
Liabilities[5]	(21,257)	(1,096)	(5.16)		(23,123)	(725)	(3.14)	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	-	-			-	-		
Embedded derivaties and ALM	(464)	(26)			(1,014)	(98)		
Total liabilities	(21,721)	(1,122)		(5.17)	(24,137)	(823)		(3.41)
Interest margin			1.55	1.49			1.30	1.30

* Reclassified.
** See Note 1 B.
For footnotes see page 165.

SCHEDULE C – INCOME AND EXPENSE RATIOS OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES[1] (CONTINUED)

REPORTED AMOUNTS**

	2004				*2003			
			Rate of income (expense)				Rate of income (expense)	
	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]
	in NIS millions		%		in NIS millions		%	
Foreign Currency:								
Domestic Operations:[6]								
Assets[4][5]	30,171	1,128	3.74		30,538	(557)	(1.82)	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	1,067	124			1,744	316		
Embedded derivates and ALM	24,697	480			22,569	38		
Total assets	55,935	1,732		3.10	54,851	(203)		(0.37)
Liabilities[5]	(31,635)	(620)	(1.96)		(30,803)	514	1.67	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	(1,146)	(145)			(1,885)	(316)		
Embedded derivates and ALM	(27,143)	(397)			(25,555)	751		
Total liabilities	(59,924)	(1,162)		(1.94)	(58,243)	949		1.63
Interest margin			1.78	1.16			(0.15)	1.26
Overseas Operations of Foreign								
Extensions of the Bank:								
Assets[4][5]	38,051	886	2.33		35,502	(1,405)	(3.96)	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	3,388	6			1,960	(105)		
Embedded derivates and ALM	1,548	(3)			3,775	(196)		
Total assets	42,987	889		2.07	41,237	(1,706)		(4.14)
Liabilities[5]	(34,429)	(193)	(0.56)		***(31,645)	***1,756	5.55	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	(3,230)	41			(1,956)	106		
Embedded derivates and ALM	(1,561)	(78)			(3,743)	117		
Total liabilities	(39,220)	(230)		(0.59)	(37,344)	1,979		5.30
Interest margin			1.77	1.48			1.59	1.16

* Reclassified.
** See Note 1 B.
*** Restated - see Note 1 X.
For footnotes see page 165.

SCHEDULE C – INCOME AND EXPENSE RATIOS OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES[1] (CONTINUED)

REPORTED AMOUNTS**

	2004				*2003			
			Rate of income (expense)				Rate of income (expense)	
	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]
	in NIS millions		%		in NIS millions		%	
Total:								
Monetary assets which generated finacing income[4][5]	134,100	6,366	4.75		131,537	2,790	2.12	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	4,455	130			3,704	211		
Embedded derivaties and ALM	33,497	729			34,265	533		
Total assets	172,052	7,225		4.20	169,506	3,534		2.08
Monetary liabilities which generated financing expenses[5]	(131,296)	(3,428)	(2.61)		***(127,948)	***(1,112)	(0.87)	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	(4,376)	(104)			(3,841)	(210)		
Embedded derivaties and ALM	(33,501)	(646)			(34,089)	417		
Total liabilities	(169,173)	(4,178)		(2.47)	(165,878)	(905)		(0.55)
Interest margin			2.14	1.73			1.25	1.53
In respect of options		5				(47)		
In respect of other derivatives (excluding options, hedging derivatives, ALM and detached embedded derivatives)[3]		22				80		
Commissions on financing operations and other financing income[7]		426				255		
Other financing expenses		(11)				66		
Income from financing activities before provision for doubtful debts		3,489				2,983		
Provision for doubtful debts (including general and supplemental provisions)		(880)				(845)		
Income from financing activities after provision for doubtful debts		2,609				2,138		

* Reclassified.
** See Note 1 B.
*** Restated - see Note 1 X.
For footnotes see page 165.

SCHEDULE C – INCOME AND EXPENSE RATIOS OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES[1] (CONTINUED)

REPORTED AMOUNTS[**]

	2004				*2003			
			Rate of income (expense)				Rate of income (expense)	
	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]
	in NIS millions		%		in NIS millions		%	
Total:								
Monetary assets which generated finacning income[4][5]	134,100				131,537			
Assets related to derivative instruments[8]	75				39			
Other monetary assets[5]	4,426				2,397			
General and supplemental provisions for doubtful debts	(662)				(645)			
Total monetary assets	137,939				133,328			
Total:								
Monetary liabilities which generated finacning expenses[5]	(131,296)				***(127,948)			
Other monetary liabilities[5]	(3,912)				(2,961)			
Total monetary liabilities	(135,208)				(130,909)			
Surplus of monetary assets over monetary liabilities	2,731				2,419			
Non-monetary assets	3,903				3,684			
Non-monetary liabilities	(56)				(49)			
Total capital resources	6,578				6,054			

* Reclassified.
** See Note 1 B.
*** Restated - see Note 1 X.

Footnotes:
(1) The data in this table is presented before and after the effect of derivative instruments (including off-balance sheet effect of derivative instruments).
(2) Based on monthly opening balances, except for the non-linked Israeli currency segment in respect of which the average balances are based on daily data, and after deduction of the average balance of the specific provisions for doubtful debts.
(3) Hedging derivative instruments (excluding options), detached embedded derivatives and derivatives (ALM) constituting a part of the asset and liability management system of the Bank.
(4) The average balance of assets is net of/includes the average balance of non-realized gains/losses on adjustments to fair value of trading bonds and gains/losses in respect of available-for-sale securities, included in shareholders equity under other cumulative comprehensive income, in the item "Adjustments for the presentation of available-for-sale securities at fair value" (including in respect of bonds transferred from the available-for-sale portfolio to the bonds held to maturity portfolio), 2004 – NIS (66) million in the non-linked segment, NIS (38) million in the CPI linked segment and NIS (12) million in the foreign currency segment; 2003 – NIS 85 million in the non-linked segment, NIS (40) million in the CPI linked segment and NIS (3) million in the foreign currency segment.
(5) Excluding derivative instruments.
(6) Including Israeli currency linked to foreign currency.
(7) Including gains/losses on sale of investments in bonds and adjustment to fair value of trading bonds.
(8) Average balances of derivative instruments (excluding average off-balance sheet balances of derivative instruments).

SCHEDULE C – INCOME AND EXPENSE RATIOS OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES[1] (CONTINUED)

	2004				2003			
			Rate of income (expense)				Rate of income (expense)	
	Average ealance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]
	in US$ millions**		%		in US$ millions**		%	
Foreign Currency – Nominal in US$**								
Domestic Operations[6]								
Assets[4][5]	6,720	206	3.07		6,476	210	3.24	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	239	23			378	76		
Embedded derivates and ALM	5,496	85			4,904	77		
Total Assets	12,455	314		2.52	11,758	363		3.08
Liabilities[5]	(7,051)	(86)	(1.22)		(6,789)	(81)	(1.19)	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	(257)	(27)			(409)	(77)		
Embedded derivates and ALM	(6,041)	(71)			(5,553)	74		
Total liabilities	(13,349)	(184)		(1.38)	(12,751)	(84)		(0.66)
Interest margin			1.85	1.14			2.05	2.42
Overseas Operations of Foreign Extensions of the Bank								
Assets[4][5]	8,458	326	3.85		7,840	274	3.49	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	755	21			432			
Embedded derivates and ALM	345	4			824	3		
Total Assets	9,558	351		3.67	9,096	277		3.04
Liabilities[5]	(7,859)	(180)	(2.29)		*(6,977)	*(154)	(2.21)	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	(720)	(11)			(431)	-		
Embedded derivates and ALM	(347)	(8)			(816)	(6)		
Total liabilities	(8,926)	(199)		(2.23)	(8,224)	(160)		(1.95)
Interest margin			1.56	1.44			1.28	1.09

* Restated - see note 1X.
** Translation of the Shekel data in nominal terms into US dollars at the representative exchange rate.
For footnotes see page 167.

SCHEDULE C – INCOME AND EXPENSE RATIOS OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES[1] (CONTINUED)

	2004				2003			
			Rate of income (expense)				Rate of income (expense)	
	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]	Average balance[2]	Financing income (expense)	Excluding the effect of derivatives	Including the effect of derivatives[3]
	in US$ millions**		%		in US$ millions**		%	
Total:								
Monetary assets								
generating financing income[4][5]	15,178	532	3.51		14,316	484	3.38	
Effect of derivatives[3]								
Hedging derivatives	994	44			810	76		
Embedded derivaties and ALM	5,841	89			5,728	80		
Total assets	22,013	665		3.02	20,854	640		3.06
Monetary liabilities								
generating financing expenses[5]	(14,910)	(266)	(1.78)		*(13,766)	*(235)	(1.71)	
Effect of derivatives[3]	-	-			-	-		
Hedging derivatives	(977)	(38)			(840)	(77)		
Embedded derivaties and ALM	(6,388)	(79)			(6,369)	68		
Total liabilities	(22,275)	(383)		(1.72)	(20,975)	(244)		(1.16)
Interest margin		282	1.73	1.30		396	1.67	1.90

* Restated - see Note 1 X.

** Nominal Israeli Shekel amounts translated to US$ at the representative rate of exchange.

For footnotes see next page.

Footnotes:

(1) The data in this table is presented before and after the effect of derivative instruments (including off-balance sheet effect of derivative instruments).

(2) Based on monthly opening balances (except for the non-linked Israeli currency segment in respect of which the average balances are computed based on daily data, and after deduction of the average balance of the specific provisions for doubtful debts).

(3) Hedging derivative instruments (excluding options), detached embedded derivatives and derivatives (ALM) constituting a part of the asset and liability management system of the Bank.

(4) The average balance of assets is net of/includes the average balance of non-realized gains/losses on adjustments to fair value of trading bonds and gains/losses in respect of available-for-sale securities (including bonds transferred from the available-for-sale to the held-to-maturity portfolios) 2004 - in amount of US$ (4) million 2003 - in the amount of US$ (1) millions.

(5) Excluding derivative instruments.

(6) Including Israeli currency linked to foreign currency.

SCHEDULE D – BANK'S EXPOSURE TO FLUCTUATIONS IN INTEREST RATES AS OF DECEMBER 31, 2004

REPORTED AMOUNTS (IN NIS MILLIONS)

	On demand to 1 month	Over 1 month to 3 months	Over 3 months to 1 year	Over 1 to 3 years	Over 3 to 5 years
Non-linked Israeli Currency					
Total assets	27,891	4,640	5,642	3,678	1,113
Total liabilities	39,023	1,888	3,545	2,717	344
Difference	(11,132)	2,752	2,097	961	769
Effect of forward transactions and special commitments	1,772	2,325	(180)	(332)	4
Options	198	32	(76)	(101)	(48)
Exposure to changes in interest rates in the segment	(9,162)	5,109	1,841	528	725
Cumulative exposure in the segment	(9,162)	(4,053)	(2,212)	(1,684)	(959)
Israeli Currency Linked to the CPI					
Total assets	1,242	973	4,646	5,993	3,309
Total liabilities	963	2,138	3,737	4,756	2,504
Difference	279	(1,165)	909	1,237	805
Effect of forward transactions and special commitments	-	-	-	99	126
Options	-	-	24	23	-
Exposure to changes in interest rates in the segment	279	(1,165)	933	1,359	931
Cumulative exposure in the segment	279	(886)	47	1,406	2,337
Foreign Currency**					
Total assets	28,748	13,175	9,146	6,737	5,480
Total liabilities	30,011	13,339	9,390	6,061	5,508
Difference	(1,263)	(164)	(244)	676	(28)
Effect of forward transactions and special commitments	(694)	(2,325)	(17)	(4)	(298)
Options	(198)	(32)	52	78	48
Exposure to changes in interest rates in the segment	(2,155)	(2,521)	(209)	750	(278)
Cumulative exposure in the segment	(2,155)	(4,676)	(4,885)	(4,135)	(4,413)
Overall Exposure to Changes in Interest Rates					
Total assets***	57,881	18,788	19,434	16,408	9,902
Total liabilities***	69,997	17,365	16,672	13,534	8,356
Difference	(12,116)	1,423	2,762	2,874	1,546
Effect of forward transactions and special commitments	1,078	0	(197)	(237)	(168)
Exposure to changes in interest rates in the segment	(11,038)	1,423	2,565	2,637	1,378
Cumulative exposure in the segment	(11,038)	(9,615)	(7,050)	(4,413)	(3,035)

General notes:

(1) Full data as the exposure to changes in interest rates in each segment according to the various balance sheet items, is available on request.

(2) In this table, the data according to periods present the present value of future cash flows discounted at the internal yield rate of the particular balance sheet item. Future cash flows discounted as above include interest which will accrue at maturity date or at the date of change in the interest rate, the earlier of the two.

(3) The effect of hedge transactions is included in total assets or total liabilities, as the case may be.

* The column "No fixed maturity" shows the amount stated in the balance sheet.

** Including Israeli currency linked to foreign currency.

*** Including non-monetary assets and liabilities which are presented in the "No fixed maturity" column.

							31.12.2002	
Over 5 to 10 years	Over 10 to 20 years	Over 20 years	No fixed maturity *	Total	Rate of return %	Average duration in years	Rate of return %	Average duration in years
474	61	28	1,089	44,616	4.97	0.50	5.63	0.49
193	167	75	83	48,035	2.31	0.32	3.24	0.28
281	(106)	(47)	1,006	(3,419)	2.66	0.18	2.39	0.21
1	-	-	-	3,590				
(181)	466	54	-	344				
101	360	7	1,006	515				
(858)	(498)	(491)	515	-				
4,453	1,700	4	1	22,321	5.77	3.79	*5.80	*3.67
4,854	982	11	72	20,017	4.50	3.45	4.50	3.22
(401)	718	(7)	(71)	2,304	1.27	0.34	1.30	0.45
(41)	-	-	-	184	-	-	-	-
3	-	-	-	50	-	-	-	-
(439)	718	(7)	(71)	2,538	-	-	-	-
1,898	2,616	2,609	2,538	-	-	-	-	-
8,330	98	7	64	71,785	3.71	1.38	4.19	1.84
3,715	15	3	26	68,068	2.78	1.02	2.70	1.10
4,615	83	4	38	3,717	0.93	0.36	1.49	0.74
(287)	(149)	-	-	(3,774)	-	-	-	-
178	(466)	(54)	-	(394)	-	-	-	-
4,506	(532)	(50)	38	(451)	-	-	-	-
93	(439)	(489)	(451)	-	-	-	-	-
13,257	1,859	39	5,483	143,051		1.49		1.73
8,762	1,164	89	277	136,216		1.13		1.17
4,495	695	(50)	5,206	6,835		0.36		0.56
(327)	(149)	-	-	-				
4,168	546	(50)	5,206	6,835				
1,133	1,679	1,629	6,835					

SCHEDULE E – CREDIT RISK CLASSIFIED BY ECONOMIC SECTORS ON A CONSOLIDATED BASIS

REPORTED AMOUNTS* (IN NIS MILLIONS)

	December 31 2004				
	Balance sheet credit risk(1)	Off-balance sheet credit risk(2)	Total credit risk	Annual expense on specific provision for doubtful debts	Balance of problematic debt(3)
1. Lending Activity in Israel					
Agriculture	650	297	947	2	139
Industry	10,671	7,179	17,850	83	1,140
Construction and real estate	12,721	6,423	19,144	383	2,919
Electricity and water	1,495	191	1,686	6	37
Commerce	6,802	3,376	10,178	71	607
Hotels, hotel services and food	2,586	388	2,974	6	1,122
Transportation and storage	2,513	618	3,131	19	108
Communications and computer services	2,915	1,502	4,417	104	918
Financial services	4,123	3,782	7,905	(1)	158
Other business services	3,903	2,174	6,077	15	198
Public and community services	1,340	688	2,028	26	282
Individuals - housing loans	8,388	27	8,415	37	456
Individuals - other loans	7,426	9,642	17,068	72	605
Total	65,533	36,287	101,820	823	8,689
Credit Risk Included in the Various Economic Sectors:					
Agricultural Settlement Movements(4)	262	1	263	-	113
Local authorities(5)	308	57	365	-	42
2. Lending Activity Outside of Israel					
Agriculture	21	65	86	-	-
Industry	3,056	1,847	4,903	1	29
Construction and real estate	3,683	1,151	4,834	1	39
Electricity and water	159	-	159	-	-
Commerce	3,433	2,183	5,616	1	120
Hotels, hotel services and food	326	1	327	-	-
Transportation and storage	164	4	168	(9)	-
Communications and computer services	182	27	209	15	-
Financial services	3,040	684	3,724	8	12
Other business services	1,000	752	1,752	1	-
Public and community services	37	3	40	-	2
Individuals - housing loans	28	-	28	-	-
Individuals - other loans	1,079	102	1,181	4	5
Total	16,208	6,819	23,027	22	207

* See Note 1 B.

Footnotes:

(1) Translation of the Shekel data in nominal terms into US dollars at the representative exchange rate.

(2) Credit risk in off-balance sheet financial instruments as calculated for purposes of borrower liability limitation.Due to lack of data, only partial information regarding unutilized credit lines is included in respect of a consolidated subsidiary.

(3) The balance of problematic debts net of credit covered by collateral allowed for setoff for the purpose of a borrower or a group of borrowers liability limitation. Includes the components of off-balance sheet risk.

(4) Kibbutzim and moshavim, regional and national organizations and corporations controlled by the agricultural settlement movements.

(5) Including corporations under their control.

Credit risk and the balance of problematic debts are presented after deducting specific provisions for doubtful debts.

SCHEDULE E – CREDIT RISK CLASSIFIED BY ECONOMIC SECTORS ON A CONSOLIDATED BASIS (CONTINUED)

ADJUSTED AMOUNTS* (IN NIS MILLIONS)

	December 31 2003				
	Balance sheet credit risk(1)	Off-balance sheet credit risk(2)	Total credit risk	Annual expense on specific provision for doubtful debts	Balance of problematic debt(3)
1. Lending Activity in Israel					
Agriculture	683	255	938	2	145
Industry	10,516	6,116	16,632	132	**1,230
Construction and real estate	12,855	5,508	18,363	253	**3,136
Electricity and water	1,529	118	1,647	1	43
Commerce	6,208	2,869	9,077	55	614
Hotels, hotel services and food	2,392	357	2,749	30	1,202
Transportation and storage	2,399	707	3,106	9	190
Communications and computer services	4,535	1,406	5,941	104	943
Financial services	4,104	2,559	6,663	(8)	**301
Other business services	3,414	2,136	5,550	21	**192
Public and community services	1,542	950	2,492	8	362
Individuals - housing loans	7,919	58	7,977	24	**415
Individuals - other loans	**8,047	10,426	18,391	91	**606
Total	66,143	33,465	99,526	722	9,379
Credit Risk Included in the Various Economic Sectors:					
Agricultural Settlement Movements(4)	291	6	297	(6)	71
Local authorities(5)	377	212	589	*1	66
2. Lending Activity Outside of Israel					
Agriculture	8	66	74	-	-
Industry	2,652	1,920	4,572	70	8
Construction and real estate	2,802	988	3,790	1	113
Electricity and water	142	8	150	-	-
Commerce	2,951	2,292	5,243	36	56
Hotels, hotel services and food	281	2	283	-	-
Transportation and storage	322	-	322	(9)	*9
Communications and computer services	376	35	411	15	*31
Financial services	2,709	523	3,232	8	5
Other business services	691	517	1,208	(1)	-
Public and community services	66	27	93	-	*2
Individuals - housing loans	28	-	28	-	-
Individuals - other loans	1,106	124	1,230	2	20
Total	14,134	6,502	20,636	122	244

* See Note 1 B.
** Reclassified.
Footnotes:
(1) Credit to the public of NIS 77,047 million, investments in bonds of NIS 3,230 million. Excluding assets relating to derivative instruments created with the public.
(2) Credit risk in off-balance sheet financial instruments as calculated for purposes of borrower liability limitation.Due to lack of data, only partial information regarding unutilized credit lines is included in respect of a consolidated subsidiary.
(3) The balance of problematic debts net of credit covered by collateral allowed for set-off for the purposes of a borrower or a group of borrowers liability limitation. Includes the components of off-balance sheet risk.
(4) Kibbutzim and moshavim, regional and national organizations and corporations controlled by the agricultural settlement movements.
(5) Including corporations under their control.
Credit risk and the balance of problematic debts are presented after deducting specific provisions for doubtful debts.

SCHEDULE F - CREDIT RISK ON A CONSOLIDATED BASIS BY GEOGRAPHIC REGION - ULTIMATE RISK IN DEVELOPING COUNTRIES (LDC)

ADJUSTED FOR THE EFFECT OF INFLATION - BASED ON CPI FOR DECEMBER 2004 (IN NIS MILLIONS)

	December 31	
	2004	2003
Credit[1][2]	678	698
Off - balance sheet credit risk[3]	70	11
Total	748	709

Footnotes:
(1) After deducting specific provisions for doubtful debts.
(2) The amount of expense in respect of the specific provision for doubtful debts totals NIS 0.5 million (2003: NIS 8 million).
(3) Credit risk in off-balance sheet financial instruments as calculated for purposes of borrower liability limitation.

SCHEDULE G - CONDENSED CONSOLIDATED BALANCE SHEET FOR END OF EACH QUARTER

	2004				2003			
Quarter	4	3	2	1	4	3	2	1
	Reported amounts[1]				Adjusted amounts[1]			
	In NIS millions							
Assets								
Cash and deposits with banks	17,751	16,813	17,010	17,431	16,888	15,617	17,679	17,292
Securities	40,068	40,241	40,934	39,527	38,774	38,541	36,502	38,070
Credit granted to the public	77,508	[3]77,775	[3]76,785	[2]77,136	[2]76,464	[2]75,749	[2]72,733	[2]74,079
Credit granted to the Government	271	324	354	372	367	439	434	537
Investments in affiliated companies	1,320	1,275	1,213	1,258	1,238	1,196	1,190	1,137
Buildings and equipment	1,978	[2]1,950	[2]1,913	[2]2,122	[2]2,102	2,109	2,052	2,029
Other assets	4,155	[3][2]3,472	[3][2]3,751	[3][2]3,255	[3][2]3,869	[3][2]4,031	[3][2]3,720	[3][2]3,532
Total assets	143,051	[3]141,850	[3]141,960	[3]141,101	[3]139,702	[3]137,682	[3]134,310	[3]136,676
Liabilities and Shareholders' Equity								
Deposits from the public	121,692	[3]121,333	[3]122,037	[3]120,872	[3]119,953	[3]118,348	[3]115,843	[3]118,122
Deposits from banks	5,078	5,325	4,817	5,267	5,097	4,911	4,425	[2]4,468
Deposits from the Government	144	163	136	154	171	177	164	150
Debentures and subordinated capital notes	4,809	4,783	4,586	4,489	4,223	3,966	3,846	3,829
Other liabilities	4,493	3,602	3,878	[2]3,737	[2]3,819	[2]4,056	[2]3,809	[2]4,481
Total liabilities	136,216	[3]135,206	[3]135,454	[3]134,519	[3]133,263	[3]131,458	[3]128,087	[3]131,050
Minority' interest	449	[3]448	[3]497	[3]501	484	471	481	464
Shareholders' equity	6,386	[3]6,196	[3]6,009	[3]6,081	[3]5,955	[3]5,753	[3]5,742	[3]5,162
Total liabilities and shareholders' equity	143,051	[3]141,850	[3]141,960	[3]141,101	[3]139,702	[3]137,682	[3]134,310	[3]136,676

Footnotes:
(1) See Note 1 B.
(2) Reclassified.
(3) Restated - see annex to Schedule H hereunder.

SCHEDULE H - CONDENSED CONSOLIDATED STATEMENT OF INCOME FOR EACH QUARTER

REPORTED AMOUNTS[1] (IN MILLIONS OF NEW ISRAEL SHEKELS)

	2004			
Quarter	4	3	2	1
	Reported amounts[1]			
	In NIS millions			
Financing Income				
Income from financing activities before provision for doubtful debts	885	[3]880	[3]873	[3]851
Provision for doubtful debts	256	[3]257	[3]204	163
Profit from financing activities after provision for doubtful debts	629	[3]623	[3]669	[3]688
Non-Financing Income				
Operating commissions	447	421	429	448
Net income from investment in shares	19	15	13	56
Other income	113	79	83	77
Total non-financing income	579	515	525	581
Non-Financing Expenses				
Salaries and related expenses	657	[3]578	[3]585	691
Maintenance and depreciation of buildings and equipment	170	[2]154	[2]153	[2]155
Other expenses	262	[2]193	[2]208	[2]207
Total non-financing expenses	1,089	[3]925	[3]946	1,053
Operating income before taxes	119	[3]213	[3]248	[3]216
Provision for taxes on operating income	10	[3]112	[3]115	[3]105
Operating income after taxes	109	[3]101	[3]133	[3]111
Bank's share in operating income of affiliated companies net of tax effect	41	18	43	33
Net operating income before minority interest	150	[3]119	[3]176	[3]144
Minority interest in the operating income after taxes of consolidated companies	(5)	[3](18)	[3](16)	(17)
Net operating income	145	[3]101	[3]160	[3]127
Cumulative effect of change in accounting	(1)	-	-	-
Net income (loss) from extraordinary items, net of taxes	(10)	-	44	(10)
Net income	134	101	[3]204	[3]117
Earnings per NIS 1 Nominal Value of Share Capital (in NIS)				
Net operating income	1.48	[3]1.03	[3]1.63	[3]1.30
Net gain (loss) from extraordinary items, net of taxes[4]	(0.11)	-	0.45	(0.11)
Net income	1.37	[3]1.03	[3]2.08	[3]1.19
Weighted nominal value of share capital used for the above calculation (in NIS thousands)	98,064	98,064	98,064	98,064

Footnotes:
(1) See Note 1 B.
(2) Reclassified.
(3) Restated - see annex hereafter.
(4) Including the cumulative effect of change in accounting.

SCHEDULE H - CONDENSED CONSOLIDATED STATEMENT OF INCOME FOR EACH QUARTER (CONTINUED)

	2003			
Quarter	4	3	2	1
	Reported amounts[1]			
	In NIS millions			
Financing Income				
Income from financing activities before provision for doubtful debts	(3)738	(3)749	(3)733	(3)763
Provision for doubtful debts	227	227	224	167
Income from financing activities after provision for doubtful debts	(3)511	(3)522	(3)509	(3)596
Non-Financing Income				
Operating commissions	425	425	407	391
Net income (loss) on investment in shares	8	5	(2)	(2)
Other income	134	59	160	(2)81
Total non-financing income	567	489	565	470
Non-Financing Expenses				
Salaries and related expenses	574	565	551	574
Maintenance and depreciation of buildings and equipment	163	162	153	(2)158
Other expenses	216	148	174	167
Total non-financing expenses	953	875	878	899
Operating income before taxes in reported amounts	125	136	196	167
Erosions and adjustments(1)	7	20	25	(22)
Operating income before taxes	(3)132	(3)156	(3)221	(3)145
Provision for taxes on operating income	(3)37	(3)82	(3)134	(3)118
Operating income after taxes	(3)95	(3)74	(3)87	(3)27
Bank's share in operating income of affiliated companies, net of tax effect	29	19	47	22
Net operating income before minority interest	(3)124	(3)93	(3)134	(3)49
Minority interest, after taxes, in the operating income of consolidated subsidiaries	(12)	(16)	(17)	(15)
Net operating income	(3)112	(3)77	(3)117	(3)34
Net cumulative effect as of the beginning of the year of change in accounting	-	-	-	10
Net income, before extraordinary loss after tax	(3)112	(3)77	(3)117	(3)44
Provision for impairment in value of investment in affiliated companies	-	-	-	(173)
Net loss from extraordinary items, net of taxes	(14)	(3)	(6)	-
Net income (loss)	(3)98	(3)74	(3)111	(3)(129)
Earnings (loss) per NIS 1 Nominal Value of Share Capital (in NIS)[1]				
Net operating income	(3)1.14	(3)0.79	(3)1.19	(3)0.35
Net loss from extraordinary items, net of taxes[4]	(0.14)	(0.04)	(0.06)	(1.67)
Net income (loss)	(3)1.00	(3)0.75	(3)1.13	(3)(1.32)
Weighted par value of share capital used in the above calculation (in NIS thousands)	98,064	98,064	98,064	98,064

Footnotes:
(1) See Note 1 B.
(2) Reclassified.
(3) Restated - see annex hereafter.
(4) Including a provision for impairment in value of investment in an affiliated company and the net cumulative effect as of the beginning of the year of change in accounting.

SCHEDULE H - ANNEX OF RESTATEMENT

A. The subsidiary IDB New York has restated its interim financial statements for all the quarters of 2003 and for the first three quarters of 2004 (for additional details see Note 1 X. to the financial statements). The subsidiary Discount Mortgage Bank Ltd. has restated its interim financial statements for the second and third quarters of 2004 (for additional details see Note 4 I to the financial statements).

B. FOLLOWING IS THE EFFECT OF THE RESTATEMENT ON THE BALANCE SHEET ITEMS (IN NIS MILLIONS):

	Adjusted amounts[(1)]		
	In NIS millions		
	Before restatement	Change	After restatement
As at March 31, 2003			
Other assets	3,528	4	3,532
Deposits from the public	118,114	8	118,122
Shareholders' equity	5,166	(4)	5,162
As at June 30, 2003			
Other assets	3,713	7	3,720
Deposits from the public	115,829	14	115,843
Shareholders' equity	5,749	(7)	5,742
As at September 30, 2003			
Other assets	4,020	11	4,031
Deposits from the public	118,326	22	118,348
Shareholders' equity	5,764	(11)	5,753
As at December 31, 2003			
Other assets	3,854	15	3,869
Deposits from the public	119,924	29	119,953
Shareholders' equity	5,969	(14)	5,955
	Reported amounts[(1)]		
As at March 31, 2004			
Other assets	3,236	19	3,255
Deposits from the public	120,836	36	120,872
Shareholders' equity	6,098	(17)	6,081
As at June 30, 2004			
Credit to the public	76,809	(24)	76,785
Other assets	3,718	33	3,751
Deposits from the public	121,995	42	122,037
Minority interests	502	(5)	497
Shareholders' equity	6,037	(28)	6,009
As at September 30, 2004			
Credit to the public	77,804	(29)	77,775
Other assets	3,434	38	3,472
Deposits from the public	121,284	49	121,333
Minority interests	454	(6)	448
Shareholders' equity	6,230	(34)	6,196

SCHEDULE H - ANNEX OF RESTATEMENT (CONTINUED)

C. FOLLOWING IS THE EFFECT OF THE RESTATEMENT ON THE INCOME STATEMENT ITEMS AND ON THE EARNINGS PER SHARE[(1)] (IN NIS MILLIONS)

	For the three months ended 31.3.2003		
	Before		After
	restatement	Change	restatement
	Reported amounts[(1)]		
Income from financing activities before provision for doubtful debts	771	(8)	763
Income from financing activities after provision for doubtful debts	604	(8)	596
Operating income before taxes	153	(8)	145
Provision for taxes on operating income	122	(4)	118
Operating income after taxes	31	(4)	27
Net operating income before minority interests	53	(4)	49
Net operating income	38	(4)	34
Net income before extraordinary income after taxes	48	(4)	44
Net income (loss)	(125)	(4)	(129)
Earning per NIS 1 nominal value of share capital (in NIS):			
Net operating income	0.39	(0.04)	0.35
Net income (loss)	(1.27)	(0.05)	(1.32)

	For the three months ended 30.6.2003		
	Before		After
	restatement	Change	restatement
	Reported amounts[(1)]		
Income from financing activities before provision for doubtful debts	739	(6)	733
Income from financing activities after provision for doubtful debts	515	(6)	509
Operating income before taxes	227	(6)	221
Provision for taxes on operating income	137	(3)	134
Operating income after taxes	90	(3)	87
Net operating income before minority interests	137	(3)	134
Net operating income	120	(3)	117
Net income before extraordinary income after taxes	120	(3)	117
Net income (loss)	114	(3)	111
Earning per NIS 1 nominal value of share capital (in NIS):			
Net operating income	1.22	(0.03)	1.19
Net income (loss)	1.16	(0.03)	1.13

Footnote:
(1) See Note 1B.

SCHEDULE H - ANNEX OF RESTATEMENT (CONTINUED)

C. FOLLOWING IS THE EFFECT OF THE RESTATEMENT ON THE INCOME STATEMENT ITEMS AND ON THE EARNINGS PER SHARE[1] (IN NIS MILLIONS) (CONTINUED)

	For the three months ended 30.9.2003		
	Before restatement	Change	After restatement
	Reported amounts[1]		
Income from financing activities before provision for doubtful debts	757	(8)	749
Income from financing activities after provision for doubtful debts	530	(8)	522
Operating income before taxes	164	(8)	156
Provision for taxes on operating income	86	(4)	82
Operating income after taxes	78	(4)	74
Net operating income before minority interests	97	(4)	93
Net operating income	81	(4)	77
Net income before extraordinary income after taxes	81	(4)	77
Net income (loss)	78	(4)	74
Earning per NIS 1 nominal value of share capital (in NIS):			
Net operating income	0.83	(0.04)	0.79
Net income (loss)	0.80	(0.05)	0.75

	For the three months ended 31.12.2003		
	Before restatement	Change	After restatement
	Reported amounts[1]		
Income from financing activities before provision for doubtful debts	745	(7)	738
Income from financing activities after provision for doubtful debts	518	(7)	511
Operating income before taxes	139	(7)	132
Provision for taxes on operating income	41	(4)	37
Operating income after taxes	98	(3)	95
Net operating income before minority interests	127	(3)	124
Net operating income	115	(3)	112
Net income before extraordinary income after taxes	115	(3)	112
Net income (loss)	101	(3)	98
Earning per NIS 1 nominal value of share capital (in NIS):			
Net operating income	1.17	(0.03)	1.14
Net income (loss)	1.03	(0.03)	1.00

Footnote:
(1) See Note 1B.

SCHEDULE H - ANNEX OF RESTATEMENT (CONTINUED)

C. FOLLOWING IS THE EFFECT OF THE RESTATEMENT ON THE INCOME STATEMENT ITEMS AND ON THE EARNINGS PER SHARE[1] (IN NIS MILLIONS) (CONTINUED)

	For the three months ended 31.3.2004		
	Before restatement	Change	After restatement
	Reported amounts[1]		
Income from financing activities before provision for doubtful debts	858	(7)	851
Provision for doubtful debts	163		163
Income from financing activities after provision for doubtful debts	695	(7)	688
Salaries and related expenses	691		691
Total non-financing expenses	1,053	-	1053
Operating income before taxes	223	(7)	216
Provision for taxes on operating income	108	(3)	105
Operating income after taxes	115	(4)	111
Net operating income before minority interests	148	(4)	144
Minority interest, after taxes, in the operating income of consolidated subsidiaries	(17)	-	(17)
Net operating income	131	(4)	127
Net income (loss)	121	(4)	117
Earning per NIS 1 nominal value of share capital (in NIS):			
Net operating income	1.34	(0.04)	1.30
Net income (loss)	1.23	(0.04)	1.19

	For the three months ended 30.6.2004		
	Before restatement	Change	After restatement
	Reported amounts[1]		
Income from financing activities before provision for doubtful debts	879	(6)	873
Provision for doubtful debts	180	24	204
Income from financing activities after provision for doubtful debts	699	(30)	669
Salaries and related expenses	588	(3)	585
Total non-financing expenses	949	(3)	946
Operating income before taxes	275	(27)	248
Provision for taxes on operating income	126	(11)	115
Operating income after taxes	149	(16)	133
Net operating income before minority interests	192	(16)	176
Minority interest, after taxes, in the operating income of consolidated subsidiaries	(21)	5	(16)
Net operating income	171	(11)	160
Net income (loss)	215	(11)	204
Earning per NIS 1 nominal value of share capital (in NIS):			
Net operating income	1.74	(0.11)	1.63
Net income (loss)	2.19	(0.11)	2.08

Footnote:
(1) See Note 1B.

SCHEDULE H - ANNEX OF RESTATEMENT (CONTINUED)

C. FOLLOWING IS THE EFFECT OF THE RESTATEMENT ON THE INCOME STATEMENT ITEMS AND ON THE EARNINGS PER SHARE[1] (IN NIS MILLIONS) (CONTINUED)

	For the three months ended 30.9.2004		
	Before restatement	Change	After restatement
	Reported amounts[1]		
Income from financing activities before provision for doubtful debts	887	(7)	880
Provision for doubtful debts	252	5	257
Income from financing activities after provision for doubtful debts	635	(12)	623
Salaries and related expenses	577	1	578
Total non-financing expenses	924	1	925
Operating income before taxes	226	(13)	213
Provision for taxes on operating income	118	(6)	112
Operating income after taxes	108	(7)	101
Net operating income before minority interests	126	(7)	119
Minority interest, after taxes, in the operating income of consolidated subsidiaries	(19)	1	(18)
Net operating income	107	(6)	101
Net income (loss)	107	(6)	101
Earning per NIS 1 nominal value of share capital (in NIS):			
Net operating income	1.09	(0.06)	1.03
Net income (loss)	1.09	(0.06)	1.03

Footnote:
(1) See Note 1B.

STATEMENT OF THE BOARD OF DIRECTORS AND MANAGEMENT'S

RESPONSIBILITY FOR THE ANNUAL REPORT

The annual report was prepared by the Management of the Bank, which is responsible for its propriety. This report includes financial statements prepared in accordance with generally accepted accounting principles and the reporting requirements and directives of the Supervisor of Banks, related supplementary data similarly prepared, as well as other information.

The preparation of periodic financial statements also requires the preparation of estimates determining certain amounts and items in the financial statements. Such estimates were prepared by the Bank's Management using its best judgment.

In order to ensure that the Bank's financial statements are presented fairly, the Bank's Management maintains a comprehensive system of internal control for the purpose of ensuring that the transactions effected by the Bank are properly authorized, that the Bank's assets are properly protected and that the accounting records are a reliable basis for the preparation of the financial statements. The system of internal control is, by nature, limited in that the certainty of its ability to uncover and prevent errors and irregularities is reasonable rather than absolute. The principle of reasonable certainty is based on the recognition that the decision as to the amount of resources to be invested in operating the control procedures must take into account the benefit to be derived from such procedures.

The Bank's Board of Directors, which is responsible for drawing up the financial statements and their approval pursuant to section 92 of the Companies Law, determines the accounting policy, controls its application and the structure of the internal control system, and supervises its implementation. The President and Chief Executive Officer is responsible for the routine management of the Bank's affairs within the context of the policy determined by the Board of Directors, and he is subject to its directions. The Bank's Management operates in accordance with the policy established by the Board of Directors. The Board of Directors, through its committees, holds meetings on a regular basis with Management, the internal auditor, and the Bank's auditors for the purpose of reviewing the scope of their work and the results thereof.

The Bank's auditors, Messrs. Ziv Haft., Certified Public Accountants (Isr.), and Messrs. Somekh Chaikin, Certified Public Accountants (Isr.), audited the Bank's annual financial statements in accordance with generally accepted auditing standards including standards prescribed by the Auditors Regulations (Manner of Auditor's Performance) - 1973 and certain auditing standards published by the American Institution of Certified Public Accountants and whose application was enforced by the Supervisor of Banks. The purpose of the audits is to enable the auditors to express an opinion as to the extent to which the financial statements reflect, in accordance with generally accepted accounting principles and the reporting requirements and directives of the Supervisor of Banks, the Bank's financial position, the result of its operations, the changes in shareholders' equity and its cash flows. Pursuant to section 170 of the Companies Law, the auditors are responsible to the Bank and its shareholders for the matters stated in their report on the financial statements. The auditors' report is appended to the annual financial statements.

In addition, the data included in the Report of the Board of Directors to Shareholders and Management Review (hereinafter "the annexed data") was submitted to the auditors so that they could advise whether there were any material differences between the data contained in the financial statements and the annexed data, or whether the annexed data included details which were in substantial disagreement with evidence or information which came to their attention during the course of their audit. No such advice was received from the auditors. The auditors did not undertake any auditing procedures for this purpose in addition to those they were required to employ in their examination of the financial statements.

	Arie Mientkavich	Giora Offer	Joseph Beressi
	Chairman of the	President and	Executive Vice President,
March 29, 2005	Board of Directors	Chief Executive Officer	Chief Accountant

Somekh Chaikin

ZIV HAFT

AUDITORS' REPORT TO THE SHAREHOLDERS OF ISRAEL DISCOUNT BANK LTD.

We have audited the financial statements of Israel Discount Bank Limited (hereinafter - "the Bank") and the consolidated financial statements of the Bank and its consolidated subsidiaries: Balance sheets as at December 31, 2004 and December 31, 2003, statements of income, statement of changes in shareholders' equity and statements of cash flows for the three years, the last of which ended December 31, 2004. These financial statements are the responsibility of the Bank's Board of Directors and Management. Our responsibility is to express an opinion on these financial statements based on our audit.

We did not audit the financial statements of consolidated subsidiaries, the assets of which constitute approximately 1% and 23% of the total consolidated assets as at December 31, 2004 and 2003, respectively, and whose income from financing activities before provision for doubtful debts, which constitute approximately 1%, 12% and 27% of the total consolidated financing income before provision for doubtful debts for the three years, the last of which ended December 31, 2004. We also did not audit the financial statements of certain affiliated companies, the investment in which amounted to NIS 47.6 million and NIS 35.6 million at December 31, 2004 and 2003, respectively, and the share of the Bank in their net operating income (loss) is NIS 7.3 million, NIS 1.9 million and NIS (0.3) million, for the three years, the last of which ended December 31, 2004. The financial statements of those companies were audited by other auditors, whose reports were furnished to us, and our opinion, insofar as it relates to amounts included in respect of those companies, is based on the reports of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards, including those prescribed under the Israeli Auditors' Regulations (Auditor's Mode of Performance), 1973 and auditing standards applied in the audit of banking corporations as determined by guidelines of the Supervisor of Banks. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examination, on a test basis, of evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Bank's Board of Directors and Management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the other auditors, the financial statements referred to above present fairly, in conformity with generally accepted accounting principles, in all material respects, the financial position - of the Bank and consolidated - as at December 31, 2004 and 2003, and the results of operations, the changes in shareholders' equity and cash flows - of the Bank and consolidated - for the three years the last of which ended December 31, 2004. Furthermore, in our opinion, the abovementioned financial statements were prepared in accordance with the directives and guidelines of the Supervisor of Banks.

As explained in Note 1 B, the financial statements for dates and reporting periods following December 31, 2003, are presented in reported amounts, in accordance with accounting standards of the Israeli Accounting Standard Board. The financial statements for dates and reporting periods ended up that date, are presented in amounts that had been adjusted up to that date based on the changes in the general purchasing power of the Israeli currency, in accordance with Opinions of the Institute of Certified Public Accountants in Israel and Directives and guidelines of the Supervisor of Banks.

Without qualifying our opinion, we draw attention to the following Notes to the financial statements:

(a) Concerning Note 33 as to the proposed changes in the capital market structure. The said Note stated, among other things, that the implementation of the Bachar Committee recommendations as well as the adoption of the legislation proposed in its wake, may have a material adverse effect on the business position of the Bank and its results of operations, however, nonetheless, in view of that stated in the Note, the probability that all this will happen and the future implications of the implementation of the proposed capital market reform on the business position and the results of operations of the Bank, cannot be estimated or quantified at this stage.

(b) Concerning Notes 19 C 16.1 and 16.3 as to class actions and pleas for the approval of certain actions as class actions against the Bank and against Discount Mortgage Bank Ltd. (a consolidated subsidiary).

(c) Concerning Note 19 C, 17.2 and 17.3 as to contingencies regarding Insurance issues relating to Discount Mortgage Bank (a consolidated subsidiary).

(d) Concerning Note 19 C, 18 as to pleas for approval of actions against Harel Insurance Investments Ltd. (an affiliated company) as class actions.

(e) Concerning Note 1 X as to the adjustment by way of a restatement of the financial statements for 2003, in order to retroactively reflect in them the effect of a restatement by a subsidiary in respect of the calculation of interest on deposits.

Somekh Chaikin	Ziv Haft
Certified Public Accountants (Isr.)	Certified Public Accountants (Isr.)

March 29, 2005

BALANCE SHEET AS AT DECEMBER 31,2004

		Consolidated		The Bank	
		December 31		December 31	
	Notes	2004	2003	2004	2003
		Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)
		in NIS millions			
Assets					
Cash and deposits with banks	2	17,751	16,888	20,622	19,539
Securities	3	40,068	38,774	16,433	16,402
Credit granted to the public	4	77,508	(2)76,464	44,172	44,528
Credit granted to Governments	5	271	367	268	322
Investment in investee companies					
(consolidated – affiliated companies)	6	1,320	1,238	5,871	(3)5,635
Buildings and equipment	7	1,978	(2)2,102	1,432	(2)1,546
Other assets	8	4,155	(3)(2)3,869	2,816	(3)(2)2,609
Total assets		143,051	(3)139,702	91,614	(3)90,581
Liabilities and Shareholders` Equity					
Deposits from the public	9	121,692	(3)119,953	76,751	76,826
Deposits from banks	10	5,078	5,097	1,957	1,593
Deposits from the Government		144	171	38	54
Debentures and subordinated capital notes	11	4,809	4,223	3,575	3,642
Other liabilities	12	4,493	(2)3,819	2,907	(2)2,511
Total liabilities		136,216	(3)133,263	85,228	84,626
Minority interest		449	484	-	-
Shareholders` equity	13	6,386	(3)5,955	6,386	(3)5,955
Total liabilities and shareholders` equity		143,051	(3)139,702	91,614	(3)90,581

Footnotes:
(1) See Note 1 B.
(2) Reclassified.
(3) Restated - see Note 1 X.

The notes to the financial statements are an integral part thereof

Arie Mientkavich	Nissim Baruch	Giora Offer	Joseph Beressi
Chairman of the Board of Directors	Member of the Board of Directors	President & Chief Executive Officer	Executive Vice President Chief Accountant

March 29, 2005

STATEMENT OF INCOME FOR THE YEAR ENDED DECEMBER 31, 2004

		Consolidated		
	Notes	2004	2003	2002
		Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)
			in NIS millions	
Financing Income				
Income from financing activities before provision for doubtful debts	23	3,489	(2)2,983	2,879
Provision for doubtful debts	1I,4C	880	845	896
Income from financing activities after provision for doubtful debts		2,609	(2)2,138	1,983
Non-Financing Income				
Operating commissions	24	1,745	1,648	1,508
Net income (loss) on investment in shares	25	103	9	(11)
Other income	26	352	434	243
Total non-financing income		2,200	2,091	1,740
Non-Financing Expenses				
Salaries and related expenses	27	2,511	2,264	2,183
Maintenance and depreciation of buildings and equipment		632	636	596
Other expenses	28	870	705	785
Total non-financing expenses		4,013	3,605	3,564
Operating income before taxes in reported amounts		796	624	159
Erosions and adjustments(1)		-	30	-
Operating income before taxes		796	(2)654	159
Provision for taxes on operating income	29	342	(2)371	207
Operating income (loss) after taxes		454	(2)283	(48)
Bank's share in operating income (loss) of affiliated companies, net of tax effect	6B1	135	117	(1)
Net operating income (loss) before minority interest		589	(2)400	(49)
Minority interest, after taxes, in the operating income of consolidated subsidiaries		(56)	(60)	(25)
Net operating income (loss)		533	(2)340	(74)
Net cumulative effect as of the beginning of the year of change in accounting	1V,W	(1)	10	-
Net income (loss), before extraordinary income (loss) after tax		532	(2)350	(74)
Provision for impairment in value of investment in affiliated companies	6D	-	(173)	(8)
Net gain (loss) from extraordinary items, net of taxes	30	24	(23)	44
Net income (loss)		556	(2)154	(38)
Earnings (loss) per NIS 1 nominal value of share capital (in NIS)(1):	1S			
Net operating income (loss)		5.44	(2)3.47	(0.75)
Net gain (loss) from extraordinary items, net of taxes(4)		0.23	(1.90)	0.36
Net income (loss)		5.67	(2)1.57	(0.39)
Weighted par value of share capital used in the above calculation (in NIS thousands)		98,064	98,064	98,064

Footnotes:
(1) See Note 1 B.
(2) Restated - see Note 1 X.
(3) December 31, 2004: Including net cumulative effect as of the beginning of the year of change in accounting.
December 31, 2003: Including a provision for impairment in value of investment in an affiliated company and the net cumulative effect as of the beginning of the year of change in accounting.
December 31, 2002: Including a provision for impairment in value of investment in an affiliated company.

The notes to the financial statements are an integral part thereof.

STATEMENT OF INCOME FOR THE YEAR ENDED DECEMBER 31, 2004

		The Bank		
	Notes	2004	2003	2002
		Reported amounts[(1)]	Reported amounts[(1)]	Adjusted amounts[(1)]
			in NIS millions	
Financing Income				
Income from financing activities before provision for doubtful debts	23	2,021	1,952	1,516
Provision for doubtful debts	1I,4C	582	656	727
Income from financing activities after provision for doubtful debts		1,439	1,296	789
Non-Financing Income				
Operating commissions	24	864	827	723
Net income (loss) on investment in shares	25	75	12	(1)
Other income	26	241	353	178
Total non-financing income		1,180	1,192	900
Non-Financing Expenses				
Salaries and related expenses	27	1,671	1,445	1,391
Maintenance and depreciation of buildings and equipment		398	404	364
Other expenses	28	422	339	329
Total non-financing expenses		2,491	2,188	2,084
Operating income (loss) before taxes in reported amounts		128	300	(395)
Erosions and adjustments[(1)]		-	(36)	-
Operating income (loss) before taxes		128	264	(395)
Provision for taxes (tax saving) on operating income	29	24	116	(30)
Operating income (loss) after taxes		104	148	(365)
Bank's share in operating income of investee companies, net of tax effect	6B1	429	[(2)]192	291
Net operating income (loss)		533	[(2)]340	(74)
Net cumulative effect as of the beginning of the year of change in accounting	1V,W	(1)	10	-
Net income (loss), before extraordinary income (loss) after tax		532	[(2)]350	(74)
Provision for impairment in value of investment in affiliated companies	6D	-	(173)	(8)
Net gain (loss) from extraordinary items, net of taxes	30	24	(23)	44
Net income (loss)		556	[(2)]154	(38)

Footnotes:
(1) See Note 1 B.
(2) Restated - see Note 1 X.

The notes to the financial statements are an integral part thereof.

STATEMENT OF CHANGES IN SHAREHOLDERS' EQITY

	Share capital	Capital reserves		Total share capital and reserves
		Share premium reserve	Other capital reserves	
	in NIS millions			
Balance at January 1, 2002*	658	2,939	37	3,634
Changes in 2002 :				
Loss for the year *	-	-	-	-
Net adjustments for the presentation of available-for- sale securities at fair value *	-	-	-	-
Related tax effect *	-	-	-	-
Balance at December 31, 2002*	658	2,939	37	3,634
Changes in 2003 :				
Classification of other comprehensive income*	-	-	-	-
Income for the year*	-	-	-	-
Net adjustments for the presentation of available-for- sale securities at fair value*	-	-	-	-
Related tax effect*	-	-	-	-
Financial statements translation adjustments*	-	-	-	-
Net losses on the hedging of cash flows*	-	-	-	-
Net loss on the hedging of cash flows reclassified to the income statement*	-	-	-	-
Balance at December 31, 2003*	658	2,939	37	3,634
Changes in 2004:				
Income for the year**	-	-	-	-
Net adjustments for the presentation of available-for- sale securities at fair value**	-	-	-	-
Related tax effect**	-	-	-	-
Net income on the hedging of cash flows**	-	-	-	-
Net income on the hedging of cash flows reclassified to the income statement**	-	-	-	-
Balance at December 31, 2004**	658	2,939	37	3,634

* Adjusted amounts - see Note 1 B.
** Reported amounts - see Note 1 B.
*** Restated - see Note 1 X.
Footnote:
(1) Translation adjustments of foreign autonomous units. The consolidated subsidiary Israel Discount Bank of New York was treated until December 31, 1994, in the financial statements of the Bank as autonomous units. Accordingly this item included the financing sources of this investment and the related tax effect until that date (see also Note 1 G).

The notes to the financial statemtns are an integral part thereof.

Other cumulative comprehensive income (loss)				
Adjustments for presentation of available for sale securities at fair value	Translation adjustments[1]	Net gains (losses) on cash flow hedging	Retained earnings	Total shareholders' equity
in NIS millions				
(4)	(231)	-	2,166	5,565
-	-	-	(38)	(38)
(433)	-	-	-	(433)
(30)	-	-	-	(30)
(467)	(231)	-	2,128	5,064
9	-	(9)	-	-
-	-	-	***154	***154
779	-	-	-	779
(43)	-	-	-	(43)
-	(1)	-	-	(1)
-	-	(7)	-	(7)
-	-	9	-	9
278	(232)	(7)	***2,282	***5,955
-	-	-	556	556
(169)	-	-	-	(169)
43	-	-	-	43
-	-	2	-	2
-	-	(1)	-	(1)
152	(232)	(6)	2,838	6,386

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31, 2004

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts[(1)]	Adjusted amounts[(1)]	Adjusted amounts[(1)]	Reported amounts[(1)]	Adjusted amounts[(1)]	Adjusted amounts[(1)]
in NIS millions						
Cash Flows from Operating Activities						
Net income (loss) for the year	556	[(3)]154	(38)	556	[(3)]154	(38)
Adjustments necessary to present cash flows from operations:						
Bank's share in undistributed income (loss) of investee companies (consolidated - affiliated companies)	(109)	(101)	46	(332)	[(3)](116)	(283)
Minority interest in income of consolidated subsidiaries	56	61	25	-	-	-
Depreciation of buildings and equipment	259	[(4)]260	233	171	[(4)]169	139
Amortization	-	7	12	-	-	-
Provision for decline in value of securities held for investment	-	6	10	-	3	7
Provision for doubtful debts	974	[(5)]909	995	676	[(5)]722	814
Loss (gain) on sale of available-for-sale and held-to-maturity securities	(110)	(17)	(16)	(99)	(38)	20
Realized and non realized loss (gain) from adjustment to fair value of trading securities	(70)	[(6)](71)	69	(39)	[(6)](37)	64
Loss (gain) on change in controlling interest and provision for impairment in value in investee companies	(40)	205	18	(40)	173	8
Provision for impairment in value of buildings	-	22	10	-	21	9
Gain (loss) on sale of buildings and equipment	41	6	(55)	39	6	(52)
Net deferred taxes	(67)	[(3)](60)	63	(37)	(5)	19
Severance pay – decrease (increase) in excess of deposits over the provision	(46)	[(7)](244)	55	(48)	[(7)](215)	57
Inflation adjustment component of investing and financing activities	1,624	313	619	(31)	36	420
Changes in Balance Sheet Items:						
Other assets, net	(163)	[(3)(2)](332)	(645)	(75)	[(3)(2)](145)	(353)
Other liabilities, net	685	[(2)](249)	178	409	[(2)]22	65
Net Cash Flows from Operating Activities	3,590	[(3)]869	1,579	1,150	[(3)]750	896

Footnotes:
(1) See Note 1 B.
(2) Restated.
(3) Restated - see Note 1 X.
(4) The amounts taken to the statement of income in reported amounts are NIS 251 million and NIS 163 million, respectively.
(5) The amounts taken to the statement of income in reported amounts are NIS 906 million and NIS 724 million, respectively.
(6) The amounts taken to the statement of income in reported amounts are NIS 73 million and NIS 37 million, respectively.
(7) The amounts taken to the statement of income in reported amounts are NIS 241 million and NIS 212 million, respectively.

The notes to the financial statements are an integral part thereof.

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31, 2004 (CONTINUED)

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Adjusted amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Adjusted amounts(1)
	in NIS millions					
Cash Flows from Asset Transactions:						
Acquisition of held-to-maturity bonds	(2,171)	(3)	(89)	-	-	-
Proceeds from sale of held-to-maturity bonds	-	-	16	-	-	16
Proceeds from redemption of held-to-maturity bonds	2,205	-	1	-	-	1
Acquisition of available-for-sale securities	(21,272)	(42,532)	(43,270)	(9,121)	(8,113)	(9,262)
Proceeds from sale of available-for-sale securities	13,230	3,287	4,168	3,999	2,821	3,880
Proceeds from redemption of available-for-sale securities	5,874	38,017	31,363	5,789	4,834	2,448
Net deposits with banks	444	406	685	(315)	(600)	(736)
Trading securities, net	(627)	(1,312)	596	(539)	(879)	409
Net credit granted to the public	(1,980)	(2)(2,814)	(880)	(319)	(698)	542
Net credit granted to the Government	96	182	(6)	54	161	8
Additional investment in investee companies	109	10	(23)	180	226	9
Increase in cash due to initially consolidated companies (annex A)	-	(3)	(1)	-	-	-
Proceeds, net, from sale of investments in previously consolidated subsidiaries (annex B)	1	(2)	(5)	-	-	-
Acquisition of buildings and equipment	(372)	(2)(487)	(297)	(294)	(2)(380)	(180)
Proceeds from sale of buildings and equipment	220	66	48	219	63	40
Acquisition of other assets in a consolidated subsidiary	-	33	-	-	-	-
Net Cash Flows from Asset Transactions	(4,243)	(5,152)	(7,694)	(347)	(2,565)	(2,825)
Cash Flows From Liability and Capital Transactions:						
Net deposits from the public	1,739	(3)1,769	595	(75)	(609)	(2,739)
Net deposits from banks	(19)	705	408	364	385	(218)
Net deposits from the Government	(27)	70	4	(16)	19	(30)
Issuance of subordinated capital notes	742	609	182	65	528	161
Redemption of bonds and subordinated capital notes	(426)	(350)	(173)	(373)	(277)	(41)
Dividend paid to shareholders	(49)	(31)	-	-	-	-
Net cash flows from liability and capital transactions	1,960	(3)2,772	1,016	(35)	46	(2,867)
Increase (decrease) in cash	1,307	(1,510)	(5,099)	768	(1,768)	(4,796)
Cash balance at beginning of year (see Note 2)	13,881	15,391	20,490	11,574	13,342	18,138
Cash balance at end of year (see Note 2)	15,188	(3)13,881	15,391	12,342	11,574	13,342

Footnotes:
(1) See Note 1 B.
(2) Reclasiffied.
(3) Restated - see Note 1 X.

The notes to the financial statements are an integral part thereof.

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31, 2004 (CONTINUED)

Annex A – Decrease in cash due to initially consolidated subsidiaries

	2004	2003	2002
	Reported amounts(1)	Adjusted amounts(1)	Adjusted amounts(1)
		In NIS millions	
Assets and liabilities at acquisition date of consolidated subsidiaries:			
Working capital (excludung cash and cash equivalents)	-	21	-
Long-term assets	-	(25)	-
Goodwill	-	(1)	(1)
Non-cash proceeds	-	2	-
Total decrease in cash due to initially consolidated companies	-	(3)	(1)

Annex B - Proceeds from sale of investments in previously consolidated subsidiaries

	2004	2003	2002
	Reported amounts(1)	Adjusted amounts(1)	Adjusted amounts(1)
		In NIS millions	
Assets and liabilities of previously consolidated subsidiaries, at date of sale:			
Assets	2	-	3
Liabilities	(1)	-	-
Minority shareholder's interest	-	-	(8)
Debtors in respect of capital gains	(1)	-	-
Capital gain	1	2	-
Net cash flows on sale of investments in previously consolidated subsidiaries	1	2	(5)

Annex C - Non-cash asset and liability activity during the reported year

	2004	2003	2002
	Reported amounts(1)	Adjusted amounts(1)	Adjusted amounts(1)
		In NIS millions	
The Bank:			
Purchase of fixed assets	21	3	40
Sale of fixed assets	7	-	-
Return of lent securities	-	224	-
Lending of securities	3	-	80
Dividend	50	-	-
Consolidated:			
Purchase of fixed assets	24	7	2
Sale of fixed assets	7	-	-
Transfer of bonds from the held-to-maturity portfolio to the available–for-sale portfolio	-	-	33
Lending of securities	62	178	55
Return of lent securities	25	329	-
Investment in shares	-	91	-
The transfer of bonds for investment to trading securities	-	-	4
Dividend	-	-	10

Footnote:
(1) See Note 1 B.

The notes to the financial statements are an integral part thereof.

NOTES TO THE FINANCIAL STATEMENTS

1. SIGNIFICANT ACCOUNTING POLICIES

A. GENERAL

(1) The financial statements are prepared in accordance with the directives and guidelines of the Supervisor of Banks in Israel.

(2) The Notes to the financial statements relate to the Bank's financial statements and to the consolidated financial statements of the Bank and its subsidiaries, except where it is stated that the note relates only to the Bank, or only to the consolidated statements.

(3) In these financial statements -

Consolidated subsidiaries - companies in which the Bank holds voting rights, either directly or indirectly, exceeding fifty percent, and/or is entitled to appoint over one half of the members of their boards of directors, and whose financial statements are consolidated with those of the Bank.

Affiliated companies - companies, other than consolidated subsidiaries, the investment in which is included on the equity basis.

Investee companies – consolidated subsidiaries or affiliated companies.

Extensions abroad - consolidated subsidiaries and branches abroad.

B. DISCONTINUATION OF THE ADJUSTMENT OF FINANCIAL STATEMENTS TO THE EFFECT OF INFLATION – FINANCIAL STATEMENTS IN REPORTED AMOUNTS

Standard No. 12 of the Israeli Accounting Standard Institute, dealing with the discontinuation of the adjustment of financial statements ("Standard 12") came into effect in October 2001. According to Standard 12 and according to Standard No. 17 of December 2002, as from January 1, 2003, the adjustment of financial statements was discontinued and they are presented in reported amounts (namely, amounts adjusted on the basis of the CPI for the month of the transition, together with nominal amount which were added subsequent to date of transition, and less amounts which were deducted after that date). Until December 31, 2003, the Bank prepared financial statement on an inflation adjusted basis in accordance with instructions of the Supervisor of Banks, based on the principles determined in Opinion 36 of the Institute of Certified Public Accountants in Israel. The adjusted amounts included in the financial statements for December 31, 2003, served as a starting point for the nominal financial reporting in accordance with the Standard as from January 1, 2004.

The Supervisor of Bank has issued a provisional instruction regarding the transition of banking corporations from financial reporting on an inflation-adjusted basis to reporting in reported amounts. In view of the materiality that the Supervisor of Banks attaches to income and expenses from financial instruments included in the business results of banking corporations, and in order to enable users of their financial statements to examine the data included in the statements for 2004 in comparison to the data of 2003, special instructions were determined in respect of the comparative figures included in the financial statements for 2004, as detailed hereunder.

In these financial statements, "cost" – cost in reported amounts.

The data included in these financial statements are presented in accordance with the Standard and with the instructions of the Supervisor of Banks in "reported amounts" as follows:

(1) Balance sheet

- Monetary items are stated in nominal amounts.
- Non-monetary items are stated in reported amounts. The amounts of non-monetary assets do not necessarily represent

1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

their realizable value or updated economic value, but rather the reported amounts of such assets.

- The comparative figures are stated in inflation adjusted amounts, based on the CPI for December 2003.

(2) Statement of income

- Income and expenses relating to non-monetary items or to provisions included in the balance sheet are derived from the movement between the reported amount of the opening balance and the reported amount of the closing balance.
- The remaining components of the income statement are stated in nominal historical values.
- The comparative figures for 2003 are stated in these interim financial statements as follows:

  Income statement line items up to and including the item operating income before taxes in reported amounts, are stated when the discontinuation of the adjustment for the effect of inflation in their respect was made according to the CPI for December 2002.

  Erosions and adjustments for the effect of inflation according to the CPI for December 2003, of income and expenses included in operating income before taxes, were reclassified and are stated in a single amount in a separate line item before operating income before taxes.

  Income statement items appearing after the line item operating income before taxes, are stated in amounts adjusted for the effect of inflation based on the CPI for December 2003.
- the comparative figures for 2002 are presented as stated and adjusted for the effect of inflation on the basis of the CPI for December 2003.

(3) Statement of shareholders' equity

The comparative figures for the statement of shareholders' equity data are stated as adjusted for the effect of inflation based on the CPI for December 2003.

C. COMPARATIVE FIGURES

Several items have been reclassified, as stated in the financial statements.

D. PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the financial statements of the Bank and those of its consolidated subsidiaries. Financial statements of provident funds managed by the Bank or by a consolidated subsidiary have not been consolidated.

The Bank's financial statements include the financial statements of the property company "Nidbach Real Estate and Investments Ltd." and "Badal Computer and Management Services Ltd.", which are wholly owned by the Bank.

E. INVESTMENTS IN INVESTEE COMPANIES

Investments in the shares of investee companies (in the consolidated statements - investments in shares of affiliated companies) are presented on the equity basis, based on the financial statements of these investees as at the balance sheet date.

The Bank's share in the financial results of such investees is stated net, after amortization of the excess of cost arising on the acquisition of the investment. Excess of cost attributed to assets and liabilities is being amortized over the life of the related asset or the acquired company. Excess of cost not attributed as above (goodwill) is amortized at an annual rate of 10%.

F. FOREIGN CURRENCY AND LINKAGE

(1) Assets (except for investments in investee companies, buildings and equipment) and liabilities are stated in the balance sheet as follows:

- Those in foreign currency or linked thereto, are presented at representative exchange rates published by the Bank of

1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Israel at the balance sheet date, or at a different date, in accordance with the terms of the relevant transactions.

- Those linked to the CPI or to other indices are presented in the balance sheet according to the latest known index on the balance sheet date.
- Those optionally linked, are stated in accordance with their related terms ruling on the balance sheet date.

(2) Revenues and expenses in foreign currency or linked thereto, are presented in the statement of income at representative rates prevailing at the time of the transactions, with the addition of exchange rate differences on assets and liabilities from which these revenues or expenses resulted.

(3) The following are the representative rates of exchange and the CPI and their annual rates of change:

				Annual rate of change		
	2004	2003	2002	2004	2003	2002
		CPI (in points):		%	%	%
Balance sheet month (December index)	100.6	99.4	101.3	1.2	(1.9)	6.5
Known at balance sheet month (November index)	100.5	99.6	101.1	0.9	(2.0)	6.7
Representative exchange rate At the balance sheet date of the:						
U.S. Dollar (in NIS)	4.308	4.379	4.737	(1.6)	(7.6)	7.3
Basket of currencies (in NIS)	5.006	4.965	5.047	0.8	(1.6)	13.0
Euro	5.877	5.533	4.970	6.2	11.3	27.2

G. TRANSLATION OF FINANCIAL STATEMENTS OF EXTENSIONS ABROAD

Up to the year 1994, foreign subsidiaries were considered autonomous units, and the translation differences with respect to the investment therein was included as a separate item in Shareholders' Equity. Following guidelines of the Supervisor of Banks, foreign subsidiaries are considered, as from 1995, "extensions" of the Bank. Concurrently with the publication of Standard 12, the Israeli Accounting Standard Institute issued Standard No.13 dealing with the effect of changes in foreign currency exchange rates ("Standard 13"). The Bank implements that Standart as from January 1, 2004. Standard 13 deals with the translation of transactions in foreign currency and overseas operations into the reporting currency of the company, for the purpose of including the same in its financial statements. According to the Standard, overseas operations include a subsidiary, a company under joint control, an equity based company, a joint venture or a branch of the reporting entity, the operations of which are located or are being conducted in a country other than the country in which the reporting company is located.

In a provisional Directive issued by the Supervisor of Banks on October 16, 2001 it was clarified that overseas banking subsidiaries of local banking institution will continue to be classified as extensions ("long arm"), and that the classification of a new overseas subsidiary as an "autonomous unit" requires the approval of the Supervisor of Banks. In view of the above, the implementation of Standard 13 did not have any material effect on the financial statements of the Bank.

H. SECURITIES

(1) In accordance with directives of the Supervisor of Banks, the securities portfolio is categorized into three groups:

(a) "Held-to-maturity bonds" - bonds which the Bank intends and has the ability to hold until maturity. The bonds are presented at their adjusted cost at the reporting date.

1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(b) "Trading securities" - Securities which are held, in principle, with the intention of selling them in the short term. The securities are presented at their fair value at the balance sheet date. Gains or losses due to adjustments to fair value are recorded in the statement of income.

(c) "Available-for-sale securities" - securities not classified under the two previous categories Securities available for sale are stated at their fair value on the balance sheet date, except for shares the fair value of which is not readily available, which are stated at cost. Unrealized gains or losses resulting from the adjustment to fair value, net of the related tax effect, are recorded as a separate line item in Shareholders' Equity, and are taken to income upon sale or redemption of the securities. A provision for impairment in value not of a temporary nature is recorded in the statement of income.

(2) Swap transactions, in which the Bank acquired short-term bills issued by the Bank of Israel in exchange for other Government bonds, in a tender from the Bank of Israel, were recorded as two separate transactions as follows:
The sale of Government bonds - according to prices set in advance by the Bank of Israel.
Purchase of short-term bills - at prices the Bank obtained in the tender.

(3) The lending of securities by the Bank as cover for the short selling of securities by the borrower, is presented as part of credit to the public as long as these securities are outstanding.

(4) A foreign subsidiary enters into transactions of sale and purchase of securities, which include "buy back" terms. These transactions are classified as secured loans or secured deposits, respectively.

I. PROVISION FOR DOUBTFUL DEBTS

(1) The provision for doubtful debts includes a specific provision, a general provision, a supplemental provision and a special provision. The supplemental provision for doubtful debts of the Bank and the consolidated subsidiaries in Israel was made according to the directives of the Supervisor of Banks. The provisions for doubtful debts in the consolidated banking subsidiaries abroad, are determined according to generally accepted principles in those countries.

(2) The specific provision for doubtful debts has been recorded on the basis of the Bank's estimate of expected losses in credit portfolios, including off-balance sheet debt items, by examining and monitoring the financial condition of the debtors and their business activities, an assessment of collateral held, and an evaluation of the risks related to their financial condition, performed on a quarterly basis.
The specific provisions regarding housing loans granted by banking subsidiaries in Israel, have been calculated according to the directives of the Supervisor of Banks, on an increasing scale in accordance with the extent of the arrears.

(3) The supplemental provision for doubtful debts is calculated based on the quality of the portfolio of debts according to the characteristics of risk as stated in the directives of the Supervisor of Banks. Annual provision rates as well as final targeted provision rates were set in the original directive for each of the risk characteristics.
In February 2002, the said Directive was amended, the annual provision rates were abolished, and it was determined, with immediate effect, that banks have to reach the final target of the supplemental provision with respect to problem debts already in the same quarter in which a debt has been classified as problematic.
The Bank has 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 until September 30, 2001 - which amounted to NIS 16 million as of December 31, 2004 - the Bank obtained the approval of the Supervisor of Banks to accrue it in the years 2002 to 2005. Mercantile Discount Bank and Discount Mortgage Bank obtained the approval of the Supervisor to record the said provision over five consecutive quarters ended on December 31, 2002.

(4) The ratios of the general provision and the supplemental provision (not including the provision for off-balance sheet

1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

items), to credit granted to the public for the Bank and its consolidated subsidiaries in Israel are:

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
General provision	0.25%	0.25%	0.25%	0.25%
Supplemental provision	0.20%	0.20%	0.17%	0.18%

The directives of the Supervisor of Banks stipulate that the balance of the general provision for doubtful debts, at adjusted values, accumulated under the previous directives, at a rate of 1% of total indebtedness as at December 31, 1991, should be maintained.

5) The supplemental provision, the general provision and the special provision are not deductible for tax purposes, and in accordance with the directives of the Supervisor of Banks, no deferred tax asset has been created in connection therewith.

6) A foreign subsidiary creates a general provision for doubtful debts based on past experience and management's estimate of business and economic conditions, the concentration of the credit portfolio, quality of the borrowers and trend of arrears in repayments.

7) Bad debts are written off when the Bank reaches the conclusion that the debt is uncollectible, either after taking legal proceedings, or as a result of agreements and arrangements made, most of which were in cases where legal proceedings were not taken, and the debts are not collectable, or for other reasons rendering them unrecoverable.

J. BUILDINGS AND EQUIPMENT

Buildings and equipment are presented at cost after deducting accumulated depreciation. Adjusted depreciation is calculated by the straight-line method based on the estimated useful life of the assets. The cost of buildings includes interest capitalized during the construction period. Buildings and designated for sale have been presented at their market price in those cases where it is lower than their adjusted cost.

Certain costs relating to in-house development of computer software are capitalized to investment in equipment. These costs are presented in accordance with the accounting treatment prescribed in the US Accounting Publication (Statement of Position 98-1). Software development costs for own use, which were incurred as from the end of the preliminary development stage, were capitalized. Costs of preliminary research and development as well as costs relating to the post application development stage (end of acceptance tests) were recorded in the income statement as incurred. These expenses are amortized as from the date of completion of the development, over the useful economic lives of these assets.

K. AMORTIZATION OF DEFERRED EXPENSES

Bond issue costs, net of the Treasury's participation, are amortized proportionally to the outstanding principal amount of the bonds.

The inventory of credit cards purchased by a consolidated subsidiary, is stated at cost and is being amortized over the expected period of benefit therefrom of six years, having regards to the number of clients.

L. THE BASIS OF RECOGNITION OF INCOME AND EXPENSES

Income and expenses are recognized on an accrual basis, except for interest in arrears on housing loans of a mortgage bank which is recognized when collected, and except for financing income on non-performing loans.

Sale and leaseback transactions are presented in the financial statements in accordance with International Accounting Standard (IAS) 17.

1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

M. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGE TRANSACTIONS

The Bank recognizes all derivatives as assets or liabilities on the balance sheet and measures them at fair value. Changes in the fair value of a derivative instrument shall be reflected in the statement of income, or shall be included in shareholders equity as an "other comprehensive income" component, in accordance with the designation of the derivative instrument.

The change in the fair value of derivatives hedging exposure to the change in the fair value of an asset, a liability or a firm commitment, shall be recognized in the income statement on a current basis, as well as the change in value of the hedged item, which may be related to the hedged risk.

The accounting treatment of changes in the fair value of derivatives that hedge exposure to changes in the cash flow generated by an asset, a liability or an anticipated transaction, depends on the effectiveness of the hedging relationships.

- The effective part of the change in the fair value of a derivative designated to hedge a cash flow risk, is initially reported in shareholders equity (outside the income statement) as a component of "other comprehensive income", following which, when the anticipated transaction affects the income statement, it is reclassified to the income statement.
- The non-effective part of the change in the fair value of a derivative designated as above is recognized immediately in the income statement.

For further details see Note 20 hereunder.

N. SET-OFF OF FINANCIAL INSTRUMENTS

Assets and liabilities are set-off against one another where an enforceable legal right of set-off and the intention to set-off the transactions at maturity date exist. Accordingly, designated deposits, the repayment of which to the depositor is conditional upon the extent of collection of the loans granted out of such deposits, and where the Bank has no risk of loss from such loans, are stated in the balance sheet net of the loans granted therefrom. The margin earned on this activity is included in the item "Operating commissions".

O. EMPLOYEE BENEFITS

Liabilities in respect of employee rights are covered by appropriate provisions.

P. TAXES ON INCOME

(1) The Bank and its consolidated subsidiaries use the tax allocation method with respect to timing differences in the recognition for tax purposes of certain income and expenses.

Deferred taxes have been calculated according to the "liability" method, at tax rates expected to apply during the period in which the deferred taxes are realized, based on laws in force at the balance sheet date. The realization of deferred taxes receivable is contingent upon the future existence of taxable income. Management believes that such deferred tax assets will be realizable in the future.

(2) A provision for deferred taxes is included in the financial statements for that part of the adjustment of depreciable non-monetary assets (excluding buildings - see Note 29G) which will not be deductible for tax purposes.

(3) Retained earnings of certain investee companies may be subject to additional taxes if and when distributed as cash dividends. With respect to consolidated subsidiaries - when a dividend distribution is not expected in the foreseeable future - no provision for taxes has been recorded. With respect to affiliated companies - a provision for taxes on income was recorded if an additional tax liability is likely to arise in respect of the distribution of dividend.

(4) Profits from the future sale of investments in shares of investee companies may attract additional taxes. The provision for deferred taxes does not include taxes relating to the sale of investments in investee companies as long as the supposition of the ongoing holding of the investment exists. (See also Note 29H).

1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

(5) The provision for taxes on income of the Bank and its consolidated subsidiaries which are financial institutions, for the purposes of Value Added Tax, includes profit tax levied on income as stipulated in the Value Added Tax Law. Value Added Tax levied on payroll of financial institutions is included in the statement of income under the item "Salaries and related expenses".

Q. CONTINGENT LIABILITIES

The accounting treatment of outstanding legal actions is in accordance with the provisions of the US Accounting Standard "Accounting for Contingencies" SFAS-5 and its related guidelines, and in accordance with the guidelines and clarifications of the Supervisor of Banks, based on the draft public reporting guidelines in the matter of the "Accounting for Contingencies".

In assessing the outstanding legal actions, Managements of the Bank and of its subsidiaries base themselves on opinions of their legal Counsels, which determine the probability of the exposure to the risk involved in these claims materializing.

Claims have been classified according to the probability range for a risk exposure materializing, as follows:

1) Probable – prospects of over 70%.

2) Reasonably possible – prospects of over 20% and up to and including 70%.

3) Remote – prospects of 20% or below.

According to the draft guidelines, only in rare cases may a banking corporation state in its financial statements that it is not possible to assess the prospects of a risk exposure materializing in respect of an ordinary legal action and an action approved as a class action, this in four financial statements (including one annual financial statements) to be published subsequently to the filing of an action together with a plea to have it approved as a class action suit, such period is not to include a period in which the Court has decided to stay the proceedings. Note 19 states separately the outstanding claims, in respect of which a reasonable assessment of the exposure to risk is not possible.

The Bank has described material legal proceedings being conducted against the Bank and Group companies. In this respect, the Bank has determined that as a general rule, a legal proceeding is disclosed where the amount claimed exceeds 0.5% of the equity capital of the Bank and it is not possible to assess the prospects of the risk exposure materializing, exceeds 1% of the equity capital where there are reasonably possible prospects of the risk exposure materializing, and exceeds 2% of the equity capital where the prospects of the risk exposure materializing are remote. It should be noted that as a result of this decision, certain of the claims described in the past are no longer considered material claims.

It should further be noted, that in cases where the Bank is one of the defendants in the action, and the claimants have not allocated the amount claimed to each of the defendants, the amount estimated as relevant to the Bank is computed to the best of ability, considering the fact that taking the full amount into account might be misleading and is not correct in the circumstances, and that the estimate made does not necessarily represent the allocation which at the end of the day would be decided by the Court.

The financial statements include appropriate provisions in accordance with accepted accounting principles and the estimates of the Managements of the Bank and of its subsidiaries, based on opinions of their legal Counsels.

R. STATEMENT OF CASH FLOWS

Cash flows from transactions in assets and liabilities are presented net, apart from cash flows resulting from non-monetary items, from held-to-maturity bonds, and from available-for-sale securities. Cash for this purpose includes balances of cash on-hand and deposits with banks where the initial period of deposit was up to three months.

1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

S. EARNINGS PER SHARE

Presented in accordance with the guidelines of the Institute of Certified Public Accountants in Israel, and calculated on the basis of the annual weighted average of issued and paid-up nominal share capital.

T. USE OF ESTIMATES

The preparation of financial statements in accordance with generally accepted accounting principles requires the Management to make use of estimates and assessments which affect the reported amounts of assets and liabilities, the disclosure relating to assets and contingent liabilities as well as amounts of income and expenses for the reported period. It should be clarified that actual results may differ from such estimates.

U. IMPAIRMENT IN THE VALUE OF ASSETS

The Israeli Accounting Standard Board published in February 2003, Accounting Standard 15, which deals with the impairment in the value of assets. The Standard sets out procedures which a corporation has to adopt in order to secure that assets are not stated in amounts which exceed their recoverable value, being the higher of the net selling price or the present value of the estimated amount of anticipated future cash flows to be generated by the use of the asset and its realization. The Standard applies to all assets included in the consolidated balance sheet, excluding tax assets and monetary assets (except for monetary assets comprising investments in investee companies that are not subsidiaries). The Standard also determines the principles of presentation and disclosure in respect of assets, the value of which has been impaired.

V. DISCLOSURE OF THE EFFECT OF NEW ACCOUNTING STANDARDS ON THE PERIOD PRIOR TO THEIR APPLICATION.

In June 2000, the Israeli Accounting Standard Board issued Accounting Standard No. 6, which requires "disclosure of the effect of new Accounting Standards on the period prior to the application".

Standard 19 – Taxes on Income – In July 2004, the Israeli Accounting Standards Board issued Standard No. 19 – "Taxes on Income". The Standard determines that deferred tax liabilities are to be recognized in respect of all temporary differences subject to tax, excluding a small number of exceptions. Furthermore, deferred tax assets are to be recognized in respect of all temporary differences that are tax deductible, tax losses and unutilized tax benefits, to the extent that taxable income is expected in the future against which these could be utilized, excluding a small number of exceptions. On certain matters relating to the accounting treatment of taxes on income, including the terms for recognizing a deferred tax asset in respect of carry forward losses and timing differences, the instructions of the Supervisor of Banks include additional limitations to those included in Standard No.19. The said additional limitations as determined in the instruction of the Supervisor of Banks, apply also to the Bank with regards to the said matters.

The new Standard applies to financial statements for periods beginning on January 1, 2005. The Standard determines that it is to be applied by way of stating the cumulative effect of the change in accounting treatment. The Bank believes that the application of the Standard will have no material effect, if at all, upon the financial statements.

It should be noted that the First International Bank of Israel Ltd, an affiliated company of the Bank, has elected to implement the Standard in the financial statements as of December 31, 2004, earlier than required. The Bank's share in the cumulative effect of the early application of the Standard amounts to NIS 1 million.

1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

W. CUMULATIVE EFFECT

1) The cumulative effect of changes in accounting – the implementation of the instructions of the Supervisor of Banks with respect to financial instruments and hedging transactions (2003)

As from January 1, 2003, the bank implements the rules of the Supervisor of Banks concerning derivative instruments and hedging activities. Following the application of these rules, transition adjustments have been recorded, by way of cumulative effect of change in accounting, which have the following effect on the financial position of the Bank at January 1, 2003:

Increase in net earnings of the Bank for 2003:	NIS 27 million
Increase in assets deriving from derivatives:	NIS 12 million
Increase in liabilities deriving from derivatives:	NIS 15 million

The said change increased the per share income for the year ended December 31, 2003, by NIS 0.27. See Note 20 hereunder.

2) The cumulative effect of a change in accounting method in a consolidated subsidiary (2003)

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, 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 directed 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 directive, DCMI, and following it the Bank, applied this change in accounting by way of stating its cumulative effect as of January 1, 2003.

The implementation of the above directive reduced income by NIS 17 million, and the per share income by NIS 0.17.

X. RESTATEMENT BY A CONSOLIDATED SUBSIDIARY

In the course of the preparation of the financial statements of IDB New York as of December 31, 2004, it transpired that in the period from October 2002 to July 2003, IDB New York had issued non-callable step-up deposit notes, in respect of which IDB New York had no right of call at the interest change dates.

IDB New York had accrued interest on the said deposit notes at the current contractual interest rate, while according to

1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

X. RESTATEMENT BY A CONSOLIDATED SUBSIDIARY (CONTINUED)

US generally accepted accounting principles (EITF 86-15) and the directives of the Supervisor of Banks in Israel, interest should be accrued on the said deposit notes at the effective rate at each deposit period, which takes into account the rise in interest rates until the termination of the deposit period.

The effect of the amendment of the above error on the consolidated financial statements of Discount Bank for 2003, is as follows:

	As previously reported	Adjustment in respect of IDBNY	As adjusted
		NIS millions	
Consolidated			
Operating earnings before taxes	683	(29)	654
Provision for taxes on operating earnings	386	(15)	371
Operating earnings after taxes	297	(14)	283
Bank's share in operating earnings of affiliates, net of related taxes	117	-	117
Earnings before minority interest	414	(14)	400
Minority interest in operating earnings of subsidiaries, net of taxes	(60)	-	(60)
Net operating earnings	354	(14)	340
Cumulative effect as of the beginning of the year of change in accounting	10	-	10
Net earnings before extraordinary losses after tax	364	(14)	350
Provision for impairment in value of investments in affiliates	(173)	-	(173)
Extraordinary loss after taxes	(23)	-	(23)
Net earnings	168	(14)	154
Earnings per share	1.71	(0.14)	1.57
The Bank			
The Bank's share in the operating earnings of investee companies, net of the tax effect	206	(14)	192

2. CASH AND DEPOSITS WITH BANKS[1]

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts[2]	Adjusted amounts[2]	Reported amounts[2]	Adjusted amounts[2]
	in NIS millions			
Cash and deposits with central banks	3,423	6,639	2,444	5,899
Deposits with commercial banks	12,777	8,571	10,704	6,536
Acceptances	8	11	8	11
Deposits with other banks	1,543	1,667	7,466	7,093
Total	17,751	16,888	20,622	19,539
Includes cash, deposits with banks and deposits with central banks for an initial period of up to three months	15,188	13,881	12,342	11,574

Footnotes:
(1) See Note 15 for pledges.
(2) See Note 1 B.

3. SECURITIES[1]

A. CONSOLIDATED

	December 31, 2004				
	Book value	Net adjusted cost (for shares - cost)	Non-realized gains from adjustment to fair value	Non-realized losses from adjustment to fair value	Fair value[2]
	Reported amounts*				
	in NIS millions				
(1) Held-to-maturity bonds:					
Bonds and bills:					
Government	5,531	5,531	20	27	5,524
Others	35	35	-	-	35
Total held-to-maturity bonds	5,566	5,566	20	27	5,559
(2) Available for sale securities:					
Bonds and bills:					
Government	26,352	26,153	346	147	26,352
Others	4,537	4,494	103	60	4,537
Total	30,889	(3)30,647	449	207	30,889
Shares:					
Others	894	883	12	1	894
Total available-for-sale securities	31,783	31,530	(4)461	(4)208	(5)31,783
(3) Trading Securities:					
Bonds and bills:					
Government	1,936	1,906	32	2	1,936
Others	772	773	42	43	772
Total	2,708	2,679	74	45	2,708
Shares:					
Others	11	10	1	-	11
Total trading securities	2,719	2,689	(6)75	(6)45	2,719
Total securities	40,068	39,785	556	280	40,061

* See Note 1 B.

General footnotes: See Note 23 E for details of results from bond investment activity. For results of investment activity in shares, see Note 25.

Footnotes:

(1) See Note 15 for pledges.

(2) Fair value data are generally based on market quotations, which do not necessarily reflect the price which may be received when securities are sold in large quantities.

(3) Including securities sold under repurchase terms by a foreign consolidated subsidiary amounting to NIS 8,616 million (US$ 2,200 million).

(4) Included in shareholders' equity in the item "Adjustments for presentation of available-for-sale securities at fair value".

(5) Including shares and bonds, the fair value of which is not readily available, stated at cost of NIS 632 millions.

(6) Recorded in the statement of income.

3. SECURITIES[1] (CONTINUED)

A. CONSOLIDATED (CONTINUED)

	December 31, 2003				
	Book value	Net adjusted cost (for shares - cost)	Non-realized gains from adjustment to fair value	Non-realized losses from adjustment to fair value	Fair value[2]
			Adjusted amounts*		
			in NIS millions		
(1) Held-to-maturity bonds:					
Bonds and bills:					
Government	13	13	-	-	13
Others	32	32	1	-	33
Total held-to-maturity bonds	45	45	1	-	46
(2) Available for sale securities:					
Bonds and bills:					
Government	31,082	30,782	518	218	31,082
Others	5,089	5,102	52	65	5,089
Total	36,171	(3)35,884	570	283	36,171
Shares:					
Others	(4)898	872	27	1	898
Total available-for-sale securities	37,069	36,756	(5)597	(5)284	(6)37,069
(3) Trading Securities:					
Bonds and bills:					
Government	**1231	**1,201	**30	-	**1231
Others	**369	**342	**27	-	**369
Total	1,600	1,543	57	-	1,600
Shares:					
Others	60	55	5	-	60
Total trading securities	1,660	1,598	(7)62	-	1,660
Total securities	38,774	38,399	660	284	38,775

* See Note 1 B.
** Reclassified
General footnotes: See Note 23 E for details of results from bond investment activity. For results of investment activity in shares, see Note 25.
Footnotes:
(1) See Note 15 for pledges.
(2) Fair value data are generally based on market quotations, which do not necessarily reflect the price which may be received when securities are sold in large quantities.
(3) Including securities sold under repurchase terms by a foreign consolidated subsidiary amounting to NIS 9,257 million (US$ 2,114 million).
(4) Including an amount of NIS 89 million, comprising investment in shares of a subsidiary company.
(5) Included in shareholders' equity in the item "Adjustments for presentation of available-for-sale securities at fair value".
(6) Including shares and bonds, the fair value of which is not readily available, stated at cost of NIS 642 millions.
(7) Recorded in the statement of income.

3. SECURITIES[1] (CONTINUED)

B. THE BANK

	December 31, 2004				
	Book value	Net adjusted cost (for shares - cost)	Non-realized gains from adjustment to fair value	Non-realized losses from adjustment to fair value	Fair value[2]
	Reported amounts*				
	in NIS millions				
(1) Available for sale securities:					
Bonds and bills:					
Government	13,005	12,849	207	51	13,005
Others	1,567	1,583	5	21	1,567
Total	14,572	14,432	212	72	14,572
Shares:					
Others	253	246	7	-	253
Total available-for-sale securities	14,825	14,678	(3)219	(3)72	(4)14,825
(2) Trading Securities:					
Bonds and bills:					
Government	1,602	1,590	14	2	1,602
Others	5	5	-	-	5
Total	1,607	1,595	14	2	1,607
Shares:					
Others	1	2	-	1	1
Total trading securities	1,608	1,597	(5)14	(5)3	1,608
Total securities	16,433	16,275	233	75	16,433

* See Note 1 B.

General footnote: See Note 23 E for details of results of bond investment activity. For results of investments in shares, see note 25.

Footnotes:

1. See Note 15 for pledges.
2. Fair value data are generally based on market quotations, which do not necessarily reflect the price which may be received when securities are sold in large quantities.
3. Included in shareholders' equity in the item "Adjustments for presentation of available-for-sale securities at fair value".
4. Including shares and bonds, the fair value of which is not readily available, stated at cost of NIS 25 million.
5. Recorded in the statement of income.

3. SECURITIES[1] (CONTINUED)

B. THE BANK (CONTINUED)

	December 31, 2003				
	Book value	Net adjusted cost (for shares - cost)	Non-realized gains from adjustment to fair value	Non-realized losses from adjustment to fair value	Fair value[2]
	Adjusted amounts* in NIS millions				
(1) Available for sale securities					
Bonds and bills:					
Government	13,539	13,255	330	46	13,539
Others	1,472	1,480	10	18	1,472
Total	15,011	14,735	340	64	15,011
Shares:					
Others	(3)361	337	24	-	361
Total available-for-sale securities	15,372	15,072	(4)364	(4)64	(5)15,372
(2) Trading Securities					
Bonds and bills:					
Government	**956	**938	**18	-	**956
Others	**22	**22	** -	-	**22
Total	978	960	18	-	978
Shares:					
Others	52	48	4	-	52
Total trading securities	1,030	1,008	(6)22	-	1,030
Total securities	16,402	16,080	386	64	16,402

* See Note 1 B.
** Reclassified
General footnote: See Note 23 E for details of results of bond investment activity. For results of investments in shares, see note 25.
Footnotes:
1. See Note 15 for pledges.
2. Fair value data are generally based on market quotations, which do not necessarily reflect the price which may be received when securities are sold in large quantities.
3. Including an amount of NIS 89 million, comprising investment in shares of a subsidiary company.
4. Included in shareholders' equity in the item "Adjustments for presentation of available-for-sale securities at fair value".
5. Including shares and bonds, the fair value of which is not readily available, stated at cost of NIS 124 million.
6. Recorded in the statement of income.

3. SECURITIES (CONTINUED)

C. The item includes a balance of: consolidated – NIS 324 million; the Bank – NIS 231 million, representing the proportionate share of the Bank and of Mercantile Discount Bank in the collateral received from a certain borrower, as detailed hereunder.

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.

On July 15, 2003 the Supervisor of Banks issued 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 326 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.

D. In the course of 2004, IDB New York reclassified bonds in a total amount of US$ 1,303 million from the securities available for sale portfolio to the securities held to maturity portfolio.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

A. CREDIT GRANTED TO THE PUBLIC:

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*
	in NIS millions			
Credit	77,730	**76,744	44,177	44,620
Customers' liabilities for acceptances	404	303	293	201
Total credit	78,134	77,047	44,470	44,821
General provision and supplemental provision for doubtful debts	(626)	(583)	(298)	(293)
Total	77,508	76,464	44,172	44,528

* See Note 1 B.
** Reclassified.
(1) The specific provision for doubtful debts has been deducted from the relevant items (see Note 4C).

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

B. CREDIT GRANTED TO THE PUBLIC INCLUDES:

1. CREDIT TO PROBLEM BORROWERS EXCLUDING THE AGRICULTURAL SECTOR AND LOCAL AUTHORITIES:

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*
	in NIS millions			
a) Non-Income Bearing Loans to Problem Borrowers				
Balance at balance sheet date:				
In Israeli currency, non-linked	2,241	2,273	1,724	1,856
In Israeli currency, linked to CPI	203	250	51	153
In foreign currency (including linked to foreign currency)	362	334	260	282
b) Restructured Credit to Borrowers				
1) Credit restructured during the current year, with waiver of income				
In Israeli currency, non-linked:				
Balance at balance sheet date	1	6	-	-
Average repayment period, in years	1	4	-	-
Effective rate of income:				
Included in the anticipated repayment flow	5.6%	8.2%	-	-
Included in the repayment flow according to original contracts	7.9%	10.5%	-	-
In Israeli currency, linked to CPI:				
Balance at balance sheet date	-	20	-	1
Average repayment period, in years	-	7	-	-
Effective rate of income:				
Included in the anticipated repayment flow	-	6.5%	-	-
Included in the repayment flow according to original contracts	-	7.0%	-	-

Footnote:
* See Note 1 B.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

B. CREDIT GRANTED TO THE PUBLIC INCLUDES (CONTINUED):

1. CREDIT TO PROBLEM BORROWERS EXCLUDING THE AGRICULTURAL SECTOR AND LOCAL AUTHORITIES (CONTINUED):

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*
	in NIS millions			
2) Credit restructured in prior years, with waiver of income:				
Balance at balance sheet date:				
In Israeli currency, non-linked	5	-	-	-
In Israeli currency linked to CPI	20	152	2	147
In foreign currency (including linked to foreign currency)	33	28	8	1
3) Credit restructured during the current year -				
without waiver of income:				
Balance at balance sheet date:				
In Israeli currency, non-linked	64	**116	45	46
In Israeli currency, linked to CPI	95	**120	15	35
In foreign currency (including linked to foreign currency)	141	**192	115	143
c) Restructured Credit Not Yet Executed				
Balance at balance sheet date	84	7	13	2
d) Credit in Temporary Arrears				
Balance at balance sheet date	446	**533	302	394
Interest in respect of such credit included in the statement of income	19	**39	17	32
e) Credit Under Special Supervision				
Balance at balance sheet date	4,166	**4,524	3,342	3,506

* See Note 1 B.
** See Note 4 H.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

B. CREDIT GRANTED TO THE PUBLIC INCLUDES (CONTINUED):

2. CREDIT TO THE AGRICULTURAL SECTOR:

a) Kibbutz loans – Since 1989, several arrangements have been made as regards the loans of the Kibbutz settlements, their organizations and enterprises. The parties to the arrangements were the Government, banks (among which was the Bank Group), the United Kibbutz Movement and the Kibbutz Artzi – Hashomer Hatzair (hereinafter - "the Kibbutz Arrangements")

The Kibbutz Arrangements determined, among other things, guidelines regarding the type of rearranged loans, the sources for the repayment of loans, the manner of the arrangement and the write-off required in their respect.

Already in 1997, the Bank Group implemented its share in the Kibbutz arrangements and regulated the debts of all the regional and movement corporations as well as the loans of the peripheral Kibbutz settlements (as they are defined in the Kibbutz arrangements).

Due to the fact that the payment of the amount payable to the banks out of the consideration for the land that was returned to the Israel Lands Administration (as part of the Kibbutz arrangements) has been postponed to such time that the land would be sold, uncertainty exists as to the implementation of the above arrangements.

b) Agricultural Moshavim – In 1992, the Arrangement in the Agricultural Household Sector Law (known as the "Gal Law") was published. This Law is intended to arrange the debts of the agricultural Moshavim. Accordingly, it provides, among other things, for the determination by "Rehabilitators" appointed under this Law, of the amounts of the debts, the write-off of a part thereof, setting limitations on the amounts of guarantees, reduction in interest rates and the rescheduling of the debts.

At this stage no Regulations have been published in respect of the manner of distribution of the proceeds between the various creditors (including the banks), accordingly, this issue is still uncertain.

c) Rezoning of agricultural land – The High Court of Justice cancelled in 2002 three decisions of the Israel Lands Administration regarding the rezoning of the State's agricultural land. The Israel Lands Administration determined transitory provisions for those entitled to continue to rely on earlier decisions and for those to whom the new changes would apply.

All the above affects customers of the Bank belonging to the agricultural sector who had received credit and who had provided agricultural land as collateral for their loans.

The financial statements include, on the basis of estimates, all the provisions required in view of the issues discussed in paragraphs a) to c) above.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

B. CREDIT GRANTED TO THE PUBLIC INCLUDES (CONTINUED):

2. CREDIT TO THE AGRICULTURAL SECTOR (CONTINUED):

D. Credit granted to the agricultural sector includes:(1)

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*
	in NIS millions			
Kibbutzim (including regional organizations and concerns)	249	280	192	255
Moshavim (including regional organizations and concerns)	13	11	13	10
Total Kibbutzim and Moshavim	262	291	205	265
Production and Marketing Councils	31	29	21	22
Private agriculture	339	412	199	227
Total credit to the agricultural sector	632	732	425	514

* See Note 1 B.
Footnote:
(1) Net of specific provision for doubtful debts.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

B. CREDIT GRANTED TO THE PUBLIC INCLUDES (CONTINUED):

2. CREDIT TO THE AGRICULTURAL SECTOR (CONTINUED):

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*
	in NIS millions			
E. Credit Granted to the Agricultural Sector includes:				
(1) Non-income bearing loans to problematic borrowers:				
Balance at balance sheet date:				
In Israeli currency, non-linked	11	8	8	6
In Israeli currency linked to the CPI	3	4	3	4
In foreign currency (including linked to foreign currency)	-	3	-	3
(2) Restructured credit:				
(a) Restructured credit in prior years with waiver of income:				
Balance at balance sheet date:				
In Israeli currency linked to the CPI	1	2	-	-
(b) Restructured credit during the current year without waiver of income:				
Balance at balance sheet date:				
In Israeli currency linked to the CPI	-	3	-	-
c) Credit to borrowers, as to which management decided to restructure indebtedness but has not yet implemented it Balance at balance sheet date	-	32	-	-
(3) Credit in temporary arrears:				
Balance at balance sheet date	-	3	-	-
(4) Credit under special supervision:				
Balance at balance sheet date	60	65	59	65
(5) Credit to the agricultural sector, that is not included in credit granted to problematic borrowers:				
Balance at balance sheet date	557	612	355	436
Interest in respect of such credit included in the statement of income	30	54	16	36
Total	632	732	425	514

* See Note 1 B.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

B. CREDIT GRANTED TO THE PUBLIC INCLUDES (CONTINUED):

3. CREDIT TO THE LOCAL AUTHORITIES SECTOR

a) In September 1989 an arrangement was signed between the five largest banks, including the Bank, on its own behalf and on behalf of Mercantile Discount Bank Ltd., and the Minister of Interior on behalf of the State of Israel, for rescheduling the debts of certain local authorities to the banks.

The arrangements included, among other things, provisions as to the rescheduling of loans and the granting of additional loans for a period of 15 years, and for the assignment in favor of the banks of certain Government grants.

Pursuant to the aforesaid arrangement, separate agreements were signed at various dates between the Bank and every local authority which became a party to the arrangement, regarding its debts to be covered by the arrangement. The balance of credit in the arrangement at risk of the Bank and its consolidated subsidiary as at December 31, 2004 was: on a consolidated basis - NIS 45 million; for the Bank - NIS 41 million. (December 31, 2003: consolidated - NIS 73 million; the Bank – NIS 65 million).

b) In addition, in the ordinary course of business, some of the local authorities in the arrangement received additional credit, from time to time, the balance of which as at December 31, 2004 was: consolidated – NIS 46 million; the Bank - NIS 24 million (December 31, 2003: consolidated – NIS 50 million; the Bank - NIS 21 million).

c) On June 9, 2004, the Knesset passed the Budget Bases Law (Amendment No. 31 and Provisional Instructions) 2004, which determined instructions regarding local authorities and religious councils in financial difficulties. According to the Law, the said authorities and councils, in respect of which a rehabilitation scheme has been approved, would be entitled to open special bank accounts for a period of six months and deposit therein current receipts to be used for specific purposes. Funds deposited in such accounts shall not be used for the repayment of loans taken prior to the opening of such accounts and they would not be available for pledge, forfeiture or assignment. The Law further determines that entities as above, in respect of which a rehabilitation scheme would be approved until July 1, 2007, would be entitled to deposit certain funds, including State grants, in rehabilitation accounts, and such funds would also not be available for pledge, forfeiture or assignment.

Following a plea to the High Court of Justice filed by the Union of Banks, the State has declared that the policy of the Ministry of the Interior is that local authorities would be entitled to enter the framework of the Law only until December 31, 2004, and that it has no intention of extending the effect of the special accounts for a period exceeding six months. Following this, the plea was withdrawn on November 4, 2004.

The said Law impairs the right of the banks to realize existing pledges, impairs their ability to reimburse themselves out of certain funds due to local authorities and religious councils and impairs current repayments of bank loans.

The outstanding balance of the loans to local authorities as of December 31, 2004, to which the Law applies, amounts to NIS 1 million for the Bank, and to NIS 18 million on a consolidated basis.

Managements of the Bank and of its relevant subsidiary believe, following an examination of the economic condition of these local authority, that no credit loss is expected in their case, therefore no provision has been included in respect of this debt.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

B. CREDIT GRANTED TO THE PUBLIC INCLUDES (CONTINUED):

3. CREDIT TO THE LOCAL AUTORITIES SECTOR (CONTINUED):

d. Credit to local authorities

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*
Balance at the balance sheet date	308	377	263	317

e. Credit to local authorities includes:

(1) Credit in temporary arrears:				
Balance at balance sheet date	-	-	-	-
(2) Credit under special supervision:				
Balance at balance sheet date	42	66	41	65
(3) Credit that is not included in credit granted to problematic borrowers:				
Balance at balance sheet date	266	311	222	252
Interest in respect of such credit included in the statement of income	23	23	18	16
Total	308	377	263	317

* See Note 1 B.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

C. PROVISION FOR DOUBTFUL DEBTS

	2004			
	Specific provision[1]			
	According to extend of delinquency	Other	Supplemental provision[2][3]	Total
	Reported amount*			
	In NIS millions			
Consolidated				
Balance of provision at beginning of year	95	4,421	661	5,177
Provision for current year	62	1,007	59	1,128
Reduction of provision	(41)	(174)	(24)	(239)
Collection of debts written-off in previous years	-	(9)	-	(9)
Provision charged to statement of Income	21	824	35	880
Write-offs	(3)	(396)	-	(399)
Inflationary erosion and adjustment of balances	-	5	-	5
Balance of provision at end of year	113	4,854	696	5,663
Includes - Balance of provision that was not deducted from "credit granted to the public"	-	53	70	123
The Bank				
Balance of provision at beginning of year	-	3,794	344	4,138
Provision for current year	-	725	20	745
Reduction of provision	-	(138)	(24)	(162)
written-off in previous years	-	(1)	-	(1)
Provision charged to statement of Income	-	586	(4)	582
Write-offs	-	(290)	-	(290)
Inflationary erosion and adjustment of balances	-	3	-	3
Balance of provision at end of year	-	4,093	340	4,433
Includes - Balance of provision that was not deducted from "credit granted to the public"	-	51	42	93

* See Note 1 B.

Footnotes:

(1) For loans for which a provision was made according to the extent of the delinquency - does not include a provision for interest on such debt in arrears.
For other loans - does not include provision for interest on doubtful debts after such debts were deemed doubtful.

(2) Includes balance of a general provision for doubtful debts: Consolidated: - NIS 478 million; 2003 - NIS 460 million; 2002 - NIS 496 million. The Bank: - NIS 197 million; 2003 - NIS 203 million; 2002 - NIS 200 million (see Note 1 I).

(3) Including a special provision for doubtful debts of NIS 5 million.

(4) 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.

(5) The amount taken to the income statement: consolidated 2003 – NIS 845 million; 2002 – NIS 896 million. The Bank 2003 – NIS 656 million; 2002 – NIS 727 million.

2003				2002			
Specific provision [1][4]				Specific provision[1]			
According to extend of delinquency	Other	Supplemental provision[2][3]	Total	According to extend of delinquency	Other	Supplemental provision[2][3]	Total
Adjusted amount*				Adjusted amount*			
In NIS millions				In NIS millions			
74	3,805	657	4,536	70	3,346	615	4,031
63	953	46	1,062	53	985	79	1,117
(38)	(131)	(42)	(211)	(41)	(136)	(37)	(214)
-	(3)	-	(3)	-	(7)	-	(7)
25	819	4	[5]848	12	842	42	[5]896
(5)	(283)	-	(288)	(4)	(171)	-	(175)
1	80	-	81	(4)	(212)	-	(216)
95	4,421	661	5,177	74	3,805	657	4,536
-	59	78	137	-	59	59	118
-	3,266	307	3,573	-	2,859	276	3,135
-	727	39	766	-	815	46	861
	(109)	(2)	(111)	-	(119)	(15)	(134)
	(1)	-	(1)	-	-	-	-
-	617	37	[5]654	-	696	31	[5]727
-	(158)	-	(158)	-	(106)	-	(106)
-	69	-	69	-	(183)	-	(183)
-	3,794	344	4,138	-	3,266	307	3,573
-	55	51	106	-	56	38	94

4. CREDIT GRANTED TO THE PUBLIC (CONTINUED):

D. HOUSING LOANS AND THE PROVISION FOR DOUTFUL DEBTS IN RESPECT THEREOF BASED ON THE DURATION OF DELINQUENCY

Consolidated

	December 31, 2004					December 31, 2003				
	Duration of arrears									
	Over 3 and up to 6 months	Over 6 and up to 15 months	Over 15 and up to 33 months	Over 33 months	Total	Over 3 and up to 6 months	Over 6 and up to 15 months	Over 15 and up to 33 months	Over 33 months	Total
	Reported amounts(1)					Adjusted amounts(1)				
	In NIS millions									
Amount in arrears	6	14	16	34	70	6	15	16	41	78
Of which: Interest on the amount in arrears	-	-	1	8	9	-	-	1	12	13
Balance of provision for doubtful debts based on delinquincy period(2)	-	23	39	51	113	-	20	36	39	95
Balance of loans net of provision for doubtful debts	145	140	45	13	343	143	150	42	15	350

Footnotes:
(1) See Note 1 B.
(2) Not including a provision for interest in respect of amount in arrears.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

E. COMPOSITION OF CREDIT TO THE PUBLIC[1] AND OFF-BALANCE-SHEET CREDIT RISK(2), BY SIZE OF CREDIT TO INDIVIDUAL BORROWERS

Consolidated

		December 31 2004					
		Consolidated			The Bank		
		Number of borrowers[2]	Credit	Credit risk[3]	Number of borrowers[2]	Credit	Credit risk[3]
		Reported amounts*			Adjusted amounts*		
		in NIS millions					
Credit limit (in NIS thousand):							
	Up to 10	337,065	1,465	1,206	232,043	229	1,142
Over 10	Up to 20	78,772	667	862	55,934	303	805
Over 20	Up to 40	101,344	1,256	1,988	79,804	612	1,926
Over 40	Up to 80	106,113	1,825	4,522	88,876	874	4,467
Over 80	Up to 150	49,129	2,546	2,367	35,079	1,111	2,291
Over 150	Up to 300	28,425	4,395	1,221	12,693	1,138	1,154
Over 300	Up to 600	16,379	5,313	973	5,455	1,058	867
Over 600	Up to 1,200	6,959	3,818	1,137	3,576	1,328	1,027
Over 1,200	Up to 2,000	2,439	2,567	738	1,425	1,215	630
Over 2,000	Up to 4,000	1,928	3,611	1,076	1,216	1,968	902
Over 4,000	Up to 8,000	1,236	4,217	1,640	814	2,460	1,362
Over 8,000	Up to 20,000[4]	957	7,226	3,328	539	3,772	2,303
Over 20,000	Up to 40,000[4]	421	6,369	3,449	233	3,199	2,377
Over 40,000	Up to 200,000[4]	524	24,170	12,813	301	16,698	7,792
Over 200,000	Up to 400,000[4]	21	4,165	1,790	21	4,493	1,605
Over 400,000	Up to 800,000[4]	12	3,435	2,968	12	3,453	2,829
Over 800,000	Up to 1,200,000[4][5]	3	1,461	1,028	2	785	903
Over 1,200,000	Up to 1,600,000	-	-	-	1	143	1,088
Total		731,727	78,506	43,106	518,024	44,839	35,470

* See Note 1 B.

Footnotes:

(1) Including assets related to derivative financial instruments created with the public, net of a specific provision for doubtful debts.

(2) Number of borrowers based on total credit and credit risk.

(3) Credit risk of off-balance sheet financial instruments, as computed for the purpose of limitations on a borrower.

(4) Consolidated - by combining specific balances.

(5) Consolidated: highest credit ceiling NIS 880 million.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

E. COMPOSITION OF CREDIT TO THE PUBLIC[1] AND OFF-BALANCE-SHEET CREDIT RISK(2), BY SIZE OF CREDIT TO INDIVIDUAL BORROWE

		December 31 2003					
		Consolidated			The Bank		
		Number of borrowers[2]	Credit	Credit risk[3]	Number of borrowers[2]	Credit	Credit risk[3]
		Adjusted amounts**					
		in NIS millions					
Credit limit (in NIS thousand):							
	Up to 7	350,781	1,191	626	210,455	129	579
Over 7	Up to 18	137,364	796	1,297	98,772	400	1,227
Over 18	Up to 35	*82,824	*1,160	1,084	55,986	524	1,023
Over 35	Up to 70	98,520	1,693	3,202	79,290	847	3,120
Over 70	Up to 140	60,268	2,513	3,053	45,071	1,087	3,002
Over 140	Up to 285	32,269	4,274	1,731	16,332	1,162	1,657
Over 285	Up to 530	16,140	4,620	1,089	5,704	840	958
Over 530	Up to 1,060	8,267	3,854	1,454	4,462	1,333	1,353
Over 1060	Up to 1,770	2,848	2,514	928	1,715	1,144	822
Over 1,770	Up to 3,500	2,052	3,320	1,132	1,301	1,738	942
Over 3,500	Up to 7,100	1,342	4,260	1,493	907	2,506	1,288
Over 7,100	Up to 17700[4]	946	6,467	3,017	578	3,529	2,130
Over 17,700	Up to 35000[4]	448	6,471	3,536	252	3,439	2,177
Over 35,000	Up to 177000[4]	544	22,655	12,462	323	15,881	8,137
Over 177,000	Up to 355000[4]	26	4,548	1,569	24	4,489	1,531
Over 355,000	Up to 710000[4]	12	4,339	2,032	10	3,391	1,776
Over 710,000 Up to	1065000[5][4]	3	2,372	262	4	2,382	1,127
Total		794,654	77,047	39,967	521,186	44,821	32,849

* Reclassified
** See Note 1 B.
Footnotes:
(1) Net of specific provision for doubtful debts.
(2) Number of borrowers based on total credit and credit risk.
(3) Credit risk of off-balance sheet financial instruments, as computed for the purpose of limitations on a borrower.
(4) Consolidated - by combining specific balances.
(5) Consolidated and the Bank: highest credit ceiling NIS 967 million.

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

F) DETAILS AS TO THE MANNER OF COMPUTING THE SPECIFIC PROVISION FOR HOUSING LOANS – CONSOLIDATED

	December 31, 2004				
			Specific provision		
	Balance of debt	Balance in arrears	According to extent of delinquency	Other	Total
	Reported amounts*				
	In NIS millions				
Housing loans(1)	315	64	107	-	107
"Large loans"(2)	77	22	9	19	28
Other loans	122	20	24	12	36
Total	514	106	140	31	171

* See Note 1 B.

Footnotes:

(1) Loans, which according to the Directive of Bank of Israel, the provision in respect thereof is to be computed based on the period in arrears.

(2) Housing loans, the outstanding balance of each exceeds NIN 767 thousand.

F) A DEVIATION FROM THE LIMITATIONS ON THE INDEBTEDNESS OF A BORROWER AND A GROUP OF BORROWERS

As a result of an audit performed by the Supervisor of Banks, the Bank has recently received information, according to which corporations considered to belong to two groups of borrowers, as previously known to the Bank, were in fact one group of borrowers.

Had the Bank been aware of this information, the two groups of borrowers would have been treated as one group, resulting in a deviation from the volume of credit permitted to that group according to the provisions of Proper Banking Procedures regarding "Limitations on the indebtedness of a borrower and a group of borrowers" (hereinafter – "borrower limitations"), as well as a deviation from the volume of credit permitted to the six major borrower groups of the Bank, requiring the increase of the supplemental provision for doubtful debts in 2003 by NIS 0.7 million, which provision was increased in 2004 to NIS 2.8 million.

It should be further noted that up to and including 2002, the said corporations have been presented as one group of borrowers, which was separated into two groups only as from 2003 onwards.

In the financial statements for 2004, all the indebtedness of the said corporations is stated as one group of borrowers, however the total amount of this indebtedness exceeds the borrower limitations by an amount of NIS 318 million, and the volume of indebtedness of all the six major groups of borrowers at the Bank does not exceed the limitations.

The Supervisor of Banks has clarified that for the time being he will continue to consider the said groups of borrowers as one group.

G) CORRECTION OF A MISTAKE IN THE CLASSIFICATION OF PROBLEMATIC DEBTS AS OF DECEMBER 31, 2003 – MERCANTILE DISCOUNT BANK

A credit audit performed by the Supervisor of Banks at Mercantile Discount Bank disclosed a mistake, which this bank has always been doing, of not classifying problematic debts relating to loans secured by a mortgage (not comprising housing loans), the outstanding balance of which at September 30, 2004 amounted to NIS 214 million, of which NIS 131 million relates to the period ended December 31, 2003 (out of total credit managed by the mortgage division of

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

Mercantile Discount Bank amounting to NIS 2 billion). Most of the unclassified amounts, as stated above, comprise loans, which have been rescheduled and which according to directives of Bank of Israel, had to be classified by the bank as "reorganized" problematic debts. The said directive states that such a classification requires automatically the creation of "a supplementary provision for doubtful debts", at a certain rate of the debt in question. Amendment of the balance of problematic debts as of December 31, 2003, was made by way of a restatement. Due to materiality considerations, the supplementary provision for doubtful debts, required as a result of the amendment of the problematic debts as of December 31, 2003, in the amount of NIS 3 million, as stated, was recognized as an expense in 2004.

H) CORRECTION OF THE TREATMENT OF THE PROVISION FOR DOUBTFUL DEBTS IN ACCORDANCE WITH THE PERIOD IN ARREARS IN THE INTERIM FINANCIAL STATEMENTS AS OF JUNE 30 AND SEPTEMBER 30, 2004 – DISCOUNT MORTGAGE BANK LTD.

In accordance with the directives of Proper Banking Procedure No 314 concerning the treatment of problematic debts, a mortgage bank is required to compute the specific provision using the system of provision based on the period in arrears, in respect of housing loans the outstanding balance of which is lower than a determined ceiling, and for such a group only. The provision based on the period in arrears is a minimum provision, and where the bank's management has information that such a provision is insufficient, it has to increase the specific provision.

In assessing the required specific provision, Discount Mortgage Bank implemented of its own choice, the system of provision based on the period in arrears also in respect of two additional groups – housing loans in excess of the said ceiling and general loans secured by a mortgage on a dwelling unit, except in specific cases.

In the course of 2004, in view of the continued crisis in the real estate market, the additional slowdown in both the private housing and commercial property markets, the continued slowdown in economic activity, Discount Mortgage Bank conducted an in-depth survey and examination of all problematic debts in all segments of activity of this bank.

Within the framework of this survey of problematic debts, Discount Mortgage Bank decided in the second quarter of 2004, to change to a computation of a specific provision in respect of the said two groups. This transition required great effort and the allocation of considerable manpower. Discount Mortgage Bank did so believing that this is the fair treatment, which complies with the directives of Proper Banking Procedure. Discount Mortgage Bank continued this treatment also in the third quarter of 2004. Accordingly, the provision based on the period in arrears was reduced in the second and third quarters together, by an amount of NIS 29 million, and the specific provision was increased by NIS 21 million. In total, the provision was decreased by NIS 8 million.

On October 25, 2004, Bank of Israel published a draft directive expanding and clarifying the provision system based on the period in arrears. In this respect several discussions were held between Bank of Israel and the mortgage banks.

The said draft clarifies and determines that even though a mortgage bank is entitled to implement the period of arrears system with respect to certain additional groups of borrowers, in addition to the housing loan group up to a ceiling, once a specific provision based on the period of arrears has been established in respect of a certain loan, it cannot be reduced unless as a result of debt amounts collected in cash.

Once Discount Mortgage Bank had learnt of the draft directive, which requires a different treatment than that applied by the bank, it approached the Bank of Israel, of its own volition, requesting clarifications. In response to this approach, Discount Mortgage Bank has been informed that the Bank of Israel's position is that the treatment applied in the financial

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

statements as of June 30, 2004 and September 30, 2004 was not in accordance with written and oral instructions given to mortgage banks in recent years. The Bank of Israel also reiterated its position in a letter sent to the mortgage banks on November 14, 2002.

Accordingly, the Bank of Israel instructed Discount Mortgage Bank to amend in accordance with its above instructions, the provisions for doubtful debts made in the second and third quarters of 2004, and to present this amendment, giving the quarterly details, in the annual financial statements of Discount Mortgage Bank.

Discount Mortgage Bank acted according to the requirements of the Bank of Israel, while emphasizing that its treatment in the second and third quarters of 2004 were in accordance with the instructions of Proper Banking Procedure, and that it understood that the prohibition as to the reduction in the provision based on the period in arrears, unless by way of cash collection of the amounts in arrears, as was reflected in the Bank of Israel letter of 2002, applies only to the group to be treated according to the period in arrears per the instructions of Proper Banking Procedure.

The amendment increased the specific provision based on the period in arrears, for the second and third quarters of 2004, by NIS 29 million.

It should be noted that the said amendment has not affected the comparative figures as at December 31, 2003, and for periods ended on that date, and its effect is reflected in the restatement of the interim financial data for June 30, 2004 and September 30, 2004 and for the periods ended on those dates.

5. CREDIT GRANTED TO GOVERNMENTS

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)
Credit from proceeds of debenture issues	5	14	1	1
Credit for supplementing the interest for qualified housing loans	53	57	-	-
Less - advance interest supplement from the Government	(53)	(57)	-	-
Other credit(2)	266	353	267	321
Total credit granted to Governments	271	367	268	322

Footnotes:
(1) See Note 1 B.
(2) Including credit to foreign governments: Consolidated - NIS 51 million (2003: NIS 130 million), the Bank - NIS 48 million (2003: NIS 87 million).

6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES

A. CONSOLIDATED

	December 31, 2004			December 31, 2003		
	Affiliated companies	Consolidated subsidiaries	Total	Affiliated companies	Consolidated subsidiaries	Total
	Reported amounts[1]			Adjusted amounts[1]		
	In NIS millions					
Investments						
Shares stated on equity basis[2]	1,257	62	1,319	1,218	20	1,238
Other investments:						
Capital notes	-	-	-	-	-	-
Shareholders' loans	1	-	1	-	-	-
Total other investments	1	-	1	-	-	-
Total investments	1,258	62	1,320	1,218	20	1,238
Includes:						
Earnings accumulated since January 1, 1992	359	(23)	336	243	(17)	226
Items accumulated in shareholders' equity since January 1, 1992:						
Adjustments in respect of presentation of securities available for sale at fair value, net	11	-	11	19	-	19
Adjustment for translation of foreign currency financial statements	(2)	-	(2)	(2)	-	(2)
Cash flow hedging	-	-	-	(2)	-	(2)
Details Eegarding Goodwill						
Period of amortization		10 years			10 years	
Original amount	2	85	87	2	37	39
Unamortized balance	1	62	63	2	20	22
Details Regarding the Allocated Excess of Cost:						
Period of amortization		20 years			20 years	
Original amount	114	-	114	144	-	144
Unamortized balance	97	-	97	129	-	129
Book and Market Values of Marketable Investments:						
Book value	1,179	-	1,179	1,159	-	1,159
Market value	1,398	-	1,398	1,357	-	1,357

Footnotes:
(1) See Note 1 B.
(2) Includes earnings and translation adjustments in autonomous units accumulated from the acquisition date up to December 31, 1991.

6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

B. THE BANK

	December 31, 2004			December 31, 2003		
	Affiliated companies	Consolidated subsidiaries	Total	Affiliated companies	Consolidated subsidiaries	Total
	Reported amounts[1]			Adjusted amounts[1]		
	In NIS millions					
Investments:						
Shares stated on equity basis[2]	1,232	4,424	5,656	1,198	[3]4,225	[3]5,423
Other investments:						
Convertible securities	-	-	-	-	18	18
Subordinated debt notes and Capital notes	-	140	140	-	119	119
Shareholders' loans	1	74	75	-	75	75
Total other investments	1	214	215	-	212	212
Total investments	1,233	4,638	5,871	1,198	[3]4,437	[3]5,635
Includes:						
Retained earnings since January 1, 1992	376	1,826	2,202	258	[3]1,729	[3]1,987
Items accumulated in shareholders' equity since January 1, 1992:						
Adjustments in respect of presentation of securities available for sale at fair value, net	11	17	28	19	5	24
Adjustment for translation of foreign currency financial statements	(2)	35	33	(2)	35	33
Cash flow hedging	-	-	-	(2)	-	(2)
Details Regarding Excess of cost:						
Period of amortization		10 years			10 years	
Original amount	-	80	80	-	33	33
Unamortized balance	-	61	61	-	19	19
Details Regarding the Allocated Excess of Cost:						
Period of amortization		20 years			20 years	
Original amount	114	-	114	144	-	144
Unamortized balance	97	-	97	129	-	129
Book and Market Values of Marketable Investments:						
Book value	1,179	510	1,689	1,159	532	1,691
Market value	1,398	369	1,767	1,357	315	1,672

Footnotes:
(1) See Note 1 B.
(2) Includes earnings and translation adjustments in autonomous units accumulated from the acquisition date up to December 31, 1991.
(3) Restated - see Note 1 X.

6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

B. THE BANK (CONTINUED)

The Bank's share of income or loss of investee companies

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Adjusted amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Adjusted amounts(1
	In NIS millions					
The Bank's share of operating income (loss) of investee companies (consolidated - affiliated companies)	135	117	(1)	475	(2)275	318
Provision for taxes:						
Current taxes	-	-	-	44	(2)81	27
Deferred taxes	-	-	-	2	2	-
Total provision for taxes	-	-	-	46	(2)83	27
The Bank's share of operating income (loss) of investee companies (consolidated - affiliated companies), after tax	135	117	(1)	429	(2)192	291

Footnotes:
(1) See Note 1 B.
(2) Restated - see Note 1 X.

6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

C. INFORMATION ON PRINCIPAL INVESTEE COMPANIES

Name of Company	Details of Company	Share in Capital Conferring Rights to Profits 2004	Share in Capital Conferring Rights to Profits 2003	Share in Voting Rights 2004	Share in Voting Rights 2003	Value Of Investment In Shares On Equity Basis 2004 Reported amounts*	Value Of Investment In Shares On Equity Basis 2003 Adjusted amounts*	Market Value 2004 Reported amounts*	Market Value 2003 Adjusted amounts*
		As a percentage				In NIS millions			
1. Consolidated Subsidiaries									
Discount Bancorp, Inc.(1)	Holding company, U.S.A.	100.00	100.00	100.00	100.00	27	28	-	-
Israel Discount Bank of New York(2)	Commercial bank, U.S.A	100.00	100.00	100.00	100.00	2,287	**2,246	-	-
Mercantile Discount Bank Ltd.	Commercial bank	100.00	100.00	100.00	100.00	951	897	-	-
Discount Mortgage Bank Ltd.	Mortgage bank	65.07	65.07	65.07	65.07	510	532	369	315
Israel Credit Cards Ltd.(3)	Credit card service	51.00	35.00	63.00	51.00	179	81	-	-
Discount Leasing Ltd.	Equipment leasing	100.00	100.00	100.00	100.00	92	90	-	-
Discount Israel Capital Markets and Investments Ltd.	Underwriting and investments	100.00	100.00	100.00	100.00	123	103	-	-
Manpikim - Discount Bank Issues Corporation Ltd.	Securities issue	100.00	100.00	100.00	100.00	53	53	-	-
Ilanot-Discount Ltd.(4)	Mutual fund management	55.00	55.00	55.00	55.00	65	65	-	-
Israel Discount Bank (Switzerland) SA	Commercial bank, Switzerland	100.00	100.00	100.00	100.00	76	75	-	-
Companies held by Israel Discount Bank of New York									
Discount Bank (Latin America)(5)	Commercial bank, Uruguay	100.00	100.00	100.00	100.00	109	97	-	-
IDBNY Realty (Delaware), Inc.(5)	Holding company, USA	100.00	100.00	100.00	100.00	1,266	1,008	-	-
IDBNY Realty Inc.(6)	REIT, USA	100.00	100.00	100.00	100.00	6,756	6,881	-	-
2.Affiliated Companies									
First International Bank of Israel Ltd.(7)	Commercial bank	26.45	26.45	11.09	11.09	804	746	796	694
Harel Insurance Investments Ltd.(8)	Holding company	(9)15.89	20.00	(9)15.89	20.00	375	413	602	663

* See Note 1 B.
** Restated - see Note 1 X.

Footnotes:
(1) A holding company, wholly-owned by the Bank, which as of February 9, 2000 fully owns and controls Israel Discount Bank of New York.
(2) The company is owned by Discount Bancorp, Inc.
(3) See Note 34, including in respect to the change in classification of shares purchased with the intention of their sale, which in the past were stated as available-for-sale securities.
(4) In accordance with an agreement dated September 1999, between the Bank and Ilanot Batucha Investment House Ltd., according to which the Bank acquired control of Ilanot Discount Ltd., Ilanot Batucha (or whoever replaces it) has been granted an option to sell to the Bank the remaining shares in Ilanot Discount held by it, in consideration for their value in accordance to a valuation of Ilanot Discount as of date of exercise of the option. This option is exercisable within a period of nine months from the date of closing of the transaction in which a control core in the Bank would be purchased for the first time (see also Note 37, hereunder).
(5) Included in the financial statements of Israel Discount Bank of New York.
(6) Included in the financial statements of IDBNY Realty (Delaware), Inc.
(7) For further details regarding that investment see d hereunder.
(8) This invested was acquired at the beginning of December 2001. The excess of cost over equity value at acquisition date has been attributed to the life assurance portfolio of the Harel Group.
(9) The decline in the rate of holdings in Harel does not impair the rights of the Bank, granted to it under the agreement with the Hamburger Group that regulate the relations between them as shareholders in Harel.
(10) Including adjustments from translation of autonomous units abroad and adjustments for the presentation of certain securities of investee companies at fair value.
(11) Goodwill.
(12) Allocated excess of cost.

of which excess of cost balance		Other investment		Contribution to net operating income		Dividend		Other items recorded In shareholders equity[10]		Guarantees issued for consolidated subsidiaries in favor of entities outside the Group	
2004	2003	2004	2003	2004	2003	2004	2003	2004	2003	2004	2003
Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*	Reported amounts*	Adjusted amounts*
In NIS millions											
-	-	-	-	(2)	(1)	-	-	2	1	-	-
-	-	-	-	140	**(43)	153	278	(236)	(245)	-	-
-	-	65	66	104	86	50	-	19	18	-	-
-	-	-	18	(23)	18	-	-	-	-	7	7
[11]45	-	46	25	32	23	23	13	-	-	-	-
-	-	-	-	2	3	-	-	-	-	4	4
-	-	98	98	19	(21)	-	-	(1)	(2)	-	-
-	-	-	-	-	1	-	-	-	-	-	-
[11]16	[11]19	-	-	6	(1)	5	-	-	-	-	-
-	-	-	-	1	(5)	-	-	-	-	-	-
-	-	-	-	(1)	(7)	-	-	-	(13)	-	-
-	-	-	-	4	(40)	-	-	9	7	-	-
-	-	-	-	102	(253)	250	257	(2)	6	-	-
-	-	-	-	65	43	-	-	11	18	-	-
[12]97	[12]129	-	-	63	73	13	12	-	-	-	-

7. BUILDINGS AND EQUIPMENT

A. COMPOSITION

	Consolidated			The Bank		
	Buildings and land(1)	Equipment, furniture and vehicles	Total	Buildings and land(1)	Equipment, furniture and vehicles	Total
	Reported amounts(2) in NIS millions					
Cost						
Balance at beginning of the year(2)	1,945	(3)2,860	4,805	1,426	(3)1,969	3,395
Additions	57	334	391	44	267	311
Disposals	(263)	(556)	(819)	(260)	(546)	(806)
Balance as at December 31,2004	1,739	2,638	4,377	1,210	1,690	2,900
Depreciation						
Balance at beginning of the year(2)	789	(3)1,914	2,703	560	(3)1,289	1,849
Depreciation for the year	36	223	259	22	149	171
Accumulated depreciation on disposals	(13)	(550)	(563)	(10)	(542)	(552)
Balance as at December 31, 2004	812	1,587	2,399	572	896	1,468
Depreciated balance as at December 31,2004	927	1,051	1,978	638	794	1,432
Depreciated balance as at December 31,2003(2)	1,156	(3)946	2,102	866	(3)680	1,546
The average depreciation rate in 2004	2.9%	14.0%	9.0%	2.7%	16.9%	9.8%
The average depreciation rate in 2003	2.8%	15.0%	9.5%	2.7%	17.0%	10.0%

(1) Includes:
- Installations and leasehold improvements, the depreciated balance of which amounted to NIS 93 million - consolidated and to NIS 45 million in the Bank. (2003: NIS 99 million - consolidated; and NIS 54 million - in the Bank).
- Interest capitalized in prior years net of amortization, in the amount of NIS 3 millions (2003: NIS 25 millions) The interest caitalized in 2003, in the amount of NIS 11 million, was computed at the rate of 6.3%, being the average cost of subordinated capital notes issued at the time of the investment.

(2) See Note 1 B.
(3) Reclassified.

B. The Bank and a consolidated subsidiary own leasehold rights for various periods ending in the years 2008 to 2034. The Bank and a consolidated subsidiary are the owners of non-capitalized leasehold rights: Consolidated – NIS 30 million (2003: NIS 23 million). The Bank, stand alone: NIS 28 million (2003: NIS 20 million). The Bank and a consolidated subsidiary are the owners of capitalized leasehold rights: Consolidated – NIS 132 million (2003: NIS 138 million). The Bank, stand alone – NIS 101 million (2003: NIS 107 million).

C. The depreciated cost of buildings not yet registered in the names of the Bank or of its subsidiaries at the Land Registry Office, excluding buildings intended for sale, amounts to NIS 221 million (2003: NIS 225 million) on a consolidated basis, and NIS 168 million (2003: NIS 171 million) for the Bank.

D. The depreciated cost of buildings not in use by the Bank, and which are mostly let to outside parties, amounts to NIS 25 million (2003: NIS 26 million) on a consolidated basis, and NIS 18 million (2003: NIS 19 million) for the Bank.

E. 31.12.2003 - Including additions in respect of an initially consolidated company by a subsidiary at a cost of NIS 2 million, and accumulated depreciation of NIS 1 million.

7. BUILDINGS AND EQUIPMENT

F. The cost of in-house development of computer software (in NIS millions):

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions			
The cost of software put into operation	470	272	428	230
Accumulated depreciation	(134)	(80)	(106)	(57)
Undepreciated balance	336	192	322	173
Cost of software not yet in operation	176	179	167	177
Total	512	371	489	350

See Notes 19 C 21 hereunder, for details regarding the renovation of the central computer infrastructure of the Bank.
Footnote:
(1) See Note 1 B.

8. OTHER ASSETS

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions			
Net deferred tax assets (see Note 29H)	593	(2)558	409	407
Excess advance tax payments over current provisions	230	(3)(2)183	186	(3)(2)170
Excess deposits for severance pay and pensions, over provision (see Note 16E)	433	387	394	345
Issue costs and discount expenses of debentures and subordinated capital notes	4	2	5	2
Income receivable	142	118	128	78
Debit balances of derivative financial instruments	1,755	(2)1,678	1,480	(2)1,395
Credit cards activity debts	121	(2)149	-	-
Surrender value of life assurance policies owned by the Bank and corporate owned life insurance	510	486	-	-
Assest received in settlement of debts	-	2	-	-
Other debtors and debit balances	367	(2)306	214	(2)212
Total other assets	4,155	(3)3,869	2,816	(3)2,609

Footnotes:
(1) See Note 1 B.
(2) Reclassified.
(3) Restated - see Note 1 X.

9. DEPOSITS FROM THE PUBLIC

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts[1]	Adjusted amounts[1]	Reported amounts[1]	Adjusted amounts[1]
	in NIS millions			
Demand deposits	11,375	7,130	8,395	5,092
Time and other deposits	[3]101,367	[2]98,773	60,449	59,868
Acceptances	8	11	8	11
Savings schemes deposits	8,942	14,039	7,899	11,855
Total deposits from the public	121,692	[2]119,953	76,751	76,826

Footnotes:
(1) See Note 1 B.
(2) Restated - see Note 1 X.
(3) A consolidated subsidiary entered into short-term repurchase agreements for the sale and repurchase of substantially identical securities. These agreements were classified as secured borrowings.
All the securities sold under the repurchase agreements (see Note 3A), are secured by designated deposits, the balance of which at December 31, 2004 was NIS 8,787 million (December 31, 2003: NIS 8,559 million).

10. DEPOSITS FROM BANKS

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts[1]	Adjusted amounts[1]	Reported amounts[1]	Adjusted amounts[1]
	in NIS millions			
Commercial banks:				
Demand deposits	148	278	204	197
Time deposits	1,874	2,093	1,195	865
Acceptances	404	303	294	201
Central banks:				
Time deposits	111	111	91	91
Specialized banking institutions:				
Demand deposits	39	74	39	74
Time deposits	2,502	2,238	134	165
Total deposits from banks	5,078	5,097	1,957	1,593

Footnote:
(1) See Note 1 B.

11. DEBENTURES AND SUBORDINATED CAPITAL NOTES[1]

			Consolidated		The Bank	
			December 31			
	Average maturity years[2]	Internal rate of return[2]	2004 Reported amounts[3]	2003 Adjusted amounts[3]	2004 Reported amounts[3]	2003 Adjusted amounts[3]
		%	in NIS millions			
Debentures in Israeli Currency, linked to CPI	7.08	5.37	670	13	-	-
Subordinated capital notes in Israeli currency, linked to CPI	4.23	6.37	3,905	3,978	3,365	3,441
Subordinated capital notes in non-inked Israeli currency	0.08	4.68	151	150	210	201
Subordinated capital notes convertible into shares in CPI linked Israeli currency	4.38	6.79	83	82	-	-
Total debentures and subordinated capital notes			4,809	4,223	3,575	3,642

Footnotes:
(1) See Note 15 A.
(2) Rate of return which discounts the projected payment flow of amounts presented in the balance sheet.
Period to maturity is the average of the repayments periods weighted by the cash flows discounted at the internal rate of return.
Data regarding the internal rate of return and the period to maturity relates to the consolidated statements at December 31, 2004.
(3) See Note 1 B.

12. OTHER LIABILITIES

	Consolidated		The Bank	
	December 31		December 31	
	2004 Reported amounts[1]	2003 Adjusted amounts[1]	2004 Reported amounts[1]	2003 Adjusted amounts[1]
	in NIS millions			
Excess current tax provisions over advance payments	83	43	3	-
Net provision for deferred taxes (see Note 29 H)	27	62	27	61
Income in advance	107	[2]85	44	[2]44
Provision for doubtful debts in respect of guarantees	122	137	92	106
Accrued expenses	341	292	189	127
Provisions for vacation pay, seniority bonus and retirement benefits	811	740	697	621
Excess of the provision for severance and retirement benefits over amounts deposited (See Note 16 E)	3	2	-	-
Credit balances of derivative financial instruments	1,795	[2]1,644	1,616	[2]1,429
Credit cards activity creditors	389	342	-	-
Securities purchased for future delivery	-	160	-	-
Amounts received from realization of Other creditors and credit balances	815	[2]312	239	[2]123
Total other liabilities	4,493	3,819	2,907	2,511

Footnotes:
(1) See Note 1 B.
(2) Reclassified.

13. SHAREHOLDERS' EQUITY

A.The authorized, issued and paid-up nominal Share Capital (in New Israel Shekels):

	December 31,2004 and 2003	
	Authorized	Issued and Fully Paid-Up
Ordinary "A" Shares of NIS 0.1 par value each	100,000,000	98,063,921
6% Cumulative Preference Shares, of NIS 0.00504 par value each (equivalent to 10 pounds sterling each)	202	202
Total	100,000,202	98,064,123

Ordinary "A" Shares are registered and are listed for trade on the Tel Aviv Stock Exchange.

B. 6% cumulative preference registered shares:

The dividend and the rights of these shareholders are linked to the representative rate of exchange of the New Israel shekel to the pound sterling at the date of each payment. At the balance sheet date, every holder of a preference share, the par value of which is equivalent to 10 pounds sterling, is entitled to an annual dividend in an amount of NIS 4.98, and at the time of liquidation to a distribution in an amount of NIS 83.08. According to an Opinion issued by the Institute of Certified Public Accountants in Israel, non-participating preference shares are not to be included as part of shareholders' equity, and accordingly they are presented under the item "other liabilities".

14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS

General - Proper Banking Procedures Nos. 311 and 341 regarding "minimum capital ratio" and "allocation of capital in respect of exposure to market risk" require banking institutions to maintain a ratio of capital to risk components which shall not fall below a rate of 9% of the weighted total of the risk components in their balance sheet and off-balance sheet assets. The measurement of capital for this purpose is based on its classification into three main components: Tier I capital, Tier II capital and Tier III from which are deducted the banking institution's investments in non-banking affiliates and in subsidiaries which are not consolidated in its consolidated financial statements.

Tier I capital includes the shareholders equity, and the minority interest in the capital of consolidated subsidiaries, net of goodwill.

Tier II capital includes certain subordinated notes, which comply with characteristics defined by the Supervisor of Banks, and which have been approved by him for this purpose, as well as the general provision for doubtful debts. The volume of subordinated notes is limited to 50% of the Tier 1 capital.

The Tier III capital includes subordinated capital notes, which comply with characteristics determined in Directives of the Supervisor and which were approved by him for this purpose. It was required, inter-alia, that these capital notes will include an explicit condition, according to which payment of the indebtedness shall not be made if such payment will result in the minimal capital ratio falling below the minimum requirements of the Supervisor.

The weighted total of risk components in the business of the Bank, includes the balances of all assets included in the balance sheet and of off-balance sheet items (guarantees, derivative financial instruments etc.), which are weighted according to the degree of credit risk, as determined by the Directives.

Included in the weighted total of risk assets is the estimate of market risk relating to the marketable portfolio of the Bank and to its exposure to linkage base and interest risk. Such estimate was made based on principles determined by the Supervisor.

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 ratio of capital to risk

14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

assets, was based on two sources: Annual earnings, net of dividends and the raising of funds by the issue, as from December 1996, of subordinated capital notes in ever increasing volumes, 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 a 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 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 volume of subordinated capital note (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 volume of capital raising 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 the control in the Bank, at least during a number of years following the sale of a core of control of the Bank.

Concurrently, the Bank began also examining the possibilities of expanding its capital base aside from a new share issue.

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., 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 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, Bank 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, the alternative of a sale of the investment in IDB New York seemed the only one which could bring a significant improvement of the Bank's capital base.

In October 2002, the Bank concluded the process of electing 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 of potential buyers. After making a survey of several world leading identifying banks, the Bank decided to engage the investment bankers Goldman Sachs & Co., with whom an agreement has been signed.

14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

Goldman Sachs & Co. has begun preliminary 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 at 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.

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.

The Bank was informed on April 20, 2004, that the Board of Directors of M.I. Holdings Ltd. had considered the various options presented to it by the Bank, and decided in agreement with the Director General of the Ministry of Finance and the Accountant General, that it does not approve the request of the Bank for an additional issue of share capital by the Bank or for the sale of its holdings in IDB New York.

The Bank believes that the said decision may halt the pace of the implementation of the business plans of the Bank.

For details of the sale subsequent to balance sheet date of the controlling interest in the Bank, see Note 37, hereunder.

1. CAPITAL FOR CALCULATING RATIO OF CAPITAL

	December 31	
	2004	2003
	Reported amounts(1)	Adjusted amounts(1)
	In NIS millions	
Tier I capital	6,619	(2)6,098
Tier II capital:		
Upper Tier II capital(3)	254	251
Other Tier II capital	3,305	3,044
Tier III capital(4)	41	41
Deductions(5)	(824)	(763)
Total capital	9,395	(2)8,671

Footnotes:

(1) See Note 1 B.

(2) Restated - see Note 1 X.

(3) The balance of the general provision for doubtful debts in the amount of NIS 211 million (2003: NIS 208 milion) constitutes a part of the upper Tier II and is not deducted from credit to the public.

(4) Held against market risk only.

(5) The balance of investment in shares and in subordinated liability notes of financial affiliated companies and non-consolidated subsidiaries. This balance is deducted from the amount of capital and therefore also from the balance of investments in affiliated companies.

14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

2. WEIGHTED CREDIT RISK BALANCE

	December 31			
	2004		2003	
	Balances[6]	Weighted credit risk	Balances[6]	Weighted credit risk
	Reported amounts[1]		Adjusted amounts[1]	
	In NIS millions			
Credit risk assets				
Assets				
Cash and deposits with banks	17,751	3,005	16,888	2,262
Securities	40,068	6,911	38,774	*6,901
Credit granted to the public[4]	77,719	65,902	(2)76,672	(2)65,208
Credit granted to the government	271	2	367	31
Investment in affiliated companies[5]	1,320	432	1,238	455
Buildings and equipment	1,978	1,978	(2)2,102	(2)2,102
Other assets	4,155	2,909	(3)(2)3,869	(3)(2)2,702
Total assets	143,262	81,139	(3)139,910	(3)79,661
Off-Balance Sheet Instruments				
Transactions whose balance represents credit risk	13,088	10,170	11,744	8,938
Derivative financial instruments	5,401	2,540	4,780	2,114
Other	362	361	397	397
Total off-balance sheet instruments	18,851	13,071	16,921	11,449
Total credit risk assets	162,113	94,210	156,831	91,110
Market risk		1,318		1,617
Total risk assets	162,113	95,528	156,831	92,727

Footnotes:
(1) See Note 1 B.
(2) Reclassified.
(3) Restated - see Note 1 X.
(4) The balance of the general provision for doubtful debts in the amount of NIS 211 million (2003: NIS 208 milion) constitutes a part of the upper Tier II and is not deducted from credit to the public.
(5) The balance of investment in shares and in subordinated liability notes of financial affiliated companies and non-consolidated subsidiaries. This balance is deducted from the amount of capital and therefore also from the balance of investments in affiliated companies.
(6) Assets - year-end balances Off balance sheet instruments - par value The weighted average balances of off balance sheet instruments, are computed taking into account their conversion factor into credit.

14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

3. RATIO OF CAPITAL TO RISK ASSETS

	December 31	
	2004	2003
	Percent	
A. The bank		
Ratio of tier I capital to credit risk assets	6.9	(3)6.6
Ratio of total capital to credit risk assets	9.8	(3)9.4
Ratio of total minimal capital required by the Supervisor of Banks	9.0	9.0
B. Significant subsidiaries		
1. Mercantile Discount Bank LTD. and its subsidiaries		
Ratio of tier I capital to credit risk assets	7.3	7.2
Ratio of total capital to credit risk assets	10.6	10.8
Ratio of total minimal capital required by the Supervisor of Banks	9.0	9.0
2. Discount Mortgage Bank LTD. and its subsidiaries		
Ratio of tier I capital to credit risk assets	9.3	10.1
Ratio of total capital to credit risk assets	10.5	11.6
Ratio of total minimal capital required by the Supervisor of Banks	9.0	9.0
3. Discount Bancorp Inc.(1)		
Ratio of tier I capital to credit risk assets	11.4	(3)12.3
Ratio of total capital to credit risk assets	12.5	(3)13.5
Ratio of total minimal capital required by the Supervisor of Banks	(2)8.0	(2)8.0
4. Israel Credit Cards LTD.		
Ratio of tier I capital to credit risk assets	8.5	8.5
Ratio of total capital to credit risk assets	9.9	9.7
Ratio of total minimal capital required by the Supervisor of Banks	9.0	9.0

Footnotes:
(1) The data in this item were computed in accordance with the rules applicable in the U.S.A.
(2) IDB New York, a subsidiary of Discount Bancorp Inc., was classified by the FDIC as "well capitalized". Maintaining the said classification requires the maintenance of a capital ratio, including the minimum ratio, of 10% and of a primary minimum capital ratio of 6%.
(3) Restated - see Note 1 X.

4. **Issue of subordinate capital notes – March 2004.** On March 18, 2004, Manpikim – Discount Bank Issues Corporation 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 The Bank of Israel will be removed from the second tier capital of the Bank in the course of 2004. The Supervisor of Banks approved the inclusion of 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

14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

the publishing of the prospectus. Such capital notes were listed for trade on the Stock Exchange, and were gradually sold by the said subsidiary, in accordance with the needs of the Bank.

Issue of deferred capital notes – November 2004. On November 10, 2004, Manpikim successfully concluded an issue of deferred capital notes (series "B") in the amount of NIS 73 million. Additional deferred capital notes (series "B") in the amount of NIS 227 million, were issued prior to the publication of the Prospectus to a subsidiary of Manpikim and were registered for trade on the Stock Exchange.

Near to that date, deferred capital notes (series "A") in a total amount of NIS 300 million, were registered for trade (these were added to deferred capital notes (series "A") of a par value of NIS 500 million that are traded already) of which NIS 40 million were issued to institutional investors, and the balance was issued to a subsidiary of Manpikim.

The deferred capital notes series "A" and "B" that were issued to a subsidiary of Manpikim will be gradually sold by it, in accordance with the needs of the Bank. The proceeds of the issue were deposited with the Bank, which has accepted responsibility towards the note holders for the repayment in full of the principal, interest and linkage increments of all the capital notes.

Most of the said deferred capital notes were issued to replace capital notes that had been issued in the past and which in accordance with Bank of Israel instructions were deducted from the second tier capital of the Bank in the course of the 2004 and are to be deducted from it in the course of 2005. The Supervisor of Banks approved the inclusion of the said subordinate capital notes as second tier capital of the Bank.

15. PLEDGES

A. All debentures in Israeli currency linked to the CPI (see Note 11) were issued by Discount Mortgage Bank Ltd., Manpikim - Discount Bank Issues Corporation Ltd. and Discount Bank for Industrial Finance Ltd., and are secured by a floating charge on their property. On January 1, 1995, Discount Bank for Industrial Finance Ltd. merged with Israel Discount Bank Ltd., and the liabilities relating to the debentures issued by Discount Bank for Industrial Finance Ltd. were taken over by the Bank, such debentures are deemed to be capital notes, and are secured by a token deposit of NIS 100.

B. Mercantile Discount Bank Ltd., is a member of the Ma'of Clearing House Ltd. ("the Ma'of Clearing").

The "Maof" Clearing House established a risk fund in an amount to be determined by the Board of Directors of the Clearing House from time to time. A member of the Clearing House is responsible towards it for his share of the risk fund, which is determined proportionally to his options activity, or in accordance with the amount of collateral that he has to provide in favor of the "Maof" Clearing House.

In accordance with an agreement signed by the Mercantile Discount Bank and the Ma'of Clearing, the bank made a collateral in favor of the Ma'of Clearing, in respect of its responsibility towards the Clearing for transactions effected by the bank or by its customers and for the bank's share in the Risk Fund. According to the agreement, the Clearing House is committed to refund to Mercantile Discount Bank the amount of the collateral together with the profits thereon. Nonetheless, the "Maof" Clearing House, at its discretion, retains the right to realize the collateral, in whole or in part, in reducing the debt of Mercantile Discount Bank towards it by a similar amount.

The value of the collateral in favor of the "Maof" Clearing House, as stated, amounted on December 31, 2004, to NIS 37 million.

C. Israel Discount Bank of New York ("Discount New York") placed a lien on securities in favor of the Federal Reserve Bank in New York, which serves as security for certain liabilities of Discount New York, stemming from its appointment as a recipient of deposits of payments and taxes for the U.S. Treasury; and as collateral security for certain liabilities, which

15. PLEDGES (CONTINUED)

include the payments and undertakings for indemnity against members of the Clearing House in New York, in accordance with the rules of the Clearing House, and as part of its obligations as a recipient of deposits of moneys administered within the scope of bankruptcy proceedings. The market value at December 31, 2004, of the pledged securities amounts to US$ 23 million (NIS 99 million) [December 31, 2003 – US$ 25 million (NIS 109 million)].

In addition, Discount New York pledged securities in favor of the Federal Home Loan Bank, as a collateral for deposits received from it. The market value of these securities amounts at December 31, 2004 to $ 457 million (NIS 1,969 million) [as at December 31, 2003: US$ 690 million (NIS 3,020 million)].

Discount New York has sold securities, under buyback terms, in the amount of US$ 2,245 million (NIS 9,671 million) as of December 31, 2004 [as at December 31, 2003: US$ 2,128 million (NIS 9,317 million)].

D. Deposits with IDB New York in the amount of US$ 25 million, were pledged, in accordance with the supervisory regulations relating to banks in the United States, in favor of loans and credit lines granted by IDB New York to companies outside the United States belonging to the Bank's Group.

E. Deferred notes issued by the Bank in accordance with a Prospectus of April 1997, are not secured by a pledge on the assets of the Bank, except for a token first charge on a deposit of NIS 1.

F. The Bank is a member of the Euroclear Clearing House, which serves as a clearing system for transactions in securities traded on international markets, made through this clearing house. For this purpose, the Bank has pledged cash and securities in the amount of US$ 20 million.

G. Discount Leasing Ltd. registered in favor of the State of Israel, a first floating charge on its assets, unlimited in amount, in respect of investment grants received.

H. Note 19 C(6) discribes the risk fund established by the Maof clearing house. The Bank's share in the fund, deriving from the volume of the clearing activity on behalf of the Bank's customers as of December 31, 2004, amounted to NIS 25.3 million. The balance of the security, which the Bank has to provide in favor of the clearing house (an off-balance sheet liability) based on scenarios devised by the Stock Exchange in respect of the activity of the Bank's customers and in respect of the activity of the Bank itself (nostro) as of December 31, 2004, was NIS 75 million. According to the resolutions of the board of directors of the Maof clearing house, the Memorandum and Bye Laws of the Maof clearing house were amended as from April 1, 2004, as was the security setup of the Maof clearing house. All member of the clearing house, including the Bank, were asked to sign new pledge agreements to secure their liabilities, which replaced the previous pledge documents signed in favor of the Maof clearing house, and to deposit liquid security only (State of Israel bonds and/or cash as required by the Bye Laws).

The Bank agreed to provide the Ma'of Clearing with a first floating charge on all funds to be deposited by the Bank in three accounts in the name of the Ma'of Clearing, to be opened with another bank, this as a payment on account of amounts, which the Bank may become liable for in respect of Ma'of transactions at the risk of the Bank. This liability is conditional upon certain terms and the Bank may under certain circumstances demand the repayment of certain amounts. As part of these accounts, the Bank has pledged bonds in favor of the Maof clearing house, the balance of which as of December 31, 2004 amounted to NIS 304.5 million.

I. Discount New York pledged securities in the amount of US$ 374 million in favor of Euroclear Clearing House.

J. As collateral for the obligations of Yatzil Finance and its subsidiaries towards the banks, the said companies registered an assignment by way of a pledge and a fixed and floating pledges on all their rights according to agreements with business houses for the discount of IsraCard, VISA, American Express and Diners Club Israel vouchers, and all the rights to receive monies and payments from IsraCard, ICC, American Express and Diners, under power of assignment of rights

14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

and under the business house agreement. As of balance sheet date, the amount of the rights to receive monies and payments as above, totals NIS 487 million.

k. Israel Discount Bank (Switzerland) has pledged assets in the amount of SFR 11.5 million, as collateral for credit facilities in the amount of US$ 2 million and for a deposit in respect of the leasing of premises.

16. EMPLOYEE BENEFITS

A. The liability of the Bank and its subsidiaries for severance pay to their employees, based on the customary one month's salary for each year of employment, is fully covered by deposits with severance pay funds, by insurance policies and pension funds. The redemption value of the insurance policies and amounts accumulated in pension funds are not included in the balance sheet since they are neither controlled nor managed by the Bank or its subsidiaries.

Members of the Bank's Management are entitled to the customary severance payments, while several of whom are entitled also to an "adjustment" bonus of up to 12 months' salary upon retirement pursuant to individual agreements signed with them. This liability is covered by deposits in severance pay funds and insurance policies. The pension liability of foreign subsidiaries is covered by current deposits into a recognized foreign pension fund, based on actuarial computations.

In certain consolidated banking subsidiaries, several officers are entitled to "adjustment" bonus" equal to nine to twelve months' salaries, and in respect of which adequate provisions have been included.

B. 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, which constitute 25% of the maximum theoretical liability, based on a conservative assessment of the total risk in this respect.

Certain of the General Managers of the subsidiaries are also entitled to a special bonus in case they would be dismissed or would be compelled to retire due to change of ownership of the Bank, this within a period of twelve months from the date of such change. The financial statements include a provision of 25% of the maximum theoretical liability, based on a conservative assessment of the risk as a whole in this respect.

C. The Bank's employees and those of its consolidated subsidiaries in Israel are entitled to long-service bonuses equal to a certain number of monthly salaries, and to a certain number of additional vacation days, upon completing 20, 30 and 40 years of employment in the Bank. In accordance with instructions of the Supervisor of Banks the provision in respect of this liability is computed on an actuarial basis and stated at its present value. The discount rate, which was determined by the Supervisor of Banks on an actuarial computation is 4%. [Insert Ebe16.3] The financial statements include provisions for long-service bonuses totaling: Consolidated – NIS 385 million (2003: NIS 330 million); the Bank - NIS 330 million (2003: NIS 280 million).

Employees of the Bank and its consolidated subsidiaries in Israel are entitled to annual vacation as provided by labor agreements in force, and subject to the guidelines of the Annual Vacation Law - 1951. The financial statements include provisions for vacation pay as follows: Consolidated - NIS 124 million (2003 - NIS 120 million); and for the Bank - NIS 101 million (2003 - NIS 96 million).

D. Employees of the Bank and its subsidiaries are entitled to certain benefits after retirement. The liability was computed on an actuarial basis at a discount rate of 4.0%.

The amount of the provision at balance sheet date: Consolidated – NIS 302 million (2003: NIS 290 million); the Bank - NIS 266 million (2003: NIS 245 million).

16. EMPLOYEE BENEFITS (CONTINUED)

E. THE PROVISION AND DEPOSITS FOR EMPLOYEES' SEVERANCE PAY ARE AS FOLLOWS:

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions			
Deposits	1,973	1,820	1,721	1,583
Provision	1,543	1,435	1,327	1,238
Excess of deposit over provision	430	385	394	345
The excess (shortage) of amounts deposited over the provision is included in the item:				
Other assets (Note 8)	433	387	394	345
Other liabilities (Note 12)	(3)	(2)	-	-
Total, Net	430	385	394	345

Footnote:
(1) See Note 1 B.

The Bank and its subsidiaries are not permitted to withdraw these deposit funds except for the purpose of making severance payments.

F. In the years 2000-2004, the Bank encouraged early retirement of employees, focusing on an employee population having defined characteristics, in respect of which a focused effort to encourage their early retirement was made. In this framework, the said employees were approached and were offered early retirement at beneficial terms.
(As to expenses relating to early retirement, see note 27).

G. Several of the subsidiaries have adopted employee remuneration plans, according to which the General Managers and/or other employees of these subsidiaries are entitled to a bonus, the amount of which is based upon their business results. The necessary provisions in respect of these bonuses are included in the financial statements.
The previous general manager of one of the subsidiaries might be entitled in the future to a share of the gain on investments made in the period of his employment by the subsidiary, also during a number of years subsequent to his retirement.

16. EMPLOYEE BENEFITS (CONTINUED)

H. IDB New York has a liability for the payment of pensions to its employees, in respect of which it has established a pension fund, in which contributions by the employer and by the employees are deposited. The annual deposits with the fund are based on calculations made by an independent actuary. Following are the principal details concerning the said liability:

	As at December 31	
	2004	2003
	In US$ millions	
The actuarial liability for pension payments	31	28
Fair value of the pension fund assets	29	25
The actuarial liability for pension payments, net of market valueof the Fund's assets	(2)	(3)
Balance of the deferred actuarial loss	3	5
Balance of the net assets of the pension fund included in the financial statements (Note 8)	1	2
Pension payment expenses recognized in the income statement	2	5
The assumptions used for the measurement of the components of the pension plan:		
	%	%
The annual discount rate	6.00	6.25
The anticipated annual rate of return on the Fund's Assets	8.50	8.50
The annual rate of increase in employee payroll	4.25	4.75

I. For details as to an agreement singed subsequent to balance sheet date, alongside with the agreement signed for the sale of a control core of the Bank, between the New Federation of Labor, the Representative Committee of Discount Bank Employees and the Accountant General at the Ministry of Finance, and which determined, among other things, that the "entitled employees" (as defined in the agreement) will receive, under certain conditions, a bonus from the State and from the Bank, and that the power of the employment charter as a collective employment agreement at the Discount Bank would be extended for a period of five years, see Note 37, hereunder.

17. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS

CONSOLIDATED

	December 31 , 2004						
	Israeli currency		Foreign currency[2]				
	Non linked	Linked to the CPI	In US$	In Euro	In other currencies	Non monetary Items	Total
	Reported amounts[1]						
	in NIS millions						
Assets							
Cash and deposits with banks	2,612	1,550	7,108	4,609	1,872	-	17,751
Securities	12,784	1,978	22,750	1,212	439	905	40,068
Credit granted to the public	27,441	18,768	25,798	2,111	3,390	-	77,508
Credit granted to Governments	-	12	259	-	-	-	271
Investments in affiliated companies	-	1	-	-	-	1,319	1,320
Buildings and equipment	-	-	-	-	-	1,978	1,978
Other assets	1,779	12	2,055	117	65	127	4,155
Total assets	44,616	22,321	57,970	8,049	5,766	4,329	143,051
Liabilities							
Deposits from the public	45,405	14,872	50,486	8,462	2,467	-	121,692
Deposits from banks	315	339	4,147	247	30	-	5,078
Deposits from the Government	63	23	58	-	-	-	144
Debentures and subordinated capital notes	151	4,658	-	-	-	-	4,809
Other liabilities	2,101	125	1,936	123	112	96	4,493
Total liabilities	48,035	20,017	56,627	8,832	2,609	96	136,216
Difference	(3,419)	2,304	1,343	(783)	3,157	4,233	6,835
Effect of Hedging Derivative Instruments:							
Derivative instruments (except for options)	-	-	244	45	(289)	-	-
Effect of non Hedging Derivative Instruments:							
Derivative instruments (except for options)	3,590	184	(1,863)	916	(2,827)	-	-
Options in the money, net, (in terms of base asset)	70	-	160	(231)	-	1	-
Options out of the money, net, (in terms of base asset)	274	50	(381)	57	-	-	-
Total	515	2,538	(497)	4	41	4,234	6,835
Options in the money, net, (discounted nominal value)	465	-	(220)	(246)	-	1	-
Options out of the money, net, discunted nominal value)	1,090	490	(1,508)	(65)	(8)	1	-

Footnotes:
(1) See Note 1 B.
(2) Includes those linked to foreign currency.

17. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS (CONTINUED)

CONSOLIDATED (CONTINUED)

	December 31 , 2003						
	Israeli currency		Foreign currency[2]				
	Non linked	Linked to the CPI	In US$	In Euro	In other currencies	Non monetary Items	Total
	Adjusted amounts[1]						
	in NIS millions						
Assets							
Cash and deposits with banks	5,843	1,648	6,584	2,327	486	-	16,888
Securities	10,431	3,513	22,174	1,393	305	958	38,774
Credit granted to the public	[3]26,832	18,840	25,457	2,020	3,315	-	76,464
Credit granted to Governments	-	26	341	-	-	-	367
Investments in affiliated companies	-	-	-	-	-	1,238	1,238
Buildings and equipment	-	-	-	-	-	[3]2,102	2,102
Other assets	[4][3]1,567	45	[4]1,992	107	39	[3]119	[4]3,869
Total assets	[4]44,673	24,072	[4]56,548	5,847	4,145	4,417	[4]139,702
Liabilities							
Deposits from the public	43,488	17,534	[4]48,798	7,943	2,190	-	[4]119,953
Deposits from banks	1,113	423	3,436	101	24	-	5,097
Deposits from the Government	80	27	64	-	-	-	171
Debentures and subordinated capital notes	150	4,073	-	-	-	-	4,223
Other liabilities	[3]1,755	124	1,606	151	102	81	3,819
Total liabilities	46,586	22,181	[4]53,904	8,195	2,316	81	[4]133,263
Difference	[4](1,913)	1,891	[4]2,644	(2,348)	1,829	4,336	[4]6,439
Effect of Hedging Derivative Instruments:							
Derivative instruments (except for options)	-	-	418	(253)	(165)	-	-
Effect of non Hedging Derivative Instruments:							
Derivative instruments (except for options)	2,296	(256)	(2,679)	2,514	(1,875)	-	-
Options in the money, net, (in terms of base asset)	388	12	(409)	3	6	-	-
Options out of the money, net, (in terms of base asset)	169	23	(166)	(13)	(13)	-	-
Total	[4]940	1,670	[4](192)	(97)	(218)	4,336	[4]6,439
Options in the money, net, (discounted nominal value)	654	13	(677)	4	6	-	-
Options out of the money, net, discunted nominal value)	(229)	443	(126)	(57)	(31)	-	-

Footnotes:
(1) See Note 1 B.
(2) Includes those linked to foreign currency.
(3) Reclassified.
(4) Restated - see Note 1 X.

17. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS (CONTINUED)

BANK

	December 31 , 2004						
	Israeli currency		Foreign currency[2]				
	Non linked	Linked to the CPI	In US$	In Euro	In other currencies	Non monetary Items	Total
	Reported amounts[1]						
	in NIS millions						
Assets							
Cash and deposits with banks	2,499	5,665	6,154	4,560	1,744	-	20,622
Securities	12,170	1,522	1,481	997	10	253	16,433
Credit granted to the public	18,983	8,230	12,107	1,872	2,980	-	44,172
Credit granted to Governments	-	12	256	-	-	-	268
Investments in affiliated companies	-	144	65	-	-	5,662	5,871
Buildings and equipment	-	-	-	-	-	1,432	1,432
Other assets	1,468	6	1,118	103	50	71	2,816
Total assets	35,120	15,579	21,181	7,532	4,784	7,418	91,614
Liabilities							
Deposits from the public	36,750	10,852	19,418	7,684	2,047	-	76,751
Deposits from banks	321	187	1,147	285	17	-	1,957
Deposits from the Government	18	20	-	-	-	-	38
Debentures and subordinated capital notes	210	3,365	-	-	-	-	3,575
Other liabilities	1,276	96	1,254	122	92	67	2,907
Total liabilities	38,575	14,520	21,819	8,091	2,156	67	85,228
Difference	(3,455)	1,059	(638)	(559)	2,628	7,351	6,386
Effect of non hedging derivative instruments:							
Derivative instruments (except for options)	3,343	184	(1,565)	712	(2,674)	-	-
Options in the money, net, (in terms of base asset)	286	-	(55)	(231)	-	-	-
Options out of the money, net, (in terms of base asset)	243	50	(350)	57	-	-	-
Total	417	1,293	(2,608)	(21)	(46)	7,351	6,386
Options in the money, net, (discounted nominal value)	293	-	(47)	(246)	-	-	-
Options out of the money, net, (discounted nominal value)	1,041	491	(1,467)	(65)	-	-	-

Footnotes:
(1) See Note 1 B.
(2) Includes those linked to foreign currency.

17. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS (CONTINUED)

BANK (CONTINUED)

	December 31 , 2003						
	Israeli currency		Foreign currency[2]				
	Non linked	Linked to the CPI	In US$	In Euro	In other currencies	Non monetary Items	Total
	Adjusted amounts[1]						
	in NIS millions						
Assets							
Cash and deposits with banks	5,809	5,510	5,482	2,339	399	-	19,539
Securities	9,883	3,100	2,136	836	34	413	16,402
Credit granted to the public	18,446	8,227	13,099	1,846	2,910	-	44,528
Credit granted to Governments	-	24	298	-	-	-	322
Investments in affiliated companies	-	142	66	-	-	(4)5,427	(4)5,635
Buildings and equipment	-	-	-	-	-	(3)1,546	1,546
Other assets	(4)(3)1,263	28	1,171	92	19	(3)36	(4)2,609
Total assets	(4)35,401	17,031	22,252	5,113	3,362	(4)7,422	(4)90,581
Liabilities							
Deposits from the public	35,648	12,462	19,656	7,211	1,849	-	76,826
Deposits from banks	546	206	668	156	17	-	1,593
Deposits from the Government	31	23	-	-	-	-	54
Debentures and subordinated capital notes	201	3,441	-	-	-	-	3,642
Other liabilities	(3)1,035	94	1,091	149	81	61	2,511
Total liabilities	37,461	16,226	21,415	7,516	1,947	61	84,626
Difference	(4)(2,060)	805	837	(2,403)	1,415	(4)7,361	(4)5,955
Other transactions:							
Futures contracts	1,952	(256)	(2,372)	2,355	(1,679)	-	-
Options in the money, net, (in terms of basic asset)	355	12	(376)	3	6	-	-
Options out of the money, net, (in terms of basic asset)	159	23	(156)	(13)	(13)	-	-
Total	(4)406	584	(2,067)	(58)	(271)	(4)7,361	(4)5,955
Options in the money, net, (discounted nominal value)	579	13	(602)	4	6	-	-
Options out of the money, net, (discounted nominal value)	(386)	443	31	(57)	(31)	-	-

Footnotes:
(1) See Note 1 B.
(2) Includes those linked to foreign currency.
(3) Reclassified.
(4) Restated - see Note 1 X.

18. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS AND MATURITY PERIODS[1]

CONSOLIDATED (IN NIS MILLIONS)

A. Anticipated Future Contractual Cash Flows as of December 31, 2004

	On demand within or 1 month	Over 1 month and up to 3 months	Over 3 months and up to 1 year	Over 1 year and and up to 2 years
Israeli currency, non-linked:				
Assets	12,473	1,801	14,311	3,787
Liabilities	22,341	4,189	14,675	5,867
Difference	(9,868)	(2,388)	(364)	(2,080)
Derivative instruments (excluding options)	1,807	2,341	(500)	(135)
Options (in terms of base assets)	198	32	(76)	187
Israeli currency, CPI-linked:				
Assets	1,303	731	4,172	3,277
Liabilities	603	872	2,546	3,039
Difference	700	(141)	1,626	238
Derivative instruments (excluding options)	(60)	(63)	230	104
Options (in terms of base assets)	-	-	24	23
Foreign currency-local activity[3]:				
Assets	12,657	4,644	5,401	2,298
Liabilities	15,921	10,698	4,390	229
Difference	(3,264)	(6,054)	1,011	2,069
Derivative instruments (excluding options)	(1,699)	(2,255)	236	(27)
Options (in terms of base assets)	(198)	(32)	52	(210)
Foreign currency-foreign activity of extensions:				
Assets	7,279	2,381	3,447	1,854
Liabilities	13,669	2,734	4,955	2,646
Difference	(6,390)	(353)	(1,508)	(792)
Non-monetary items:				
Assets	-	-	-	-
Liabilities	-	-	-	-
Difference	-	-	-	-
Total:				
Assets	33,712	9,557	27,331	11,216
Liabilities	52,534	18,493	26,566	11,781
Difference	(18,822)	(8,936)	765	(565)
Derivative instruments (excluding options)	48	23	(34)	(58)
Options (in terms of base assets)	-	-	-	-
B. Balance Sheet Amount at Decemver 31, 2003				
Total:				
Assets	*30,378	9,503	*25,163	13,019
Liabilities	*51,586	18,241	*25,851	11,138
Difference	(21,208)	(8,738)	(688)	1,881
Derivative intrument (excuding options)	84	(22)	97	(11)

*Reclassified

Footnotes:

(1) This Note presents the anticipated future contractual cash flows in respect of assetes and liabilities according to linkage base and according to the remaining period to the contractual maturity date of each cash flow. The data is shown net of the provision for doubtful debts.

(2) Includes past-due receivables totaling NIS 1034 million (2003: NIS 996 million).

(3) Includes linked to foreign currency.

(4) As included in Note 17 “Assets and liabilities according to linkage base”, including off-balance sheet amounts in respect of derivatives.

Over 2 years and up to 3 years	Over 3 years and up to 4 years	Over 4 years and up to 5 years	Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	Total cash flows	Balance sheet amount(4) No fixed maturity date(2)	Total
2,840	988	1,662	5,759	168	33	43,822	4,093	44,616
506	232	172	274	173	76	48,505	83	48,035
2,334	756	1,490	5,485	(5)	(43)	(4,683)	4,010	(3,419)
47	29	3	2	-	-	3,594	-	3,590
(288)	(46)	(2)	(181)	466	54	344	-	344
3,039	2,126	1,992	6,869	5,252	521	29,282	161	22,321
1,676	1,733	1,499	10,438	2,297	5	24,708	72	20,017
1,363	393	493	(3,569)	2,955	516	4,574	89	2,304
(6)	(25)	10	(3)	-	-	187	-	184
-	-	-	3	-	-	50	-	50
2,076	1,182	1,418	3,384	979	69	34,108	676	32,803
532	70	101	247	39	12	32,239	26	33,320
1,544	1,112	1,317	3,137	940	57	1,869	650	(517)
(63)	(20)	(15)	1	-	-	(3,842)	-	(3,774)
288	46	2	178	(466)	(54)	(394)	-	(394)
1,641	1,368	1,700	3,806	10,171	19,282	52,929	74	38,982
2,352	2,193	3,317	4,368	-	-	36,234	1	34,748
(711)	(825)	(1,617)	(562)	10,171	19,282	16,695	73	4,234
-	-	-	-	-	-	-	4,329	4,329
-	-	-	-	-	-	-	96	96
-	-	-	-	-	-	-	4,233	4,233
9,596	5,664	6,772	19,818	16,570	19,905	160,141	9,333	143,051
5,066	4,228	5,089	15,327	2,509	93	141,686	278	136,216
4,530	1,436	1,683	4,491	14,061	19,812	18,455	9,055	6,835
(22)	(16)	(2)	-	-	-	(61)	-	-
-	-	-	-	-	-	-	-	-
8,181	7,431	*5,149	*22,373	*19,201	*16,654	*157,052	10,060	*139,702
4,900	3,146	3,924	18,729	2,863	78	*140,456	306	*133,263
3,281	4,285	1,225	3,644	16,338	16,576	16,596	9,754	6,439
(91)	(17)	(9)	(19)	-	-	12	-	-

18. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS AND MATURITY PERIODS[1]

THE BANK (IN NIS MILLIONS)

A. Anticipated Future Contractual Cash Flows as of December 31, 2004

	On demand within or 1 month	Over 1 month and up to 3 months	Over 3 months and up to 1 year	Over 1 year and and up to 2 years
Israeli currency, non-linked:				
Assets	9,980	853	10,942	2,826
Liabilities	16,379	3,789	12,102	5,591
Difference	(6,399)	(2,936)	(1,160)	(2,765)
Derivative instruments (excluding options)	1,616	2,301	(509)	(135)
Options (in terms of base assets)	178	39	(37)	101
Israeli currency, CPI-linked:				
Assets	1,023	548	3,470	2,515
Liabilities	287	659	1,467	1,853
Difference	736	(111)	2,003	662
Derivative instruments (excluding options)	(60)	(63)	230	104
Options (in terms of base assets)	-	-	25	22
Foreign currency-local activity[3]:				
Assets	12,252	4,326	5,087	2,026
Liabilities	14,327	9,926	4,138	204
Difference	(2,075)	(5,600)	949	1,822
Derivative instruments (excluding options)	(1,507)	(2,210)	245	(27)
Options (in terms of base assets)	(178)	(39)	12	(123)
Foreign currency-foreign activity of extensions:				
Assets	597	325	637	396
Liabilities	866	461	134	-
Difference	(269)	(136)	503	396
Non-monetary items:				
Assets	-	-	-	-
Liabilities	-	-	-	-
Difference	-	-	-	-
Total:				
Assets	23,852	6,052	20,136	7,763
Liabilities	31,859	14,835	17,841	7,648
Difference	(8,007)	(8,783)	2,295	115
Derivative instruments (excluding options)	49	28	(34)	(58)
Options (in terms of base assets)	-	-	-	-
B. Balance Sheet Amount at December 31, 2003				
Total:				
Assets	22,187	5,754	*17,766	9,748
Liabilities	31,382	13,901	*18,270	7,153
Difference	(9,195)	(8,147)	(504)	2,595
Derivative instrument (excluding options)	98	16	28	(11)
Options (in terms of base assets)	-	-	-	-

*Reclassified

Footnotes:

(1) This Note presents the anticipated future contractual cash flows in respect of assetes and liabilities according to linkage base and according to the remaining period to the contractual maturity date of each cash flow. The data is shown net of the provision for doubtful debts.

(2) Includes past-due receivables totaling NIS 605 million (2003: NIS 549 million).

(3) Includes linked to foreign currency.

(4) As included in Note 17 “Assets and liabilities according to linkage base”, including off-balance sheet amounts in respect of derivatives.

Over 2 years and up to 3 years	Over 3 years and up to 4 years	Over 4 years and up to 5 years	Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	Total cash flows	No fixed maturity date[2]	Balance sheet amount[4] Total
2,411	918	1,732	5,516	58	28	35,264	2,733	35,120
356	146	109	235	140	73	38,920	95	38,575
2,055	772	1,623	5,281	(82)	(45)	(3,656)	2,638	(3,455)
46	25	1	-	-	-	3,345	-	3,343
51	155	27	15	-	-	529	-	529
1,984	1,557	1,377	4,534	2,101	232	19,341	161	15,579
1,094	1,224	1,040	8,473	2,164	6	18,267	72	14,520
890	333	337	(3,939)	(63)	226	1,074	89	1,059
(6)	(25)	10	(3)	-	-	187	-	184
-	-	-	3	-	-	50	-	50
2,001	1,398	1,342	2,755	244	37	31,468	538	31,205
463	45	83	226	-	-	29,412	26	30,578
1,538	1,353	1,259	2,529	244	37	2,056	512	627
(63)	(17)	(17)	3	-	-	(3,593)	-	(3,527)
(51)	(155)	(27)	(18)	-	-	(579)	-	(579)
115	146	150	-	-	-	2,366	8	2,292
-	-	-	-	-	-	1,461	1	1,488
115	146	150	-	-	-	905	7	804
-	-	-	-	-	-	-	7,418	7,418
-	-	-	-	-	-	-	67	67
-	-	-	-	-	-	-	7,351	7,351
6,511	4,019	4,601	12,805	2,403	297	88,439	10,858	91,614
1,913	1,415	1,232	8,934	2,304	79	88,060	261	85,228
4,598	2,604	3,369	3,871	99	218	379	10,597	6,386
(23)	(17)	(6)	-	-	-	(61)	-	-
-	-	-	-	-	-	-	-	-
5,956	4,912	*3,340	*14,033	*2,966	*430	87,092	*11,390	*90,581
1,810	1,447	1,412	10,530	2,642	60	88,607	280	*84,626
4,146	3,465	1,928	3,503	324	370	(1,515)	11,110	5,955
(90)	(18)	(10)	(19)	-	-	(6)	-	-
-	-	-	-	-	-	-	-	-

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions			
A. Off-Balance Sheet Financial Instruments				
Contract balances or their stated amounts at year end				
Transactions involving credit risk:				
Letters of credit	1,902	1,515	581	468
Credit guarantees	1,601	(5)1,427	991	(5)727
Guarantees for home purchasers	3,019	2,720	1,495	1,441
Liabilities for open credit card transactions	5,326	(5)4,424	1,852	1,624
Other guarantees and obligations	1,998	2,321	1,656	1,973
Unutilized credit line for credit cards	11,722	11,039	8,068	7,390
Unutilized revolving and other credit lines	3,221	(5)3,169	2,723	(5)2,458
Irrevocable commitments to extend credit approved but not yet granted	8,589	(4)6,671	3,814	(4)2,319
Commitment to issue guarantees	1,760	1,830	727	748
B. Off-Balance Sheet Commitment at Year-End Regarding activity based on loan repayments(2)				
Balance of loans granted out of deposits repayable according to the repayment of the loans(3)				
Israeli currency - non linked	270	321	227	280
Israeli currency - linked to the CPI	2,397	2,457	47	60
Foreign currency	654	400	654	400
Total	3,321	3,178	928	740

Footnotes:
(1) See Note 1 B.
(2) Loans and deposits granted out of deposits, the repayment of which to the depositors is conditional upon , the collection of these loans (or deposits),with a margin or with a collection commission (instead of a margin).
(3) Standing loans and government deposits made in respect thereof, totaling NIS 299 million (2003:NIS 342 million), have not been included in the table.
(4) Including an amount of NIS 880.4 million, in respect of a long-term project, in accordance with a decision of the Tel-Aviv district Court given in a Plea for a Mandatory Injunction to be issued by the Court after the Bank had informed the cancellation of the agreement. The Bank appealed against the said decision.
(5) Reclassified.

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS(CONTINUED)

B. OFF BALANCE SHEET COMMITMENT AT YEAR-END REGARDING ACTIVITY BASED ON LOAN REPAYMENTS (CONTINUED)

2.Cash flows in respect of collection commissions and interest margins of activity based on loan repayments - Consolidated[1]

	December 31,2004							2003
	Up to 1 year	Over 1 year and up to 3 years	Over 3 years and up to 5 years	Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	Total	Total
Future contractual flows	20	34	31	61	71	3	220	236
Expected future flows based on Management's estimates of early repayments	19	33	29	53	53	2	189	205
Discounted expected future flows based on Management's estimates of early repayments[2]	19	31	25	39	31	1	146	155

3. Information as to the granting of loans during the year by the mortgage banks:

	31.12.2004	31.12.2003
Loans out of deposits repayable according to the repayment of loans	141	130
Standing loans	2	27

Footnotes:
(1) The CPI linked segment includes the foreign currency segment. The CPI linked segment includes also the non-linked shekel segment as amounts in this segment do not exceed 10% of totl amounts repayable according to collection of loans granted therefrom.
(2) Discounted at the rate of 4.14% (2003: 4.3%).

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	in NIS millions			
1. Long-term lease contracts - rent payable in future years:				
First year	69	66	32	34
Second year	69	59	33	31
Third year	68	57	34	30
Fourth year	44	55	23	28
Fifth year	41	37	21	21
Sixth year and thereafter	286	299	163	165
Total	577	573	306	309
2. Guarantees to ensure rights of members in provident funds (nominal)	6,945	6,568	6,945	6,568
3. Commitment to Maof Clearing House – Banks[1]	6	17	5	13
4. Commitment to acquire buildings and equipment	21	45	9	36
5. Borrowed securities[3]	28	50	10	7

Footnote:
(1) See Note 19 C and 7.

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS

6. The Bank is a member of the Ma'of Clearing House Ltd., and, together with the other members of the Ma'of clearing house, is responsible, vis-à-vis the clearing house, for every binding financial obligation arising from transactions in options undertaken on the stock exchange.

For this purpose, the Ma'of clearing house has set up a risk fund. As of the date of the balance sheet, the Bank's share of the risk fund was approximately NIS 25 million, which, at that time, constituted 3.6% of the fund. The Bank has been asked to provide collateral in favor of the Ma'of clearing house (Government bonds) in such a sum as will secure the possible indebtedness arising on account of the Bank's share in the risk fund, together with a further sum determined by the extent of the Bank's activity in this area (see Note 15 H).

In addition, the Bank has provided the clearing house with an undertaking that it will pay any monetary debt that may arise during the course of operations of its customers in relation to the writing of options traded within the clearing house.

7. Members of the Tel Aviv Stock Exchange Clearing House issued a mutual guarantee, according to which they are obligated, upon demand of the Clearing House to cover any loss sustained by the Stock Exchange Clearing House as a result of a shortage of securities or a default of one of the members.

Each member's share in covering the damage is the ratio between the financial turnover of the member as compared to the aggregate financial turnover of all the members liable for payment to the Clearing House as a consequence of a loss, calculated on the basis of the 12-month period ending on the last day of the month preceding the month in which the event causing the loss occurred.

As collateral for its liability to the Clearing House, Mercantile Discount Bank has provided a guarantee by another bank as to 50% of its liability to the Clearing House and produced a self guarantee in respect of the remaining balance of the liability. At December 31, 2004, the liability of Mercantile Discount Bank in this respect amounted to NIS ___ million.

8. The Bank is committed to the Tel Aviv Stock Exchange and to the Exchange Clearing House to maintain the integrity of the assets of the customers of Tachlit Discount - Investment Consulting and Management Company Ltd. (a wholly owned consolidated subsidiary of the Bank), and to the effect that it will act in accordance with the guidelines of the Stock Exchange.

9. Consolidated subsidiaries of the Bank are engaged in providing a variety of trusteeship services and serve, inter alia, as trustees for certain debentures issued to the public according to a prospectus and which are traded on the Stock Exchange.

10. a) The previous Articles of Association of the Bank, which were amended in March 2002, prescribed that the Bank shall indemnify any person who serves or served as a representative of the Bank, or at its request, as a Director in another company in which the Bank has an interest, for the expenses incurred by such person in connection with legal proceedings instituted against him in respect of acts of commission or omission in the course of fulfilling his duties as a Director of such other company, and for an amount he is ordered to pay under a judgment handed down in such legal proceedings, including by way of a settlement to which the Bank has agreed, unless the judicial authority in such proceedings has found that the acts as aforesaid on the part of such person were performed not in good faith. The Bank is entitled to issue a letter of indemnity to any such Director of another company, including a Director of the Bank who serves as a Director in the other company, at terms and conditions approved by the Board of Directors. Accordingly, the Bank has issued letters of indemnity, unlimited as to amount, to Directors who serve or served at the Bank's request in other companies held, directly or indirectly, by the Bank.

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

b) According to the Articles of Association of the Bank, any employee or clerk of the Bank who is not an executive officer, will be indemnified out of the funds of the Bank for any liability incurred by him in his capacity as an employee or clerk of the Bank in defending himself in any legal proceedings, whether civil or criminal, in which a judgment is given in his favor or in which he is acquitted, and the Bank is entitled to indemnify him for any financial liability imposed on him in favor of another person for an act done in his capacity as an employee or clerk of the Bank.

c) The Articles of Incorporation of certain consolidated subsidiaries of the Bank allow for indemnification of officers under certain conditions, subject to the provisions of the Law. Certain companies in certain cases granted such indemnification

d) Directors and other executive officers of the Bank, including the officer serving as secretary of the Bank until December 31, 1996, (hereinafter in this paragraph - "Officers"), were granted an indemnity for any financial liability imposed on any of them, in all matters connected, directly or indirectly, with the Prospectus regarding the offer for sale of securities by the State of Israel and issue of securities by the Bank published on April 8, 1997, under terms specified in the letter of indemnification. Under any circumstances, the maximum amount of the indemnity to all the Officers of the Bank on an aggregate basis shall not exceed the gross proceeds received by the State of Israel from the issue of securities under the abovementioned prospectus (including proceeds to be received from the exercise of purchase options offered by the abovementioned prospectus) in addition to the gross proceeds received by the Bank from the offer of securities in accordance with the abovementioned Prospectus.

e) Manpikim – Issue Company of Discount Bank Ltd., a wholly owned and controlled subsidiary of the Bank, has granted indemnification to its Directors, with respect to a financial liability that might be imposed on any of them and with respect to reasonable legal expenses in connection with a Prospectus for the public issue and the listing for trade of subordinate capital notes, published on March 12, 2004, under terms specified in the letter of indemnification. In any event, the maximum amount of the indemnification payable to all Directors as a group will not exceed the gross proceeds of the said issue.

Manpikim – Issue Company of Discount Bank Ltd. has granted its Directors identical indemnification in connection with a Prospectus regarding the offer to the public and the listing for trade of subordinated capital notes issued on November 3, 2004.

11. In connection with the prospectus for the offer of sale dated April 8, 1997, the Bank is committed to indemnify the underwriters, or any one of them, For any amount (including expenses) they may be ordered to pay, as a result of a claim, the cause of action of which is connected with the prospectus or arises there from, and which the underwriters are ordered to pay as aforesaid, or would settle with the consent of the Bank, all under the terms set out in the letter of indemnity.

12. The practice of the Bank is to grant, from time to time, and at terms and circumstances accepted in the banking business, letters of commitment and of indemnification, limited or unlimited in amount, and for limited or unlimited periods, and everything in the ordinary course of business of the Bank. Inter alia, such letters of indemnity are granted within the framework of the regulations of the Clearing House as to lost checks; are granted to Receivers and Liquidators; are granted in respect of negligence claims, to providers of various services including assessors, project manager etc; to customers in respect of lost check books; to credit card companies as part of the accountability with them; or indemnification granted as part of a contractual obligation.

This includes a full indemnification granted by the Bank to an assessor, in respect to any damage, which might be caused to him as a result of rendering valuation opinions, except in the case where gross negligence or malfeasance might be

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

found (see Note 6 D above); and a similar indemnification that the Bank gave to an expert who had provided the bank with an economic opinion.

13. The Bank is obligated to Visa International Service Association, that should Israel Credit Cards Ltd. ("ICC") or one of the banks recommended by it for membership in Visa International, breach, deny or neglect the payment of any sum, or will do or refrain from doing anything required of it according to the bylaws of Visa International and its standards of operations, the Bank shall unconditionally indemnify Visa International and its members against all losses, damages, costs, expenses, etc. which may be caused as a result, and which exclusively relate to international payments outside of Israel.

The Bank's guaranty to Visa International is a continuous guaranty, which will remain fully in force until all the moneys and obligations due are fully settled and fulfilled.

A similar undertaking was given to Visa International by Bank Leumi (BLL). BLL and the Bank agreed between themselves, inter alia, that although each of them signed an unlimited guaranty for the benefit of Visa International on behalf of CAL, the responsibility as per the above guaranty shall take effect in a manner so that BLL will assume the responsibility for 65% of the sums that shall be demanded in accordance with the guaranties, and the Bank shall assume the responsibility for 35% of the sums that shall be demanded in accordance with the guaranties, this being in accordance with the ownership percentages of each of the banks in CAL.

In accordance with an agreement dated January 3, 2000, signed by the Bank and Leumi Financial Holdings Ltd., whereby the Bank acquired BLL's shares in CAL, the Bank agreed to cause the release of BLL from its said guaranties as from the date the agreement came into force, in respect of any guaranty that had not been exercised prior to January 3, 2000 (date of signature of the agreement). The Bank has further agreed that in the event that it will not succeed in releasing BLL of the said guaranties, the Bank will indemnify BLL, upon the latter's first request, in each case where BLL will in fact pay any amount as a result of these guaranties. Visa International confirmed in a letter dated February 26, 2002, that BLL was released from its guarantees. In agreements with other shareholders of CAL signed by the Bank, such other shareholders have undertaken to cause the release of the Bank and to be responsible for the indemnification of the Bank in respect of their relative share in such guarantee. (See also Note 34).

In November 2004, the Bank endorsed the above guarantees in favor of Visa Europe Services Inc., an autonomous branch of Visa International representing Visa members operating in Europe.

14. Within the framework of permits granted to the Bank for the construction of a building at 156 Herzl Street, Tel Aviv, which was sold during the course of its construction to a third party, the Bank is obligated to the Tel Aviv Municipality and to the third party, to bear the costs involved in evacuating tenants from the plot. To the best of the Bank's knowledge as at the date of the financial statements, the Municipality had not yet begun evacuating the tenants from the plot, and the Bank is unable to assess the cost of its participation in the evacuation of tenants as aforesaid.

15. Various actions against the Bank and its consolidated subsidiaries:

Various actions are pending against the Bank and its consolidated subsidiaries. These include class action suits and requests to approve actions as class action suits. Among others, allegations are raised in these claims with regard to the unlawful debiting of interest and/or the debiting of interest not in accordance with agreements, subjecting one service to another service, failure to execute instructions, applications for the confirmation of attachment orders in respect of attachments served by third parties on the assets of debtors which they allege are held by the Bank, the unlawful debiting of accounts, mistakes in value dates, the invalidity of collateral security and the realization thereof, applications for injunctions ordering the Bank to refrain from paying out bank guarantees or documentary credit, as well as allegations

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

pertaining to provident funds, securities, construction loans, applications for the removal of restrictions on an account pursuant to the Dishonored Checks Law, 1981. In the opinion of the Management of the Bank, which is based, inter alia, on legal opinions and/or on the opinion of managements of its consolidated subsidiaries, which are based upon the opinion of their counsels, respectively, as the case may be, adequate provisions have been included in the financial statements, where required.

The total exposure with respect to claims filed against the Bank alone, whose prospects of materializing, in whole or in part, has been assessed as reasonably possible, amounts to approximately NIS 72.6 million.

15.1 Below are details with regard to actions against the Bank, including a class action suit and a request to approve an action as a class action suit:

15.1.1 August 25, 1998, it transpired that despite the fact that a number of letters of guarantee issued by the Bank in a total amount in NIS equaling US$ 8 million, were returned to the Bank due to the cancellation of the transaction giving rise to these letters of guarantee, another bank as well as the beneficiary under such letters of guarantee, who allegedly endorsed his rights to that other bank, claim that the other bank is in possession of the original letters of guarantee. Both the other bank and the beneficiary claim that such letters of guarantee are in force, as no notice of cancellation was given by them, and that the Bank is liable under these letters of guarantee, whether they are in possession of the original letters or in possession of identical copies. In view of these circumstances, which gave rise to suspicion of criminal acts, the matter was referred to a police investigation; following which a third party was charged with fraud and falsification. The said third party has since been found guilty and was sentenced to a long term imprisonment.

On October 19, 1998, the other bank filed a lawsuit against the Bank in the amount of NIS 6 million, in respect of two of the letters of guarantee the date of which fell due.

On November 10, 1998, the Bank filed a lawsuit against the other bank and the beneficiary, which, inter alia, requests a declaration that the said letters of guarantee are invalid or are to be cancelled, requests the reimbursement of an amount of NIS 3 million, which had already been paid (under protest) under these letters of guarantee up to the date of submitting the lawsuit, and for a declaration of the right of the Bank for reimbursement of any amount which may be paid in the future in respect thereof. Alternatively, the Bank requests that the damage be allocated among the parties involved, so that the full burden of the damage will not fall on the Bank.

On January 14, 2004, a verdict was given by the Jerusalem District Court, in which the Court admitted the claim of the other bank and dismissed the claim of the Bank.

The Bank paid the plaintiffs the amount determined in the judgment, and then submitted an appeal on March 19, 2004.

On February 1, 2005, the Supreme Court approved a compromise agreement made by the parties and granted the authority of a judgment thereto. Under the terms of the agreement, the Bank's insurer undertook to pay the sum of US$ 50,000 to the guarantee beneficiary. The agreement clearly specified that the Bank had no obligation or responsibility with respect to this payment. Subject to the foregoing, all the parties agreed to a final and absolute waiver of any claim or demand, as from one against the other, with respect to any matter connected to or touching upon the guarantees that were the subject of the proceedings, the amounts paid in respect thereof both before and after the granting of the judgment by the District Court, and all other matters brought before the Court during the course of the legal proceedings in this matter.

Thus, the legal proceedings with respect to the above matter were brought to a close.

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

15.1.2 On November 14, 1999, the Bank received notice of a request for exemption from litigation levy submitted to the Tel-Aviv District Court by a former customer of the Bank, to enable him to file a claim against the Bank in the amount of NIS 467 million. Both the State and the Bank opposed this exemption request. In a hearing, which took place on May 1, 2000, the plaintiff was awarded an exemption from litigation levy of NIS 456 million, which would have applied to the action.

In the action, the plaintiff alleges wrongful doings made in his accounts until 1989, and attributes to the bank acts of misappropriation of funds, which allegedly were deposited in his business and private accounts. The hearing of the evidence commenced in January 2004.

15.1.3 A lawsuit was filed on June 19, 2002, with the District Court in Tel-Aviv together with a plea to approve it as a class action suit against the Banking Clearing Center (hereinafter – "MSB") and against six banks including the Bank and Mercantile Discount Bank Ltd.

The amount of the claim relating specifically to the claimant (the Ramla Municipality), as valued for the purpose of the claim totals NIS 811 thousand. Of the amount of the specific claim, the Bank's share amounts to NIS 91 thousand, and the share of Mercantile Discount Bank amounts to NIS 58 thousand. The amount of the class action against all the defendants, which the Court is asked to approve, is valued by the claimant at NIS 967.5 million.

The cause for the claim is that the defendants have created a cartel and/or a binding arrangement with respect to the clearing of permanent payment orders which the defendant banks execute. According to the claimant, in consequence of the binding arrangement between the defendants, she and similarly other customers who are charged payment order clearing services commissions, pay unreasonable and improper amounts, which are considerably higher than their real price, and which range between US$ 0.325 and US$ 0.5 for each payment order credit and NIS 17.80 for each return of a payment order. An expert opinion submitted by the claimant claims that the proper price for each such clearing transaction should be NIS 0.15 at the most, and only NIS 6.5 for each return transaction. Amongst other things, the claim is based also on the decision of the Commissioner of Restrictive Trade Practices of June 10, 2002.

The group, which the claimant proposes to represent in the class action, comprises of whoever made use of the service offered by the defendants or anyone of them, for executing the clearing of payment orders in the period of seven years prior to the date of the lawsuit.

The claimant requests the Court to declare that the defendants are party to a binding arrangement in everything connected with the charging of commissions for the clearing and return of payment orders, and to determine that the commissions collected in respect of the above transactions are higher that the reasonable and proper price which should be charged for such transactions. The Court is also requested to determine the correct and proper price for these transactions, and to instruct the defendants to repay the excess amounts collected.

On September 12, 2002, the Bank requested the Court to summarily dismiss the claim and the request for approval as a class action suit, basing itself on the following: Non payment of Court fees as due; lack of authority of the Municipality to act as a representative claimant in a matter which does not have a special and separate relationship to the population and residents of the City of Ramla; the claim relating specifically to the Municipality in the amount exceeding NIS 800 thousand, is not appropriate for a hearing in the matter of a class action.

On December 1, 2002, the Court decided in the matter of the structure of the proceedings. The Court decided that the petition for a separate hearing of the claims for summary dismissal would be only partly admitted in as far as

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

the matter relates to the claim that the plaintiff, as a Municipality, is not authorized and may not properly proceed with its own claim as a class action. The Court ordered the representative for the Attorney General, through the Tel-Aviv District Attorney's Office (civil claims), to appear at the hearing to be fixed and allowed him also to submit his position in writing. The Court also instructed the parties to submit in writing their claims as to lack of authority.

In the meantime, all the parties had submitted their briefs in writing and it transpired that the Attorney General supports the claim of the Bank that the Municipality has no authority to act as a representative of a class action in a matter which does not have a direct and separate effect upon the population of the City of Ramla.

On November 11, 2003 the Court decided to dismiss the action in limine. On February 18, 2004 the claimant filed an appeal at the Supreme Court against this decision.

It should be noted that the First International Bank, an affiliated company of the Bank, is also a defendant in this suit.

15.1.4 On November 1, 2004, an action was filed with the Court in Los Angeles against the Bank and others for the payment of damages in the sum of US$ 350 million as well as a plea for punitive damages against the Bank as the Court will determine.

Until prior to the issue of the financial statements, the Court documents have not been served on the Bank.

The plaintiff alleges that the Bank has breached explicit undertakings towards it for the granting of a credit line in the amount of US$ 3 million. The plaintiff bases the action upon several causes, amongst which are: the non-disclosure of material facts, making promises with no intension of honoring them, deceit through the non-disclosure of material facts, misrepresentations, negligence, breach of a written agreement, cover up and violation of non-competition laws.

The plaintiff alleges that due to the said breach of undertakings, the Bank brought about its demise and caused it heavy losses estimated at amount in excess of US$ 350 million.

It should be noted that according to the agreements signed between the plaintiff and the Bank, the applicable jurisdiction is that of the Courts in Israel and the applicable law is the Israeli law.

On December 17, 2004, the Bank submitted to the Court in Los Angeles a petition, requesting that the hearing of the claim be transferred from the Court of the State of California to the Federal Court. On January 25, 2005, ErgoQuest submitted an objection to this request.

On February 18, 2005, the Bank again submitted to the Court in Los Angeles, a petition requesting that the claim be dismissed on the grounds, inter alia, that the Court in Los Angeles has no jurisdiction in this matter, due to the fact that the agreement between the plaintiff and the Bank contains a clause stipulating that exclusive jurisdiction in any legal proceedings is given to a Court in Israel and applying the Israeli law to the agreements, and that the appropriate forum for hearing this matter is a Court in Israel. ErgoQuest also submitted an objection to this petition. The hearing of the petitions of both parties has been set for April 2005.

Management of the Bank, based on Counsel's opinion, believes that there are good prospects that the Court in the United States will admit the preliminary arguments of the Bank and will dismiss the action in the United States. Accordingly, the prospects of this claim are remote and in any event it would seem that the amount claimed is highly excessive. Nonetheless, the Management of the Bank, based on counsel's opinion, is unable to estimate whether the plaintiff would submit a similar claim in Israel, and if so under what causes of claim and for what amount.

Management of the Bank, based on Counsel's opinion, believes that there are good prospects that the Court in the United States will admit the preliminary arguments of the Bank and will dismiss the action in the United States.

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

Accordingly, the prospects of this claim are remote and in any event it would seem that the amount claimed is highly excessive. Nonetheless, the Management of the Bank, based on counsel's opinion, is unable to determine whether the plaintiff would submit a similar claim in Israel, and if so under what causes of claim and for which amount.

15.2 A request to approve an action against Mercantile Discount Bank ("MDB") as class action suit:

An action and a request to have it approved as a class action suit under the Banking Law (Customer Service), 1981, were submitted on December 8, 2002, against MDB and against the Bank by a customer, who in the past had submitted an action on the same ground together with a request to have it approved as a class action suit under the Securities Law, which action was dismissed because of non-payment of Court fees. The ground for the claim is the alleged damage caused to the claimant as a result of impairment in value of securities purchased on his behalf by portfolio managers, who unlawfully hiked up the prices of securities. The claimant argues that the connection of MDB to the damage claimed results from the credit granted by the Bank to the said portfolio managers, which enabled them to conduct transactions in the said securities, and from the impression received by that customer that the granting of credit served to support the prices of the securities.

As estimated by the claimant, the damage caused to him amounts to NIS 735 thousand. The total amount of damage stated in the request for approval of a class action suit against MDB and the Bank together, is NIS 500 million.

15.3 A petition to approve an action against ICC and the Bank as a class action suit, where the appeal against its approval as a class action was accepted, and a petition to approve an action against ICC and the Bank as a class action suit, which the plaintiff moved to strike:

15.3.1 On August 17, 1998, a petition was filed with the Tel-Aviv District Court, to approve the filing of a class action suit against CAL, Diners Club Israel Ltd., Isracard Ltd., Poalim American Express Ltd., Bank Leumi, Israel Discount Bank Ltd. and Bank Hapoalim (the "petition"). Concurrently a lawsuit was filed against the same respondents (the "lawsuit" and the "petition" together will be referred to hereunder as the "claim").

The claim purports to represent all business entities in Israel, which during the relevant period (as from October 22, 1994 to date of filing the claim) paid to the defendants or any one of them, for clearing services of credit card transaction vouchers, business commissions in excess of 2%, which according to the claimants, is the maximum rate that can be considered fair.

As claimed, the amount of the class action suit, were it to be approved in its entirety, would be NIS 1.725 billion, payable by all the defendants jointly and severally.

The Court decided, with the consent of the plaintiff's attorney that the cause of action under the Consumer Protection Law shall not be dealt with as part of the petition for approval of a class action. This decision means that the amount of the claim, in respect of which approval of a class action is requested, stood at NIS 1.025 billion only (as of date of submission of the claim).

On January 29, 2003, the Court admitted the submission of the class action suit against CAL, Diners Club, Isracard and American Express, as detailed in the amended indictment submitted by the appellant, inter-alia, in relation to the claim of the appellant that in the relevant period concerning the action, the above defendants were party to a monopoly in the clearing market of VISA, Diners, Isracard, MasterCard and American Express credit cards, respectively, and that, prima facie, they have misused their alleged monopolistic position, and allegedly fixed improper prices for their services (hereinafter – "the approval decision").

The Court also decided to admit the filing of a class action suit against the Bank and Bank Leumi, only in the matter

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

of the cause of action in respect of the existence of a binding arrangement. Amongst other matters, the Court decided that, prima facie, the conduct of the two banks with respect to VISA and Diners credit cards issued by CAL and Diners Club would indicate a binding arrangement. On the face of it, a binding arrangement avoids competition and the lack of competition damages those who require a service with no competition, and that the appellant and the members of the group that are, prima facie, the victims of the lack of competition.

On February 10, 2003, the Court ordered that the procedures in the class action, including the issue of the notice to the approved group, should be delayed until a decision is given in the petition for permission to appeal. On March 17, 2003, the bank petitioned to the Supreme Court for permission to appeal against the approval decision, as aforementioned. On the same day CAL together with Diners have also requested permission to appeal against the said decision of the Court.

On March 14, 2005, the Supreme Court decided to accept the Bank's appeal, and thus dismissed the plaintiff's request that the action be treated as a class action suit.

15.3.2 In September 2004, an action was filed with the Tel-Aviv District Court against ICC, the Bank and Bank Leumi together with a request for approval of the action as a class action. The amount of the class action is NIS 320 million, and it purports to represent all businesses, which since 1999 were charged by ICC with "manual statement commission" and with "minimum commission".

The claimant argues that when it joined the agreement of business houses with ICC it was promised that the only commissions that will be charged to it will be a sales commission, therefore the collection of additional commissions is unlawful; that the power determined in the agreement between it and ICC, according to which ICC is entitled to change at any time the terms of payment is a discriminating term in a uniform agreement; that the collection of commissions was made without due disclosure; and that in any event there is no factual justification for the collection of the said commissions.

The plaintiff submitted a request that the action against all the defendants be dismissed without an order for costs. The Court requested the Attorney General's position. The Attorney General has not yet presented his position.

15.4 Request to approve an action against Discount Mortgage Bank ("DMB") as a class action suit:

On November 2, 1997 a petition was filed with the Tel-Aviv District Court to approve the filing of a class-action suit against DMB and against three additional mortgage banks regarding the charging of commissions for life assurance and property insurance of borrowers. The amount set in the class-action suit is NIS 500 million, with no specific allocation to the banks involved.

Whereas, with respect to another request to approve an action as a class action, in a matter practically identical, the Court had already handed down its decision, which was appealed against, the Judge presiding in this case has decided that it will be heard only after the Supreme Court will issue a judgment in principle on the matters in dispute, which were raised in the appeal against the verdict already given. The claimant requested the Court to renew the hearing of the case, but at the hearing held on January 6, 2002. the Court decided to defer the hearing of the case to an undefined future date, anticipating the decision in principle of the Supreme Court. It should be noted that on April 3, 2003 the Supreme Court ruled in another case (not related to the banking sector). The Court ruling states that the effectiveness of Regulation 29 (of the Civil Proceedings Regulations) should be interpreted in a narrow manner, an interpretation that supports the Banks' claim in the matter. With regards to the said ruling, The Court, at the request of the claimants, allowed an additional hearing at the Supreme Court.

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

DMB has no knowledge as to when will the Supreme Court give the said decision or at what date will a hearing in this matter take place. Recently, at a hearing held in January 2004, the Judge decided to postpone the hearing of the case for an additional six months. At the end of this period, the claimant will have to decide as to continuation of the action. The plaintiffs have not yet requested to renew the hearing on the matter.

16. Additional claims against the Bank and its consolidated subsidiaries:

A class action suit and requests to approve certain actions as class action suits are pending against the Bank and its consolidated subsidiaries, which in the opinion of the Management of the Bank, which is based on legal opinions and/or on the opinion of managements of its consolidated subsidiaries, which is based on the opinions of their Counsels, respectively, as the case may be, it is not possible at this stage to evaluate their prospects of success, and therefore no provision have been included in respect therewith.

16.1 Class action suits and requests to approve as class action suits::

16.1.1 On December 8, 2002, a lawsuit was filed against the Bank and against Mercantile Discount Bank together with a plea to have it approved as a class action suit under the Banking Law (Customer Service) – 1981 This lawsuit was filed by a former customer of the Bank and of Mercantile Discount Bank, who in the past filed a suit on the same ground and a plea to have it approved as a class action suit under the Securities Law, which lawsuit was rejected as a result of non payment of Court fees.

The plaintiff raises claims against the Bank, according to which the Bank allowed the opening of fictitious accounts at the time of the securities issue by the Einy Company and granted credit to hundreds of "Straw Customers" without obtaining collateral. It is also alleged that, at a later stage, the Bank enabled the manipulation in the price of the shares. The plaintiff alleges that in doing so, the Bank violated the Securities Laws (Dispersion obligations, reporting obligations, responsibility for misstatement in a Prospectus and fraudulently manipulating the price of the shares), violating the Banking Laws (Banking Law, Customer Service [Investment consulting]), violated proper banking procedures, caused damaging injustice (negligence, fraud and violation of legal obligations) and also performed illegal acts.

The plaintiff estimates that the damage caused to him amounts to NIS 5.7 million. The total amount of the damage stated in the petition for a class action against the Bank and Mercantile Discount Bank together is NIS 500 million.

The Bank and Mercantile Discount Bank have submitted several preliminary pleas, including a plea for dismissal of the action due to the non-payment of Court fees, pleas for summary dismissal of the action, due to duplicate proceedings and misuse of the judicial process, and a plea for deleting documents and items from the claim brief. A date for the hearing the said pleas has not been fixed as yet.

The Court has deferred the date by which the reaction to the request for approval may be submitted until such time as these requests are decided, so that in effect, at this stage, the proceeding is in practice delayed until the decision on the preliminary requests.

See section 15.2 above for details of the action filed against Mercantile Discount Bank based on other grounds.

16.1.2 On May 23, 2004, a request was filed with the Tel-Aviv District Court to approve an action filed against the Bank as a class action. In the action the claimants state an amount of NIS 1,900 or NIS 33 (depending on the cause) as a personal claim and an amount of NIS 779 million for the class action.

According to the claimants, the Bank charged them with a line entry commission in respect of certain activities, where no commission should have been charged in their respect, this in accordance with instructions of the

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

Supervisor of Banks "Procedures regarding commissions". In addition it is claimed that the Bank unlawfully collects a line entry commission because the payment for the line entry is included already in the "ledger fees". Thus, according to the claimants, the Bank charges a double commission for the same service. According to the claimants the line entry commission derives from a binding agreement within the banks regarding the commission price, and constitutes a restrictive practice as defined in the Restrictive Business Practices Law. Accordingly the commission is unlawfully collected and is prohibited.

The class action requests a declarative relief according to which the Bank was not entitled to collect an excess line entry commission during the period of seven years prior to the filing of the action and that it was not entitled to collect a line commission at all.

On September 1, 2004, the Bank filed a response to the request for approval of a class action, in which it requested to have the request dismissed both in limine and as to substance.

The hearing of the approval request and of the action has not yet begun at this stage.

16.1.3 On June 23, 2004, an action was filed with the Tel-Aviv District Court together with a request for approval of this action as a class action. The personal claim included in the action is NIS 6. The claimant estimates that the class numbers about 375,000 members and the amount of the class action is estimated by the claimant at NIS 200 million. (According to the Bank's examination, even in the most extreme scenarios, the maximum amount to which the Bank would be exposed would not exceed NIS 100 million).

According to the claimant, the Bank, in its publications and in information provided orally, created a presentation according to which the drawing of cash by way of the automatic teller machines is a commission free transaction, while in fact the Bank collects a line entry commission with respect to such an activity.

The hearing of the approval request and of the action has not yet begun at this stage.

16.2 On September 1, 2004, an application for exemption from the Court fee was submitted to the Tel Aviv District Court in connection with a suit in a sum of NIS 500 million brought by the liquidators of a company against forty defendants, one of which was the Bank.

The suit against the Bank turns on three causes only, which relate to alleged injury valued at $4 million in respect of a transaction undertaken between the company in liquidation and a third party involving the sale of an asset mortgaged to the Bank, which, according to the liquidators' assertions, was sold for less than its true value, the release of the shareholders of one of the companies in the group from their guarantees in relation to the debts of the company to the Bank totaling NIS 3 million; and the return of deferred payment orders to the company in liquidation without the items passing through the company's bank account, thus causing injury valued at NIS 9 million.

For reasons of caution, it should be noted that although the liquidators claim that the behavior of the Bank as described above led to the final liquidation of the company, but this assertion was made in general terms only without any specific claims having been made by the liquidators as to the injury attributable to the Bank in relation to this cause of action.

The Bank submitted an objection to the requested exemption. The hearing on the request has not yet been held and for so long as the exemption from payment of the Court fee is withheld, the suit is not considered to have been submitted.

16.3 A request to approve a certain action against Discount Mortgage Bank ("DMB") as class action suit:

On June 19, 2000, two borrowers of DMB filed with the District Court a petition for approval of an action as a class action suit against DMB and against the Israel Phoenix Insurance Co. Ltd. ("Phoenix"), where the properties of the

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

borrowers are insured. The action is for an amount of NIS 105 million.

The borrowers claim, inter alia, that DMB has insured their properties for amounts which exceed their reinstatement value, and that the sum insured was increased in excess of the increase in the Consumer Price Index.

On September 10, 2000, DMB filed its response to the petition for approval of a class action suit, in which the Court is requested to dismiss the petition in limine and as regards its substance. It should be noted that Phoenix Insurance also responded to the petition requesting the Court dismiss the petition in limine and as regards its substance.

On October 29, 2000, the claimants submitted their reply to the above response, in which they repeat the request for approval of a class action suit.

On December 25, 2000, the Court decided that the arguments raised in this petition were similar to the arguments raised in the pleas for approval of class actions discussed in (15.4.2) above, and consequently the Court decided to defer the hearing of the said petition until after the verdict is given in those other pleas. The Supreme Court rejected on April 4, 2001, a plea for permission to appeal this decision.

In its decision of December 25, 2000, the District Court did not determine that proceedings against Phoenix Insurance should also be stayed. Phoenix Insurance petitioned the Supreme Court for permission to appeal in this respect. On January 28, 2002, the Supreme Court admitted the plea of Phoenix Insurance and ordered to stay proceedings against it at the District Court.

The Management of the Bank, based on the opinion of the Management of DMB, based on Counsel's opinion, is of the opinion that it is not possible to estimate the prospects of the action itself, at the present stage of the proceedings regarding the petition for approval of a class action suit, and no provision was included in respect thereof.

16.4 Israel Discount Capital Markets and Investments Ltd. ("DCMI") – a legal procedure:

On December 21, 1999, an indictment was filed with the Magistrate Court in Tel-Aviv against several parties including DCMI and its two former employees. The felonies attributed to DCMI and the said two employees, constitute violations of the Securities Law, which allegedly were committed during the years 1994 and 1995.

DCMI denied the accusations and has submitted to the Court a response brief. The hearing of the evidence began on March 2002. The Management of the Bank based on the opinion of the Management of DCMI, based on Counsel's opinion, is of the opinion that, it is not possible at this stage to estimate the prospects of a conviction in this case.

17. Following are details regarding contingent liabilities and other special commitments, including a plea with the Supreme Court in Jerusalem, in insurance matters relating to Discount Mortgage Bank ("DMB"):

17.1 The insurance agent license:

DMB acts as a life and property insurance agent with respect to its customers, in accordance with an insurance agent license granted to it since 1966.

In a letter dated March 4, 1997, the Supervisor of Banks informed DMB of his position that DMB, acting as an insurance agent, is a non-permissible activity for this bank under the provisions of the Banking Law (Licensing). DMB has therefore been requested to cease acting as an insurance agent and to return the insurance agent license held by it within a reasonable period of time in accordance with the provisions of the Supervision of Insurance Businesses Law. DMB has also been requested to advise the Supervisor of Banks as to the steps that have been taken in order to comply with the above.

In a letter dated March 25, 1997, DMB rejected the standpoint of the Supervisor of Banks on legal and factual

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

grounds, which support the claim of this bank, that such an activity constitutes a related activity permitted to mortgage banks.

At the beginning of each year between 1999 and 2005, DMB received a clarifying notice from the Office of the Commissioner of the Capital Market, Insurance and Savings, that despite the fact that the insurance agent license of DMB was renewed in respect of each year since 1999 onwards, in view of the discussions which are being held by the various Authorities and the legal proceedings taking place, the Commissioner reserves the right to regularize DMB's activity in the insurance business.

The insurance agent license DMB rejected the right claimed by the Commissioner to withdraw the insurance agent license granted to it.

17.2 Petition to the High Court of Justice on the subject of borrowers insurance:

In November 2004, the Bank endorsed the above guarantees in favor of Visa Europe Services Inc., an autonomous branch of Visa International representing Visa members operating in Europe.

The Institute of Insurance Agents in Israel and the Israeli Consumers Council filed in August 1998, a plea with the Supreme Court in Jerusalem, sitting as a High Court of Justice, requesting an Order Nisi and an Interim Order against the Minister of Finance, the Attorney General, the Supervisor of Banks, the Commissioner of the Capital Markets, Insurance and Savings Division (the "Commissioner of Insurance"), the Commissioner of Restrictive Trade Practices and four mortgage banks including DMB.

It is alleged in the plea that the respondent banks engage in insurance brokerage, a matter prohibited by law, and therefore the Court is requested to instruct the governing bodies appearing as respondents to the plea, to exercise their authority in the matter of supervision, inquiry and indictment, respectively. As to the supervisory authority, the Court is requested to instruct the relevant governing bodies to cause the mortgage banks to refrain from dealing in insurance brokerage, and to cause insurance companies to refrain from accepting insurance business referred to them by the banks and from paying the banks' commissions in this respect.

In October 1998, the State Attorney's Office submitted a response on behalf of the various State authorities stating, inter-alia, that the issue of selling of insurance by the mortgage banks is being discussed for quite some time by the various State authorities, and that the State requires an additional period of time in order to conclude such discussions, formulate a policy and arrive at an overall arrangement of the matter, including, where necessary, an appropriate legislation and instructions to the banks as to its implementation. The State Attorney's Office also indicated that the Minister of Finance is not willing to allow mortgage banks to engage in the all encompassing marketing of insurance policies.

The response brief further stated that no police inquiry has been instituted against the mortgage banks, therefore, at this stage, no charges can be preferred against the banks, based on findings of an investigation which did not take place.

A Court hearing in the matter was held on February 2, 2000. In its decision the Court ordered the relevant State's authorities to provide reason why they should not take steps to terminate the activity of mortgage banks in the insurance brokerage business, as long as the law does not regulate the said activity. The Court has also ordered all the respondents, including the banks, to give reason why supplementary arrangements, which will allow supervision over the activity of banks in insurance business, should not be determined. The Court ordered that responses to the order nisi issued should be submitted within six months from date of submission of the Court's decision.

On October 5, 2000, the Authorities submitted their response affidavit to the said request for an Order Nisi.

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

17.2 Petition to the High Court of Justice on the subject of borrowers insurance (continued):

It appears from this affidavit, that the minister of Finance is of the opinion that it is to the benefit of the consumers and of the Israeli economy to continue and allow the mortgage banks to offer the borrowers to purchase the relevant insurance through them, subject to the regulation of this activity in accordance with the principles of the proposed arrangement described above. In addition, the response affidavit states that following the decision of the Minister of Finance, work began on drafting the principles of the proposed arrangement into legislation, and that it is expected to complete the memorandum for the proposed Bill and the draft Regulations within the next few months. Under these circumstances, it is argued in the response affidavit that the request for a remedy as part of the Order Nisi is no longer needed. Furthermore, and considering, inter alia, the many years in which the mortgage banks have provided insurance services, and the damage which may be caused to the banking system and to the borrowing public if this activity is to be stopped, the activity of the respondent mortgage banks in this action should not be stopped, until the said arrangement is completed and that the decision of the Minister of Finance in this matter should not be interfered with. Based on these arguments and on additional arguments stated in the response affidavit, the Court was requested to reject the plea.

On November 13, 2002, a response brief to the request on behalf of Discount Mortgage Bank Ltd., was submitted to the Court. The response brief requests the Court to summarily dismiss the request of the bank and dismiss the request itself on the grounds detailed in the response brief. The submission of the response briefs by the other respondents has also been completed.

On December 12, 2001, the proposed Law for the Supervision of Insurance Business (Special Agent License – Temporary Regulation) - 2001, was published dealing with the regulation of the continued activities of the banks in property insurance and in life assurance, which is incidental to the granting of housing loans. According to the Law proposal, the Supervisor will be empowered to issue banks with a special agent license on condition that the personnel transacting insurance business on behalf of the bank will hold an insurance agent license. Furthermore, the Minister of Finance, after consultation with the Governor of Bank of Israel, will be empowered to issue regulations regarding the involvement of banks in insurance business. According to the Law proposal, the Law will remain in effect for a period of three years from the date it will come into effect.

The Management of Discount Mortgage Bank believes that under the said conditions, unless changed, the ability of the bank to operate in this market will be restricted, though at this stage it is not possible to evaluate the effect of the proposed change, if approved, on the future income of DMB.

Between December 2001 and February 2005, the hearing in the High Court of Justice had been continually postponed at the request of the State authorities, which had been trying, in different ways, to arrive at an arrangement on the subject of insurance policies being sold along with mortgage loans.

On February 20, 2005, the Supervisor of Banks published a circular relating to the marketing of life assurance and property insurance policies in connection with loans taken out for housing purposes. The circular was accompanied by a joint policy declaration of the Supervisor of Banks and the Supervisor of Insurance, dated February 17, 2005, which prescribes the principles for marketing life assurance and property insurance policies by a banking corporation as security for the repayment of a housing loan.

According to the policy declaration, which is expected to be anchored in legislation and Bank of Israel directives, the above insurance policies will be marketed at unmanned sales points operated by technological means, that will be

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

17.2 Petition to the High Court of Justice on the subject of borrowers insurance (continued):

separated from all other banking activities. The policies will be sold through an authorized agent acting as an authorized insurance agency, whose business is quite distinct from that of the Bank, by employees of the agency who are not employees of the Bank.

A banking corporation shall be entitled to possess full ownership of the insurance agency, whose business shall be limited to insurance policies referred to above. The agency shall have a computer system at its disposal segregated from the banking corporations computer system, access to which shall be available only to agency employees. It shall be forbidden to use the information obtained by the insurance agency for any purpose other than that for which the agency was established. Collection of the premiums on the insurance policies shall be made separately from those of the loan.

Any banking corporation interested in receiving a permit to control an insurance agency for the aforementioned activities should apply to the Supervisor of Banks.

In the above circular, the Supervisor of Banks have clarified that, as of October 1, 2005, a banking corporation shall not market insurance policies except in accordance with the directives described in the circular. The above notwithstanding, an insurance policy entered upon before October 1, in accordance with the previous arrangements, may be continued or renewed

On February 21, 2005, DMB formed a fully owned subsidiary named Discount Mortgage Agency Ltd., with the future intention of applying to the Supervisor of Banks for a permit that would allow the subsidiary to operate as an insurance agency in accordance with the terms of the said circular.

The State has submitted a further request for the granting of an agreed extension for the purpose of submitting an updating notice within an additional six months, i.e., by July 2, 2005. Within the request, the State has noted that, in its opinion, the process of regulating the operations of the mortgage banks in the insurance field is expected to conclude in the near future. As of the date of the financial statements, the Bank is not aware of any decision with respect to the State's request for an extension for the purpose of submitting an updating notice.

In a memorandum for the law proposal regarding "Improved competition and reduced centralization and minimization of conflicts of interest in the Israel capital market," published in February, a proposal is presented for the amendment of the Banking (Licensing) Law so as to allow for the possibility of a bank to solely control a corporation which operates as an insurance agency and whose business involves the sale of life assurance and property insurance policies along with mortgage loans.

The Management of the Bank, based on the opinion of the Management of DMB, based on Counsel's opinion, believes that at this stage it is not possible to assess the outcome of the matter. If the plea is admitted however, it will result in a significant decline in the income of DMB.

17.3 DMB offers life assurance policies to borrowers who were granted housing loans as part of the collateral set-up securing the repayment of the loan. On November 4, 1997, the assurance company granting these policies received a letter from the Ministry of Finance – Capital Market, Insurance and Savings Division, instructing it to stop, as from January 1, 1998, the payment of commissions to the bank in respect of life assurance of borrowers.

Counsel for the insurance company has written to the Supervisor of Insurance Business disputing the contention that the payment of commissions was unlawful.

Nevertheless, DMB is aware of the fact, which was also stated in the State's response to the appeal to the High Court of Justice, that discussions between the Supervisor of Banks and the Supervisor of Insurance, and the

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

mortgage banks, in order to achieve an arrangement for the past and present operations of those banks with respect to the issuance of life assurance policies to borrowers.

Discount Mortgage Bank Ltd. has no means of evaluating whether the said instruction will remain in force and whether it will have an effect on its earnings from such commissions, including commissions received in prior years (the income from the said commissions recorded by the bank in the years 1998 to 2004, amounts in total to NIS 105 million).

The income of DMB from life insurance commissions, amounted to NIS 13 million in 2004, compared with NIS 14 million in 2002. The income of DMB from property insurance commissions amounted to NIS 12 million in 2004, compared with NIS13 million in 2003.

18. Pleas for approval of suits as class action suits – Harel Insurance Investments Ltd. (hereinafter - "Harel"):

The financial statements of Har'el describe, inter alia, various claims and requests for those claims to be approved as class action suits, in relation to which it was noted that, after consulting the company's legal advisors, the management of Har'el is unable to assess the prospects of these claims as follows:

18.1 A plea was submitted in October 2000, to the District Court in Tel-Aviv-Yafo, to approve an action against a consolidated subsidiary of Harel - Harel Insurance - as a class action suit, on behalf of all customers of Cellcom Israel Ltd. ("Cellcom"), who purchased insurance for their cellular telephones as from 1994 (hereinafter - "the Plea"). The other respondents in this case are Cellcom and Clal Insurance Company Ltd.

It is claimed in the Plea that VAT was unlawfully collected on the premium component, and also that unlawful insurance services were provided, in contravention of the Insurance Business Supervisory Law, 1981. A claim affidavit was attached to the Plea, which the claimants request to approve, the total amount of which, against all respondents, is NIS 402 million.

On January 3, 2005, a hearing took place at which the respondents suggested to the plaintiffs that they suspend their claim until the Supreme Court hands down a decision on another case which may have a significant bearing on the present claim. However, the plaintiffs did not accede the respondents' proposal. A further hearing was set for September 7, 2005.

18.2 On January 9, 2005, a request was submitted in the Tel Aviv District Court for the approval of a class action against a subsidiary of Har'el, Har'el Insurance. The claim concerns a claim that Har'el Insurance misled its commercial customers on the signing of comprehensive insurance contracts for vehicles weighing up to four tons, by failing to disclose that while the premium payable is calculated by reference to the full value of the vehicle as set out in the Yitzchak Levi tariff (which includes a VAT component), in the event of a claim being made on the policy, Har'el Insurance deducts the VAT component from the value of the vehicle. The plaintiffs estimated the total value of the damage sustained by all the members of the above group at NIS 31 million per year, and over a period of seven years, at NIS 217 million. (The relief sought is recompense by reference to of Har'el Insurance's records, and not by reference to the said estimate).

19. Certain requests for approval of class actions against the First International Bank of Israel Ltd.

19.1 The financial statements of the First International Bank of Israel Ltd. in describing details relating to claims made against that bank in amounts that are material, or claims which, by their nature, bear similar characteristics to other claims, the aggregate amount of which is material, make mention, inter alia, of two claims made by a single plaintiff in May 2004, together with a request that these two claims be approved as a class action suit. These two claims specify that the First International Bank was not entitled, in general, to charge a line entry commission, and in

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

particular for cash withdrawals. The full amount of these class action claims is NIS 550 million.

19.2 The financial statements of the First International Bank of Israel Ltd. in describing details of requests for approval of class actions that are pending against this bank and against its subsidiaries, and with respect to which management of the First International Bank, after consulting with legal advisors, is unable to estimate, at this stage, the prospects of these claims and therefore no provision has been made therein, make mention, inter alia, of the following procedure:

In 1997, claims were brought in the Tel Aviv District Court against two subsidiaries of the First International Bank – the First international Mortgage Bank Ltd. and the Mortgage Ltd. and Atzma'ut Mortgage and Development Bank Ltd. (hereinafter: "the mortgage banks in the First International Group"), and against other mortgage banks, in which it was claimed that the said banks unlawfully charged borrowers with a commission relating to life assurance and property insurance policies, and that the borrowers are entitled to the refund of such amounts. These claims total approximately NIS 1.5 billion (in nominal values). A petition to approve these action as a class action suits was also filed. The said claims and petition did not include the manner of calculation of the said amount; neither did they include details as to what part of the amount is attributed to the mortgage banks in the First International Group.

In November 1997, the Court rulled as to the action filed in July 1997, according to which it dismissed the claim in the form of a class action according to the Banking Law (Customer service), 1981, and the Restrictive Practices Law, 1988. Nevertheless, the Court ruled that it was possible to hear a claim for a declarative relief under Section 29 of the Civil Code Regulations, with respect to causes of action created prior to May 10, 1996 (date of publication of the amendments to these Laws regarding class actions).

In December 1997, the said banks applied to the Supreme Court for permission to appeal against the said judgment, as well as petitioned the court to stay execution of the proceedings until judgment is passed in this appeal. The request for permission to appeal and for the stay of execution has been admitted by the Supreme Court. The Court also ruled that a date for the hearing of the appeal would be fixed after submission by the parties of their arguments in the appeal case.

In a hearing held by the Supreme Court in the above appeal on November 25, 2001, the parties accepted the suggestion of the Court to stay the hearing of the appeals until a judgment is given in another appeal case pending at the Supreme Court, in which a fundamental decision is to be given in the matter of the status, applicability and terms of Section 29 of the Civil code Regulations, a question standing at the heart of the said appeal. As a result, no hearing took place on that date.

On April 2, 2003, a judgment was given in that other appeal in the matter of the status and applicability of Section 29 for the purpose of submitting a class action. Therefore, on April 10, 2003, the Supreme Court decided that the parties submit their arguments in writing as to the continuation of the appeal proceedings in view of the above decision.

As of date of signing the financial statements, all the parties have submitted their arguments as above. The decision of the Supreme Court in the matter has not yet been given.

20. Discount Israel Capital Markets and Investments Ltd., is a partner in several venture capital funds, and in this respect is obligated to invest in these funds. Furthermore, Discount Israel Capital Markets and Investments Ltd. owns 19.6% of the equity capital of Menif – Financial Services Ltd., which is engaged in the complementing of the equity capital of building contractors by providing guarantees.

As of December 31, 2002, Discount Capital Markets is committed to additional investments as follows: US$ 2.9 million

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

in the Mezzanine Fund; US$ 0.4 million in the International Fund; US$ 5.6 million in the second Vertex Fund; US$ 3.1 million in the Vitalife Fund; US$ 2.6 million in the Stage One Fund; US$ 0.8 in the Goldengate Bridge Fund and US$ 4 million in the Fortisimo Capital Fund. Through "Menif", the company also has an obligation to grant to building contractors guarantees amounting to US$ 6 million. As of December 31, 2003, outstanding guarantees granted amounted to NIS 11.6 million.

In addition, as of December 31, 2004, the Bank is committed to invest US$ 17.4 million in FIMI Opportunity Fund. Furthermore, Mercantile Discount Bank has a commitment to invest in five venture capital funds amounts totaling NIS 11 million, as of December 31, 2003 (as of December 31, 2003 – NIS 14 million).

21. a) A consolidated subsidiary of the Bank, "Badal" Computer and Management Services Ltd., entered on May 26, 1998, into an agreement with IBM Israel Ltd. ("IBM"), whereby Badal will purchase computers and peripheral equipment from IBM, and that IBM shall convert the existing central computer system of the Bank to the IBM computers, on a "turn key project" basis.

The contract price was US$ 18 million (not including VAT), of which an amount of US$ 8 million was paid by June 30,1999. At the end of June 1999, Badal informed IBM of the abrogation of the engagement, due to the format for the implementation of the conversion, which was found to be inapplicable.

b) The Bank has formed a workplan concerning the execution of a 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'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 amounted to US$ 116 million, not including VAT.

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

19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

for completion of the project, which, at the time, was estimated at one additional year (namely, completion of the project by the end of 2006). 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.

During the second half of 2004, additional systems were installed within the framework of the second roll out, including a significant system concerning deposits that was launched successfully in December 2004. Following the launching of this system, several failures have been discovered (most of them repaired), including the non-presentation of data relating to deposits in foreign currency at the automatic service machines (though this data was recorded in the central EDP system), and a failure as a result of which notices to customers have not been issued in time regarding deposits entries made and notices as to future maturities of deposits.

The second stage was also not implemented according to the set time schedules (as updated) and also deviated from the updated budget.

As a result of the conclusions drawn from the second roll out, the third roll out has been re-planned (as was the execution of all projects relating to the fourth roll out). Following this, Management of the Bank has prepared an update of the budget required for the second roll out (based on the actual cost) and of the budgets for the third and fourth roll outs. An update for the fifth roll out will be made, if necessary, with the progress of the project and the preparation of a detailed planning of these roll outs.

This budgetary update has recently been discussed by the Computerization Committee of the Board, which decided to recommend to the Board that the budget be increased to US$ 185 million, excluding VAT (namely: US$ 216 million including VAT). The Board of Directors is to deliberate this issue in one of its its coming meetings.

Until December 31, 2004, US$ 92.8 million (excluding VAT) have been invested in this project.

22. Sale of properties:

a) On June 30, 2002, the Bank signed an agreement for the sale of the plot of land adjacent to the Bank's Management building, on the corner of Yehuda Halevi and Lillienblum Streets in Tel-Aviv. The consideration for the sale is US$ 13.4 million. The agreement includes provisions for the payment of additional consideration in respect of additional building rights, if these are approved.

The Bank is committed to lease an area of some 11.6 thousand square meters in the office building to be erected on this site as well as underground and parking space, for a period of 13 years at an annual cost of US$ 2.6 million.

b) On September 19, 2002, the Bank signed an agreement for the sale of a warehouse area in Ashdod of some 37 dunums, in consideration for US$ 6.1 million.

The Bank is committed to lease an area of some 15.2 thousand square meters, of which a built-up area of 6.5 thousand square meters, for a period of 11 years, at an annual cost of US$ 309 thousand.

c) On June 4, 2004, the Bank signed an agreement with another party for the sale of the building in Ramat-Gan, which had previously been designed to serve as the offices of the Bank's management, as well as for the sale of additional rights in the property, present and future. The proceeds of the sale amount to NIS 229 million.

The bank has undertaken to lease for a period of ten years an area of 430 sq. mtrs. In the commercial floor and an area of 2,145 sq. mtrs. in the office floors, in consideration for US$ 578 thousand per annum (two floors out of the 20 floors being built).

20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES

GENERAL

1. Transactions in derivative financial instruments involve market, credit and liquidity risks.
   A. The activity of the Bank involves exposure to various risks, including market risk. The market risk includes, inter-alia, linkage base, interest and exchange rate fluctuation risks, in the correlation characteristics between the various economic parameters, etc. As part of the overall Bank's strategy for the management of market risk, as stated above, the Bank combines in its financial asset and liability management and as a market maker, a wide range of derivative financial instruments. Among these financial instruments are: Forward transactions, IRS, FRA, SWAP, options purchased or written by the Bank, which hedge against changes in foreign currency exchange rates, inflation rates, interest rates, share indices, embedded options, etc.
   B. The credit risk involved in these transactions derives from the fact that the stated amount of the transaction does not necessarily reflect its credit risk. Such risk is measured according to the maximum amount of the loss that the Bank might sustain if the other party to the transaction will not honor its terms, net of amounts subject to enforceable set-off agreements.

      In computing the fair value, the Bank takes into consideration the credit risk relating to the counter party to the transaction, as regards two categories: customers and banks, considering the quality of the product.
   C. Market liquidity risk derives from the fact that it might not be possible to contain rapidly the exposure involved, mainly in markets of low level trading.
2. Where a derivative instrument is not intended as a qualified hedging, it is stated according to its fair value, changes in fair value being taken currently to income. Certain of these derivatives are intended and qualified as fair value hedging and cash flow hedging, while others are purchased or written as part of the asset and liability management of the Bank (ALM).
3. It is possible for the Bank to enter an agreement that in itself does not constitute a derivative instrument but which contains an embedded derivative. In respect of each contract the Bank evaluates whether the economic characteristics of the embedded derivative are not clearly and closely connected to those of the hosting agreement, and examines whether an independent instrument with the same terms of the embedded instrument would have agreed with the definition of a derivative instrument. Where the above terms are fulfilled, the embedded derivative is separated from the host agreement, treated as a derivative in its own right and stated in the balance sheet together with the host agreement at its fair value, changes in its fair value being taken currently to income. Where the Bank is unable to reliably identify and measure an embedded derivative for the purpose of its separation from the host agreement, the agreement as a whole is stated in the balance sheet at fair value.
4. The Bank maintains a written documentation of all hedging relations between hedging instruments and the items hedged, as well as the object and strategy of risk management by way of creating the various hedging transactions. The documentation includes the specific identification of the asset, liability, the firm commitment or the anticipated transaction, which were determined as the hedged item, and the manner in which the hedging instrument is expected to hedge against risks involved in the hedged item. The Bank assesses the effectiveness of hedging relations both at the beginning of the transaction and on a continuing basis, in accordance with its risk management policy.
5. The Bank discontinues its hedging accounting from the following points onward when:
   a. It has been determined that the derivative is no longer effective, setting off the changes in fair value or the cash flows of the hedged items;
   b. The derivative has expired, cancelled or realized;
   c. The designation of the derivative as a hedging derivative is discontinued, due to the probability of the execution of the

20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES(CONTINUED)

transaction being remote.

d. A firm hedging commitment no longer complies with the definition of a firm commitment.

e. Management cancels the designation of the derivative as a hedging derivative.

When hedging accounting is discontinued due to the fact that a derivative is no longer qualified as hedging an effective fair value, the derivative will continue to be stated in the balance sheet at its fair value, however the hedged asset or liability will no longer be adjusted for changes in fair value. When hedging accounting is discontinued due to the fact that the hedged item no longer qualifies as a firm commitment, the derivative will continue to be stated in the balance sheet at fair value and every asset or liability which previously were stated based on the recognition as a firm commitment shall be removed from the balance sheet and recognized as income or loss for the reported period.

The net income or loss in respect of derivatives related to discontinued hedging of cash flow, will continue to be stated as part of other cumulative comprehensive profit, unless it is probable that the anticipated transaction will not materialize until the end of the initially determined time period (as documented at the beginning of the hedging relations) or within a period of two months thereafter.

Notwithstanding the above, on rare occasions, the existence of mitigating circumstances related to the nature of the anticipated transaction, which are not subject to the control or influence of the Bank, might indicate the probability that the anticipate transaction would in fact materialize at a date subsequent to the end of the additional two month period. In such a case, the net profit or loss in respect of the derivative, which hedges the discontinued cash flow, will continue to be reported as part of other cumulative comprehensive profit, until they are reclassified when the anticipated transaction will affect the income statement. If it is probable that the additional period of two months and the anticipated hedged transaction do not fall even under the exception mentioned above, the profit or loss reported as part of other cumulative comprehensive profit, are to be immediately reclassified to the income statement.

FAIR VALUE HEDGING

6. Certain derivatives are being designated by the Bank as hedging fair value. The changes in the fair value of derivatives hedging against exposure to changes in fair value of an asset or liability, are currently recognized in the income statement, as well as the changes in the fair value of the hedged item, that could be related to the risk being hedged.

   In 2004, the Bank recorded an expense of les than NIS 0.1 million, in respect of the lack of effectiveness related to fair value hedging in the item "Income from financing operations (before provision for doubtful debts") (In 2003: NIS 0.2 million).

CASH FLOWS HEDGING

7. The Bank designates certain derivatives as hedging against cash flows. The accounting treatment of changes in derivatives hedging against exposure to changes in the cash flow derived from an asset, liability or an anticipated transaction depends on the effectiveness of the hedging relations.

   - The effective part of the change in the fair value of the derivative designated to hedge cash flow, is initially recognized in the shareholders equity (and not in the income statement) as a component of other comprehensive profit, and later on, when the anticipated transaction affects the income statement, it is reclassified to the income statement.
   - The non-effective part of the change in the fair value of the derivative designated as above is forthwith recognized in the income statement.

20. DERIVATIVE INSTRUMENT ACTIVITY –VOLUME, CREDIT RISK AND DUE DATES

A. VOLUME OF ACTIVITY ON A CONSOLIDATED BASIS

	December 31, 2004				
	Interest rate contracts		Foreign currency	Contracts on shares	Commodities and other
	Shekel/CPI	Other	shares	contracts	and other
	Reported amounts[1]				
	in NIS millions				
1. Par value of derivative instruments					
A. Hedging derivatives[2]					
Forward contracts	-	1,334	-	-	-
Other option contracts:					
Options purchased	-	153	6	847	9
Swaps	-	1,916	340	-	-
Total	-	3,403	346	847	9
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	746			
B. ALM derivatives[2][3]					
Futures contracts	-	82	-	-	-
Forward contracts	606	2,077	19,001	-	-
Options purchased	-	-	-	2	-
Other option contracts:					
Options written	-	-	63	-	-
Options purchased	-	-	469	1	-
Swaps	-	5,782	4,107	-	-
Total	606	7,941	23,640	3	-
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	3,186			
C. Other derivatives[2]					
Forward contracts	-	1,345	310	134	1,105
Marketable option contracts:					
Options written	-	-	594	1,860	15
Options purchased	-	-	594	1,868	15
Other option contracts					
Options written	-	1,195	13,476	853	9
Options purchased	-	1,138	13,390	27	-
Swaps	-	638	-	-	-
Total	-	4,316	28,364	4,742	1,144
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	-			
D. Credit derivatives and SPOT foreign currency swap contracts					
SPOT foreign currency swap contracts	-	-	2,921	-	-

Footnotes:
(1) See Note 1 B.
(2) Excluding credit derivatives and SPOT foreign currency swap contracts
(3) Derivatives comprising a part of the asset and liability management system.

20. DERIVATIVE INSTRUMENT ACTIVITY –VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

A. VOLUME OF ACTIVITY ON A CONSOLIDATED BASIS (CONTINUED)

	December 31, 2003				
	Interest rate contracts		Foreign currency	Contracts on shares	Commodities and other
	Shekel/CPI	Other			
	Adjusted amounts[1] in NIS millions				
A. Hedging derivatives[2]					
Forward contracts	-	122	-	-	-
Marketable option contracts:					
Options purchased	-	254	-	795	-
Swaps	-	2,133	470	-	-
Total	-	2,509	470	795	-
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	1,283			
B. ALM derivatives[2][3]					
Futures contracts	-	4	-	-	-
Forward contracts	347	1,839	16,211	-	-
Marketable option contracts:					
Options written	-	-	88	-	-
Options purchased	-	-	403	1	-
Swaps	-	4,877	7,734	-	-
Total	347	6,720	24,436	1	-
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	2,222			
C. Other derivatives[2]					
Forward contracts	-	4	-	486	647
Marketable option contracts:					
Options written	-	-	336	1,767	320
Options purchased	-	-	336	1,767	320
Other option contracts:					
Options written	-	254	9,459	796	-
Options purchased	-	232	9,056	8	-
Swaps	-	33	-	-	-
Total	-	523	19,187	4,824	1,287
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	4			
D. Credit derivatives and SPOT foreign currency swap contracts					
SPOT foreign currency swap contracts	-	-	4,757	-	-

Footnotes:
(1) See Note 1 B.
(2) Excluding credit derivatives and SPOT foreign currency swap contracts
(3) Derivatives comprising a part of the asset and liability management system.

20. DERIVATIVE INSTRUMENT ACTIVITY –VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

A. VOLUME OF ACTIVITY ON A CONSOLIDATED BASIS (CONTINUED)

	December 31, 2004				
	Interest rate contracts		Foreign		
	Shekel/CPI	Other	currency shares	Contracts on contracts	Commodities and other
	Reported amounts[1]				
	in NIS millions				
2. Gross fair value of derivative instruments					
A. Hedging derivatives					
Positive gross fair value	-	159	117	62	2
Negative gross fair value	-	288	-	5	-
B. ALM derivatives					
Positive gross fair value	1	450	497		-
Negative gross fair value	7	535	413	-	-
C. Other derivatives					
Positive gross fair value	-	47	553	49	57
Negative gross fair value	-	25	597	44	57

Footnote:
(1) See Note 1 B.

	December 31, 2003				
	Interest rate contracts		Foreign		
	Shekel/CPI	Other	currency shares	Contracts on contracts	Commodities and other
	Adjusted amounts[1]				
	in NIS millions				
A. Hedging derivatives					
Positive gross fair value	-	273	131	57	-
Negative gross fair value	-	367	10	3	-
B. ALM derivatives					
Positive gross fair value	-	283	598	-	-
Negative gross fair value	-	298	442	-	-
C. Other derivatives					
Positive gross fair value	-	-	356	75	31
Negative gross fair value	-	-	350	129	31

Footnote:
(1) See Note 1 B.

20. DERIVATIVE INSTRUMENT ACTIVITY –VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

B. DERIVATIVE INSTRUMENT CREDIT RISK BASED ON THE COUNTERPART TO THE CONTRACT, ON A CONSOLIDATED BASIS

	December 31, 2004					
	Governments Stock markets	Banks	Dealers/ brokers	central and banks	Others	Total
	Reported amounts[1]					
	In NIS millions					
Gross positive fair value of derivative instruments[2]	15	523	140	439	877	1,994
Net of set-off agreements	6	-	-	-	125	131
Balance of assets deriving from derivative instruments[3]	9	523	140	439	752	1,863
Off-balance sheet credit risk in respect of derivative instruments[4]	79	2,808	143	182	2,189	5,401
Total credit risk in respect of derivative instruments	88	3,331	283	621	2,941	7,264

Footnotes:
(1) See Note 1 B.
(2) Of which, NIS 108 million of positive gross fair value of derivative instruments.
(3) Of which, a balance of non-related derivative instruments of NIS 1,755 million reflected in the item "Other assets".
(4) Off-balance sheet credit risk in respect of derivative instruments (including derivative instruments having a negative fair value) as computed for the purpose of limitations on a single borrower indebtedness.

	December 31, 2003					
	Governments Stock markets	Banks	Dealers/ brokers	central and banks	Others	Total
	Adjusted amounts[1]					
	In NIS millions					
Gross positive fair value of derivative instruments[2]	13	758	127	201	705	1,804
Net of set-off agreements	3	-	-	-	79	82
Balance of assets deriving from derivative instruments[3]	10	758	127	201	626	1,722
Off-balance sheet credit risk in respect of derivative instruments[4]	67	2,746	129	124	1,714	4,780
Total credit risk in respect of derivative instruments	77	3,504	256	325	2,340	6,502

Footnotes:
(1) See Note 1 B.
(2) Of which, NIS 44 million of positive gross fair value of derivative instruments.
(3) Of which, a balance of non-related derivative instruments of NIS 1,678 million reflected in the item "Other assets".
(4) Off-balance sheet credit risk in respect of derivative instruments (including derivative instruments having a negative fair value) as computed for the purpose of limitations on a single borrower indebtedness.

20. DERIVATIVE INSTRUMENT ACTIVITY –VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

C. DUE DATES – PAR VALUE: CONSOLIDATED YEAR END BALANCES

	December 31, 2004				
	Up to 3 months	From 3 months to 1 year	From 1 Year to 5 years	Over 5 years	Total
	Reported amounts[1]				
	in NIS millions				
Interest rate contracts:					
Shekel/CPI	-	412	194	-	606
Other	3,467	4,485	5,423	2,285	15,660
Foreign currency contracts	32,141	18,538	2,486	2,106	55,271
Contracts on shares	3,783	331	1,306	172	5,592
Commodities and other contracts	1,042	94	17	-	1,153
Total	40,433	23,860	9,426	4,563	78,282

	December 31, 2003				
	Up to 3 months	From 3 months to 1 year	From 1 Year to 5 years	Over 5 years	Total
	Adjusted amounts[1]				
	in NIS millions				
Interest rate contracts:					
Shekel/CPI	87	242	18	-	347
Other	1,106	3,889	3,329	1,428	9,752
Foreign currency contracts	28,594	17,488	1,991	777	48,850
Contracts on shares	3,881	528	1,044	167	5,620
Commodities and other contracts	1,287	-	-	-	1,287
Total	34,955	22,147	6,382	2,372	65,856

Footnote:
(1) See Note 1 B.

21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS

A. GENERAL

The instruction of Bank of Israel regarding the determination of the fair value of financial instruments (the "instruction"), was applied based on the methods and principal assumptions described hereunder. Nothing in the data presented hereunder should be taken as an indication of the economic value of the Bank, nor does the data purport to assess such value.

B. FAIR VALUE OF FINANCIAL INSTRUMENTS

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

Assessing the fair value by discounting future cash flows and determining the discount rate, is subjective. Therefore, the data for most of the financial instruments given hereunder, does not serve as an indication for the realization value of the financial instrument on the reporting date. Discounting the future cash flows was made, where possible, by discount rates in effect at the reporting date, without taking into consideration fluctuations in interest rates. Using different discount rates assumptions, may result in significantly different fair value amounts. This relates particularly to financial instruments bearing a fixed interest rate or non-interest bearing.

Additionally, in arriving at the fair value amounts, no consideration was given to commissions receivable or payable as part of the business activity, neither do they include the tax effect.

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

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

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

C. METHODS AND MAIN ASSUMPTIONS USED IN ESTIMATING THE FAIR VALUE OF FINANCIAL INSTRUMENTS

Bank deposits, non-marketable bonds and loan notes and credit to the Government:

Discounting future cash flows at rates at which the Bank transacted business at the reporting date.

Marketable securities - At their market value.

Credit to the public - Fair value of the balance of credit to the public was determined at the present value of future cash flows using an appropriate discount rate. The credit balance was segmented into homogeneous groups, the cash flows of which were discounted at rates, which reflects the estimated risk related to the credit in each group.

The classification into homogenous categories in the business sector, has been made, to the extent possible, on the basis of a grading model used at present by the Bank, which reviews the level of risk inherent in the debt in accordance with financial and other indices. It should be noted that as of December 31, 2004, the Bank has classified some 95% of the indebtedness which has to be classified according to the directives of the Supervisor of Banks (31.12.2003: 94%).

In certain cases, where grading data is not available, the segmentation is made on the basis of an overall evaluation of the risk level relating to the business sectors in which the borrowers operate. In this respect, it should be noted that the general risk level, as evaluated for a particular business sector, is not necessarily identical to the risk level of a particular borrower operating in that sector, none the less, to the risk level relating to the credit which the Bank grants to that borrower.

21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS (CONTINUED)

The discount rates used were generally determined according to interest rates applying to similar transactions effected at the reporting date. With respect to short-term credit balances (initial period of up to three months), or balances bearing variable market interest (prime, LIBOR, etc.), it was assumed that the amount stated in the balance sheet reflects their fair value.

The fair value of problem debts, net of the provision for loan losses, was calculated using discount rates reflecting the high credit risk involved. In any event, these discount rates are not less than the higher interest rate applying to transactions made by the Bank at the reporting date.

Problem debts having no maturity date, are stated according to their value in the books of the Bank, as in the circumstances, it was not practicable to evaluate the timing of their repayment rate, and therefore no expected future cash flow was calculated in their respect.

The general, supplemental and special provisions for doubtful debts were not deducted from the balance of outstanding credit for the purpose of calculating the cash flows when determining the fair value.

Deposits, bonds and loan notes - Capitalizing future cash flows at a rate at which the Bank pays interest on similar deposits, or on the issue of similar bond and loan notes at the reporting date.

Financial instruments (except for derivatives and marketable financial instruments) for an initial period of up to three months and at a variable market interest rate - It is assumed that the amounts stated in the balance sheet reflect their fair value.

Derivative financial instruments - Such financial instruments, which have an active market, were evaluated at their market value, and where several such markets exist, the evaluation was made in accordance with the most active market.

Derivative financial instruments which are not traded on an active market were evaluated according to models in use by the Bank in its current operations and which take into account the risks involved in the financial instrument: market, credit and other risks. The consideration as regards the credit risk relating to the counter party to the transaction, relates to two categories: customers and banks, considering the quality of the product.

Off balance sheet financial instruments which involve credit risk - The fair value is presented according to the outstanding balance of commissions on the said transactions, which approximate fair value. The fair value of irrevocable commitments to grant credit, which were approved but not yet executed, does not differ materially from the value of these commitments, as they are presented in Note 19 A.

The bank and its banking subsidiaries in Israel present the balances and fair value estimates of Financial Instruments according to the directive of the Supervisor of Banks. A banking subsidiary abroad presents the balances and fair value estimates of Financial Instruments according to generally accepted accounting principles in the US, which do not materially differ from those of the Supervisor.

21.BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS (CONTINUED)

D. CONSOLIDATED

	Balance as of December 31,2004			
	(1)	(2)	Total	Fair value
	Reported amounts**			
	in NIS millions			
Financial assets				
Cash and deposits with banks	15,146	2,605	17,751	18,073
Securities	33,870	5,566	39,436	39,429
Credit to the public	38,443	39,065	77,508	78,161
Credit to the Government	107	164	271	270
Other financial assets	2,325	-	2,325	2,325
Total financial assets	89,891	47,400	137,291	138,258
Financial liabilities				
Deposits from the public	89,924	31,768	121,692	122,119
Deposits from banks	3,909	1,169	5,078	5,190
Deposits from the Government	77	67	144	155
Debentures and subordinated capital notes	131	4,678	4,809	5,043
Other financial liabilities	2,649	-	2,649	2,649
Total financial liabilities	96,690	37,682	134,372	135,156

	Balance as of December 31,2003			
	(1)	(2)	Total	Fair value
	Adjusted amounts**			
	in NIS millions			
Financial assets				
Cash and deposits with banks	15,194	1,694	16,888	17,153
Securities	38,132	-	38,132	38,132
Credit to the public	*35,777	40,687	*76,464	*76,936
Credit to the Government	159	208	367	366
Other financial assets	*2,159	-	*2,159	*2,159
Total financial assets	91,421	42,589	134,010	134,746
Financial liabilities				
Deposits from the public	*85,418	34,535	*119,953	*120,492
Deposits from banks	1,081	4,016	5,097	5,030
Deposits from the Government	59	112	171	192
Debentures and subordinated capital notes	129	4,094	4,223	*4,357
Other financial liabilities	*2,218	-	*2,218	*2,218
Total financial liabilities	88,905	42,757	131,662	132,289

* Reclassfied
** See Note 1 B.

Footnotes:
(1) Financial instruments the stated amounts of which approximate their fair value – instruments stated in the balance sheet at market value or which are for an initial period not exceeding three months, or based on market interest varying at frequencies of up to three months.
(2) Other financial instruments.

21.BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS (CONTINUED)

E. THE BANK

	Balance as of December 31,2004			
	(1)	(2)	Total	Fair value
	Reported amounts**			
	in NIS millions			
Financial assets				
Cash and deposits with banks	12,647	7,975	20,622	20,958
Securities	16,408	-	16,408	16,408
Credit to the public	17,960	26,212	44,172	44,296
Credit to the Government	104	164	268	267
Other financial assets	1,871	-	1,871	1,871
Total financial assets	48,990	34,351	83,341	83,800
Financial liabilities				
Deposits from the public	50,452	26,299	76,751	77,072
Deposits from banks	1,575	382	1,957	1,969
Deposits from the Government	18	20	38	37
Debentures and subordinated capital notes	210	3,365	3,575	3,749
Other financial liabilities	1,905	-	1,905	1,905
Total financial liabilities	54,160	30,066	84,226	84,732

	Balance as of December 31,2003			
	(1)	(2)	Total	Fair value
	Adjusted amounts**			
	in NIS millions			
Financial assets				
Cash and deposits with banks	12,495	7,044	19,539	19,799
Securities	16,278	-	16,278	16,278
Credit to the public	16,459	28,069	44,528	44,561
Credit to the Government	114	208	322	321
Other financial assets	*1,750	-	*1,750	*1,750
Total financial assets	47,096	35,321	82,417	82,709
Financial liabilities				
Deposits from the public	48,824	28,002	76,826	77,296
Deposits from banks	1,227	366	1,593	1,607
Deposits from the Government	31	23	54	53
Debentures and subordinated capital notes	201	3,441	3,642	*3,739
Other financial liabilities	*1,582	-	*1,582	*1,582
Total financial liabilities	51,865	31,832	83,697	84,277

* Reclassfied
** See Note 1 B.
Footnotes:
(1) Financial instruments the stated amounts of which approximate their fair value – instruments stated in the balance sheet at market value or which are for an initial period not exceeding three months, or based on market interest varying at frequencies of up to three months.
(2) Other financial instruments.

22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES

A. BALANCES:

	December 31,2004					
	Interested parties(1)		Related parties held by the Bank			
	Directors and President(2)		Affiliated companies		Others(3)	
	(4)	(5)	(4)	(5)	(4)	(5)
	Reported amounts* in NIS millions					
Assets						
Securities(6)	-	-	3	4	4	4
Credit granted to the public	1	1	35	35	435	435
Investments in affiliated companies(6)**	-	-	1,258	1,258	-	-
Liabilities						
Deposits from the public	4	6	212	263	2,851	2,910
Deposits from banks	-	-	64	117	-	-
Debentures and subordinated capital notes	-	-	18	22	185	312
Other liabilities	-	-	-	2	-	-
Credit risk in off-balance-sheet financial instruments(7)	3	3	44	85	391	391

* See Note 1 B.
** Includes unconsolidated subsidiaries in the amount of NIS 25 million (highest balance during the year NIS 25 million).
For notes to the tables see after Note 21 D.

A. BALANCES: (CONTINUED)

	December 31,2003					
	Interested parties(1)		Related parties held by the Bank			
	Directors and President(2)		Affiliated companies		Others(3)	
	(4)	(5)	(4)	(5)	(4)	(5)
	Adjusted amounts* in NIS millions					
Assets						
Deposits with banks						
Securities(6)(8)	-	-	3	3	93	93
Credit granted to the public	1	1	24	29	-	-
Investments in affiliated companies(6)**	-	-	1,218	1,218	-	-
Other assets	-	-	2	5	-	2
Liabilities						
Deposits from the public	5	8	155	177	2,135	2,803
Deposits from banks	-	-	117	128	-	-
Debentures and subordinated capital notes	-	-	14	19	319	327
Credit risk in off-balance-sheet financial instruments(7)	1	1	52	65	48	48

* See Note 1 B.
** Includes unconsolidated subsidiaries in the amount of NIS 21 million (highest balance during the year - NIS 21 million).
For notes to the tables see after Note 21 D.

22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES

B. SUMMARIZED RESULTS OF TRANSACTIONS WITH RELATED AND INTERESTED PARTIES:

	For the year ended December 31,2004		
	Interested parties[(1)]	Related parties held by the Bank	
	Directors and President[(2)]	Affiliated companies	Others[(3)]
	Reported amounts*		
	in NIS millions		
Income from financing activities before provision for doubtful debts**	-	(18)	(82)
Non-financing income	-	2	[(9)]109
Non-financing expenses***	(12)	(12)	-
Total	(12)	(28)	27

	For the year ended December 31,2003		
	Interested parties[(1)]	Related parties held by the Bank	
	Directors and President[(2)]	Affiliated companies	Others[(3)]
	Adjusted amounts*		
	in NIS millions		
Income from financing activities before provision for doubtful debts**	-	8	(119)
Non-financing income	-	4	[(9)]102
Non-financing expenses***	(8)	(15)	(2)
Total	(8)	(3)	(19)

* See Note 1 B.
** See Note 21 D.
*** See Note 21 C.

C. BENEFITS FROM THE BANK AND CONSOLIDATED SUBSIDIARIES TO INTERESTED PARTIES:

	For the year ended December 31, 2004		For the year ended December 31, 2003	
	Directors and President and CEO[(2)]		Directors and President and CEO[(2)]	
	Number of benefit		Number of benefit	
	Total benefit	Recipients	Total benefit	Recipients
	Reported amounts*			
	in NIS millions			
Interested parties employed by the Bank or on its behalf	10	2	6	2
Directors who are not employed by the Bank or on its behalf	2	14	2	16
Total	12	16	8	18

* See Note 1 B.
For notes to the tables see after Note 21 D.

22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)

D. RESULTS OF FINANCING TRANSACTIONS (BEFORE PROVISION FOR DOUBTFUL DEBTS) OF THE BANK AND ITS CONSOLIDATED COMPANIES WITH RELATED AND INTERESTED PARTIES*:

	Consolidated			Of which from Affiliated Companies		
	2004	2003	2002	2004	2003	2002
	Reported amounts**	Adjusted amounts**	Reported amounts**	Adjusted amounts**	Reported amounts**	Adjusted amounts**
	in NIS millions					
A. On assets						
Credit granted to the public	24	-	242	-	-	-
Total	24	-	242	-	-	-
B. On liabilities						
Deposits from the public	(82)	(114)	(24)	(11)	(7)	(1)
Deposits from the banks	(7)	(1)	(20)	(6)	(1)	(19)
Debentures	(36)	(16)	(1)	(2)	-	(1)
Total	(125)	(131)	(45)	(19)	(8)	(21)
C. On Derivative Financial Instrument						
Financicing income from other transactions	1	20	-	1	16	-
Total	1	20	-	1	16	-
D. Other						
Commissions from other financing income	-	-	87	-	-	82
Total	-	-	87	-	-	82
Total income from financing activities before provision for doubtful debts	(100)	(111)	284	(18)	8	61

* In respect of transactions made on the same terms that would have been made with a person that is not a related or interested party.
** See Note 1 B.

Footnotes: (relating to Note 22 A, B & C):
(1) Interested party - as defined by Securities Regulations.
Related party - as defined in Opinion 29 of the Institute of Certified Public Accountants in Israel, but is not an interested party.
(2) Including spouses and their infant children.
(3) A corporation in which the banking cororation holds 10% or more of the issued share capital or of the voting power therein, or is entitled to appoint 10% or more of its directors or its president and CEO.
(4) The balance at balance sheet date.
(5) The highest balance during the year on the basis of month-end balances.
(6) Details of these items are included also in the following notes:
Securities — Note 3.
Investments in Investee Companies — Note 6
Guarantees — Note 19 A.
(7) Credit risks of off-balance sheet derivative financial instruments as calculated for the purpose of setting borrower's limits.
(8) Available-for-sale securities in the consolidated balance sheet include also the sum of NIS 89 million, being investment in shares by a consolidated subsidiary.
(9) Income from securities operations received from provident funds managed by the Bank and by a consolidated subsidiary.

22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)

E. DATA IN REGARD TO PROVIDENT FUNDS ACCORDING TO THEIR BALANCE SHEETS WHICH HAVE NOT BEEN CONSOLIDATED:

	December 31,	
	2004	2003
	In millions of NIS	
(1) Managed by Discount Provident Fund Management Ltd. and the Bank[(1)]		
Members' balance	27,900	26,005
Investments in securities of related and interested parties	413	700
Deposits with the Bank and with its consolidated subsidiaries and affiliated companies	2,531	1,828
Capital notes	173	291
Management fees	104	97
(2) Managed by Mercantile Discount Bank:		
Members' balance	3,059	2,754
Investments in securities of related and interested parties	23	49
Deposits with the Bank and with its consolidated Subsidiaries	308	114
Management fees	19	17

Footnote:

(1) Including Kahal – Employees Supplemental Training Fund Ltd. and Kahal - Management of Further Education Funds (1996) Ltd., managed jointly with Bank Leumi Le Israel B.M. See also Note 19 C2.

22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)

F. As of October 31, 1993, the State of Israel holds a majority of the shares of the Bank (on December 31, 2004 AND 2003, it held 57.09% of the shares). The Supervisor of Banks has exempted the Bank from defining the State as "a related party" in the Bank, and accordingly balances and transactions with the State and companies under its control are not given.

G. Until 2003 IDB held approximately 12.54% of the shares of the Bank and was regarded as an interested party of the Bank. In the second half of 2003 IDB reported the sale of the shares in the Bank and since October 30, 2003, IDB is no longer an interested party in the Bank. In May 2003 the change in control of IDB was completed and a large number of companies was added to those which may have been considered interested parties in the Bank, for the said short period. Under these circumstances the Supervisor of Banks exempted the Bank from providing information as to "assets relating to transactions made with whoever was an interested party at the time of the transaction", in respect of transactions made in the ordinary course of business with IDB.

H. The Supervisor of Banks has exempted the Bank from providing information regarding transactions made in the ordinary course of business with provident and mutual funds of the Bank Leumi Group and with provident and mutual funds of the Bank Hapoalim Group, which are considered interested parties in the Bank.

I. According to an agreement between the Bank and Manpikim Discount Bank Issues Corporation (a consolidated subsidiary) in effect as from October 1, 1992, the Bank will credit this company with an amount calculated at a fixed and uniform rate of 0.07% per annum, on the CPI-adjusted balance of the deposits originating from debenture issues and with interest linked to the CPI on deposits linked to the CPI, derived from the shareholders' equity of the company.

J. The Bank has a commitment to pay directly to debenture holders and subordinate capital motes holders of the consolidated subsidiaries: Manpikim Discount Bank Issues Corporation Ltd. and Discount Mortgage Bank Ltd., upon the debentures' maturity, the amounts of the principal plus accrued interest and linkage differentials. The undertaking is in respect of the repayment of debentures, the proceeds of which were deposited with the Bank. The total of the liability in respect of the debentures of the consolidated subsidiaries, as at December 31, 2004, amounted to NIS 753 million (as at December 31, 2003 - NIS 95 million).

K. The Bank has commitments to the Tel-Aviv Stock Exchange as mentioned in Note 19C.8 and Note 19C.9.

L. The Bank is committed towards the "Ma'of" clearing house in respect of all clearing of "Ma'of" transactions and monetary liabilities derived from them relating to Ilanot.

M. Investee companies of the Bank are included in the framework of the undertaking granted by the Bank to VISA International (as stated in Note 19C.13).

N. In respect of indemnification of related and interested parties - see Note 19C.10 and 19C.11 (certain of the underwriters are interested parties).

O. Illanot-Discount, a consolidated subsidiary of the Bank, purchased capital notes of the Bank and of its other shareholder, who is an interested party in the Bank, amounting to NIS 75 million. These capital notes are not linked and do not bear interest.

In February 2003, Ilanot-Discount decided to demand immediate repayment of the said capital notes. As a result, the outstanding balance in respect of the other shareholder in the amount of NIS 34 million has been reclassified from securities held for redemption to available-for-sale securities. The said capital notes were redeemed in March 2003.

P. For details regarding the agreement signed subsequent to balance sheet date for the sale of a controlling interest in the Bank, see Note 37 hereunder.

23. INCOME FROM FINANCING ACTIVITIES BEFORE PROVISION FOR DOUBFUL DEBTS

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions					
A. On Assets**						
Credit granted to the Public	4,271	*2,798	*3,900	2,469	1,884	2,270
Credit granted to the Government	5	(24)	23	4	(21)	21
Deposits with the Bank of Israel and cash	128	325	(26)	96	323	(30)
Deposits with Banks	538	(56)	604	798	219	657
Bonds	1,450	(252)	1,442	937	751	512
Total	6,392	2,791	5,943	4,304	3,156	3,430
B. On Liabilities**						
Deposits from the public	(2,934)	(2)(976)	(3,612)	(2,297)	(2,080)	(2,495)
Deposits from the Government	(6)	(2)	(7)	(1)	(1)	(1)
Deposits from the Bank of Israel and cash	(4)	(9)	1	(3)	(7)	1
Deposits from banks	(185)	33	(196)	(55)	(38)	(48)
Debentures	(299)	(158)	(216)	(235)	(130)	(177)
Total	(3,428)	(2)(1,112)	(4,030)	(2,591)	(2,256)	(2,720)
C. In Respect of Derivative Financial Instruments and Hedging Activities						
Income (expenses) net in respect of ALM derivative instruments****	68	909	738	29	808	721
Income (expenses) net in respect of other derivative instruments	42	74	16	40	65	19
Total	110	983	754	69	873	740
D. Other						
Commissions on financing activities	120	109	126	58	48	70
Other financing income	207	89	44	105	99	(38)
Interest income on problem debts	99	*57	*67	83	39	43
Other financing expenses	(11)	66	(25)	(7)	(7)	(9)
Total	415	321	212	239	179	66
Total income from financing activities before provision for doubtful debts	3,489	(2)2,983	2,879	2,021	1,952	1,516
Of which: Net exchange differences	(57)	(224)	199	(2)	(23)	2

* Reclassified.
** Including the effective component of hedging relations
*** Derivative instruments comprising a part of the asset and liability management system of the Bank,which were not designed for hedging relations.

Footnotes:
(1) See Note 1 B.
(2) Restated - see Note 1 X.

23.INCOME FROM FINANCING ACTIVITIES BEFORE PROVISION FOR DOUBTFUL DEBTS (CONTINUED)

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions					
E. Results of Activity in Investments in Bonds						
Accrual basis, financing Income (expenses) from bonds:						
Held-to-maturity	(114)	3	5	6	(1)	9
Available for-sale	1,498	(263)	1,441	866	723	506
Trading	66	8	(4)	65	29	(3)
Total included in income on assets from financing activities	1,450	(252)	1,442	937	751	512
Gains on sale of available-for-sale bonds	112	86	53	86	59	46
Losses on sale of available-for-sale bonds*	(2)	(47)	(11)	(1)	(5)	(3)
Provision for decline in value of available-for-sale bonds	(12)	(24)	(63)	(9)	(16)	(63)
Net realized and unrealized gains (losses) from adjustment of trading bonds to fair value**	29	64	(67)	(3)	37	(64)
Total included in other financing income	127	79	(88)	73	75	(84)
Total from investments in bonds	1,577	(173)	1,354	1,010	826	428

* Of which NIS 9 million in respect of the transfer of bonds to the trading portfolio (2003: NIS 14 million).
** Of which: a part of the gains and losses relating to trading bonds that are still on hand at balance sheet date. Consolidated – NIS 32 million, the Bank – NIS 12 million (2003: consolidated – NIS 57 million, the Bank – NIS 18 million).

F. Details of the Net Effect of Derivative Instruments Hedging Earnings From Financing Operations						
Financing income (expenses) in respect of assets (item A)	26	1	-	(21)	-	-

Footnote:
(1) See Note 1 B.

24.OPERATING COMMISSIONS

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions					
Ledger fees (in Israeli and in foreign currency)	273	274	264	184	186	180
Payment order system service (in Israeli and in foreign currency)	395	404	379	281	293	260
Income from credit cards	519	470	434	54	53	44
Credit and contracts service	143	133	108	92	85	66
Computerized services, information and confirmations	43	44	40	36	37	32
Foreign trade transactions and special foregin exchange services	75	62	53	56	50	42
Income from customers' securities transactions	206	167	134	143	103	82
Margins and collection fees on credit and deposits, from deposits according to collection:						
Collection commissions on credit granted						
out of Treasury funds	17	18	20	-	-	-
Commissions and other margins	3	3	3	3	3	3
Management fees and commissions						
from life insurance	14	15	23	-	-	-
Management fees and commissions from property insurance	13	14	12	-	-	-
Commission on transfer of rent	3	4	5	-	-	-
Other income	41	40	33	15	17	14
Total operating fees	1,745	1,648	1,508	864	827	723

Footnote:
(1) See Note 1 B.

25. NET GAIN (LOSSES) FROM INVESTMENTS IN SHARES

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions					
Gains on sale of shares available-for-sale	23	6	6	23	6	3
Provision for decline in value of available-for-sale shares	(12)	(19)	(21)	-	(3)	(7)
Net realized and unrealized gains (losses) from adjustment of trading securities to fair value(2)	41	6	-	41	2	(1)
Dividends from available-for-sale or trading shares	51	16	4	11	7	4
Total from investments in shares	103	9	(11)	75	12	(1)

Footnotes:
(1) See Note 1 B.
(2) Of which, NIS 1 million (consolidated) and NIS (1) million (the Bank) being a part of the gains related to trading shares still held at balance date date (2003: Nis 3 million, the Bank - NIS 1 million).

26. OTHER INCOME

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions					
Management fees and expenses refund from provident funds	150	137	134	104	98	102
Management fees from mutual funds	138	*76	*81	14	5	3
Management fees from consolidated subsidiaries	-	-	-	3	3	3
Profit from severance pay funds	29	183	-	24	173	-
Other income	35	*38	*28	96	74	70
Total other income	352	434	243	241	353	178

* Reclassified.
Footnote:
(1) See Note 1 B.

27. SALARIES AND RELATED EXPENSES

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions					
Salaries	1,638	1,530	1,512	1,017	924	918
Severance pay, pension, further education fund, seniority bonuses, vacation and medical insurance	302	*253	*331	207	*146	*243
National Insurance and payroll taxes	321	292	212	244	230	137
Other related expenses	89	87	37	49	44	20
Adjustment of reserves for salary-related expenses due to changes in salaries during the year	40	*21	*36	37	*20	*18
Voluntary retirement program expenses	121	81	55	117	81	55
Total salaries and related expenses	2,511	2,264	2,183	1,671	1,445	1,391
Includes: Overseas salaries and related expenses	336	337	334	17	14	27

* Reclassified.
Footnote:
(1) See Note 1 B

On October 27, 2004, the Economic Policy for the Fiscal Year 2005 (Legislation Amendments) Bill – 2004 was tabled, in which it is proposed to amend the definition of wages in the Added Value Tax Law, to include also a grant payable upon retirement or death, and any amount paid by an employer to a further education fund or to a provident fund which is not a central severance pay fund, even though under Section 3 of the Income Tax Ordinance it is not considered employment income at the time the payment is made to the severance pay fund or to the provident fund.

Many ambiguities exist as to the interpretation of the application of the Bill to the various components of payroll. At this stage the Bank is unable to assess the effect of the Bill on its financial position and results of operations.

The said Bill, if passed in the proposed form, will have an effect of the payment of payroll tax in respect of amounts payable by the Bank to its employees, and thus will increase the payroll expense of the Group, by an amount estimated at NIS 28 million per annum.

28. OTHER EXPENSES

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions					
Advertising	138	107	116	41	38	37
Communications	92	99	*95	42	49	*46
Computer Services	210	136	*129	172	103	*98
Office Expenses	24	25	29	11	10	9
Insurance	42	44	21	22	22	9
Professional Services	98	84	90	35	33	30
Directors' Fees	9	8	7	2	2	2
Instruction and Training	10	10	9	7	7	6
Fees	17	17	27	10	11	12
Amortization of Goodwill	7	3	3	-	-	-
Other	(2)223	(2)172	(2)259	80	64	80
Total other expenses	870	705	785	422	339	329

* Reclassified.
Footnotes:
(1) See Note 1 B.
(2) Including expenses of NIS 6 million (2003: NIS 14 million, 2002: NIS 21 million) of an initially consolidated subsidiary in respect of damage due to the use of credit cards.

29. PROVISION FOR TAXES ON OPERATING INCOME

A. COMPOSITION:

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts[1]	Reported amounts[1]	Adjusted amounts[1]	Reported amounts[1]	Reported amounts[1]	Adjusted amounts[1]
	in NIS millions					
Taxes for current year	393	[2]423	200	67	120	2
Taxes for previous years	(39)	3	(51)	(38)	1	(51)
Total current taxes	354	[2]426	149	29	121	(49)
Addition (deduction):						
Deferred taxes for current year	(12)	[2](55)	55	(5)	(5)	16
Deferred taxes for previous years	-	-	3	-	-	3
Total deferred taxes	(12)	[2](55)	58	(5)	(5)	19
Total provision for taxes (tax saving) on operating profit (loss)	342	[2]371	207	24	116	(30)
Includes taxes of foreign subsidiaries	154	[2]78	111	-	-	1

Footnotes:
(1) See Note 1 B.
(2) Restated - See Note 1 X.

29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)

B. RECONCILIATION BETWEEN THE THEORETICAL TAX WHICH WOULD APPLY HAD THE OPERATING INCOME BEEN TAXED AT THE STATUTORY TAX RATE APPLYING TO A BANK IN ISRAEL, TO THE PROVISION FOR TAXES ON OPERATING INCOME, AS CHARGED IN THE STATEMENT OF INCOME:

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions					
Income tax at the statutory tax rate	354	(2)299	72	57	120	(181)
Income tax (tax savings) on:						
Increment (deduction) for inflation	(6)	-	-	1	-	-
Net adjustment differences on monetary assets	-	(6)	(4)	-	(7)	(12)
Income of foreign subsidiaries(3)	22	(2)71	(38)	-	-	-
General and supplemental provision for doubtful debts	4	16	20	(2)	16	19
Income exempt from tax or taxed at preferred rates	(2)	(7)	(13)	1	(3)	(11)
Adjustment differences on depreciation and capital gains	(5)	3	-	(5)	2	-
Other non-deductible expenses	18	14	16	12	9	14
Deferred taxes in respect of non-financial assets	1	-	-	(1)	-	-
Losses and timing differences (utilization), net, in respect of which no deferred tax assets were recorded	(44)	(30)	206	(37)	(36)	190
Profit tax on payroll tax	21	20	3	17	17	-
Change in the balance of deferred taxes resulting from the change in tax rates	30	-	-	19	-	-
Taxes for prior years	(39)	3	(53)	(38)	1	(48)
Erosion of advance-tax payments	-	(4)	1	-	(3)	-
Income of Israeli subsidiaries	(12)	(8)	(3)	-	-	(1)
Provision for taxes (tax saving) on income	342	(2)371	207	24	116	(30)

Footnotes:
(1) See Note 1 B.
(2) Restated - See Note 1 X.
(3) Not including inflationary component of previous years' income entitled to protection.

29. PROVISION FOR TAXES ON OPERATING INCOME

C. (1) Final tax assessments have been issued to the Bank for the tax years up to and including 2002. Following the settlement of the tax assessments for the years 2001 - 2002, the Bank cancelled excess provisions for income tax recorded in prior years on a conservative basis, in the amount of NIS 41 million. Following the settlement of the tax assessment up to and including 2000, the Bank cancelled excess provisions for income tax recorded in prior years on a conservative basis, in the amount of NIS 51 million.

(2) The major consolidated subsidiaries have received final tax assessments, or assessments deemed final, for tax years between 1997 to 2001.

D. The balance of carry forward losses and deductions for tax purposes, (Including losses in respect of available-for-sale securities, included in a capital reserve) in respect of which deferred tax assets have not been recorded by the Bank, as of December 31, 2004, amount to NIS 1,029 million, and to NIS 1,069 million on a consolidated basis. As od December 31, 2003: NIS 1,252 million and NIS 1,288 million on a consolidated basis.

E. On February 9, 2000, the Bank's shares in IDB New York were transferred to Discount Bankcorp. Inc. (hereinafter – "Bankcorp"), a wholly-owned holding subsidiary of the Bank, registered in the State of Delaware in the US. The transfer of the shares to Bankcorp was made at their value in the books of the Bank, in consideration for shares issued by Bankcorp.

The transfer of the shares was made in accordance with the provisions of Section 104A of the Income Tax Ordinance. The Bank is obligated to pay taxes in Israel with respect to the said transfer of shares, if and when such shares will be sold. The Bank provided the Income Tax Authorities with a guarantee as to the payment of the said taxes.

F. On June 29, 2004, the Knesset passed the Income Tax Ordinance Amendment Law (No.140 and provisional instruction) 2004 (hereinafter – "the Amendment").

The Amendment instituted a gradual reduction in company tax rate from a rate of 36% to a rate of 30%, as follows: 2004 - a tax rate of 35%, 2005 - a tax rate of 34%, 2006 - a tax rate of 32% and from 2007 and thereafter - a tax rate of 30%.

The reduction in company tax will reduce the aggregate statutory tax rate applying to banking corporations, as follows: 2004 - 44.52%, 2005 – 43.59%, 2006 – 41.88% and from 2007 and thereafter – 40.17%.

In view of the said amendment to the Ordinance, the provisions for future recording of tax expenses, net (deferred tax assets) have been recalculated in accordance with the tax rates that will be in effect in the period in which the realization of the deferred taxes is expected. The said updating of the deferred tax assets increased the tax expense of the Group in the first nine months of 2004 by NIS 33 million (the said amount is composed of the net effect on the balance of deferred tax assets at January 1, 2004, amounting to NIS 48 million, less deferred tax assets calculated in respect of net timing differences in the first nine months of 2004, amounting to NIS 15 million.

29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)

G. THE ADJUSTED AMOUNT OF NON-MONETARY ASSETS, THE DEPRECIATION OF WHICH WILL NOT BE RECOGNIZED AS A DEDUCTIBLE EXPENSE OR AS PART OF THE COST WHEN SOLD, AND WHICH IS DEEMED A PERMANENT DIFFERENCE IN RESPECT OF WHICH NO DEFERRED TAXES ARE RECORDED:

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions			
Balance at beginning of year	116	128	100	112
Non-deductible amount for the current year	(11)	(12)	(9)	(12)
Balance at end of year	105	116	91	100

Footnote:
(1) See Note 1 B

29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)

H. YEAR-END BALANCES OF DEFERRED TAXES RECEIVABLE AND PROVISION FOR DEFERRED TAXES:

	Consolidated				The Bank			
	Deferred tax receivable		Provision for deferred taxes		Deferred tax receivable		Provision for deferred taxes	
	2004	2003	2004	2003	2004	2003	2004	2003
	Reported amounts[1]	Adjusted amounts[1]	Reported amounts[1]	Adjusted amounts[1]	Reported amounts[1]	Adjusted amounts[1]	Reported amounts[1]	Adjusted amounts[1]
	in NIS millions							
On specific provision for doubtful debts	52	30	-	-	38	16	-	-
On provision for vacation pay and seniority bonuses	305	302	-	-	266	264	-	-
On excess of provision (deposits) of severance pay	-	-	73	59	-	-	56	41
On income tax carry-forward deductions	189	187	-	-	170	186	-	-
On foreign operations	132	[2]110	-	-	-	-	-	1
On securities	-	-	2	5	-	-	1	4
On adjustment of depreciable non-monetary assets	-	-	42	53	-	-	33	41
On adjustment of other monetary assets	-	9	-	-	-	-	-	-
On adjustment of other non-monetary assets	9	10	-	-	2	2	-	-
Reserve for tax on income of Investee companies	-	-	4	35	-	-	4	35
Total, net	687	[2]648	121	152	476	468	94	122

Footnotes:
(1) See Note 1 B.
(2) Restated - See Note 1 X.

29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)

H. YEAR-END BALANCES OF DEFERRED TAXES RECEIVABLE AND PROVISION FOR DEFERRED TAXES:

	Consolidated		The Bank	
	December 31		December 31	
	2004	2003	2004	2003
	Reported amounts[1]	Adjusted amounts[1]	Reported amounts[1]	Adjusted amounts[1]
	in NIS millions			
Deferred taxes are included:				
In "Other assets" (Note 8)	593	[2]558	409	407
In "Other liabilities" (Note 12)	(27)	(62)	(27)	(61)
Total, net	566	[2]496	382	346

Footnotes:
(1) See Note 1 B.
(2) Restated - See Note 1 X.

30. NET GAIN (LOSS) ON EXTRAORDINARY ITEMS, AFTER TAXES

	Consolidated			The Bank		
	2004	2003	2002	2004	2003	2002
	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)	Reported amounts(1)	Reported amounts(1)	Adjusted amounts(1)
	in NIS millions					
Capital gain on sale of buildings and equipment	2	2	78	2	2	75
Capital loss on sale of buildings and equipment	(42)	(2)	(2)	(40)	(2)	(1)
Provision for impairment in value of buildings(2)	-	(22)	(10)	-	(21)	(9)
Gain on sale of shares of previously consolidated subsidiary	40	-	-	40	-	-
Gain (loss) before taxes	-	(22)	66	2	(21)	65
Provision for taxes on profit from extraordinary items:						
Current taxes	(8)	-	(3)	(8)	(1)	(3)
Deferred taxes	32	-	(19)	32	-	(19)
Total provision for taxes	24	-	(22)	24	(1)	(22)
Gain (loss) after taxes	24	(22)	44	26	(22)	43
Bank's share in gain (loss) on extraordinary items of investee (in consolidated affiliated) companies, after taxes	-	(1)	-	(2)	(1)	1
Gain (loss) on extraordinary items, after taxes	24	(23)	44	24	(23)	44

Footnotes:
(1) See Note 1 B.
(2) According to the estimated recoverable value amount of the buildings.

31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION

A. GENERAL

In December 2001, the Supervisor of Banks in Israel issued directives concerning segment information reporting in a banking corporation, which followed the approval of Accounting Standard No. 11 regarding segment reporting by the Israeli Accounting Standard Board and in view of the application abroad of accounting standards concerning segment information, and in particular the application of the US Accounting Standard FAS 131 (Disclosure about segments of an enterprise and related information), implementing certain modifications concerning the special characteristics of banking corporations, mostly on the basis of the disclosure prevalent in the US banking system.

According to the directives, a segment of operations is a component of a banking corporation having the following three characteristics:

(a) Engaged in business activities that may produce income and bear expenses (including income and expenses deriving from transactions with other components of the same banking corporation);

(b) The results of its operations are reviewed on a current basis by Management and the Board of Directors in order to make decisions as to the allocation of resources to the segment and evaluate its performance;

(c) Separate financial information exists with regard to the segment.

In addition, the directives determine the disclosure requirements and the manner of presenting the financial results of segments in the financial statements.

The Supervisor of Banks clarified in January 2002, that he expects that a banking corporation heading a banking group would include disclosure as to the following segments: corporate banking, retail banking, middle market banking, private banking, real estate and construction, mortgages, credit card operations, capital market operations, non-financial companies.

Towards the publication of financial statements for 2004, the Supervisor clarified that the retail banking segment should be split into two segments, as follows: "household segment" and "small business segment"

The Bank is installing a management information system to manage profit centers according to customers, products and additional profiles (the "Tomar" system). As from the first quarter of 2004, the level of development of the system and its implementation reached a stage that enables the Bank, for the first time, to present data regarding the results of operation of the Group according to principal segments of operation, in accordance with the directives of the Supervisor of Banks.

In prior reporting periods, as the Bank was unable to present information as to financial results according to segments of operation, only partial information was presented in the reports of the Bank, with the approval of the Supervisor of Banks.

As it is not possible to retroactively extract information from the system, and the information published in the past was, as stated, partial information only, no comparative information for prior periods is presented at this stage, with the approval of the Supervisor of Banks, as regards the results of the Group according to main segments of operations.

It should be noted that due to the short time that has elapsed since the system was put into operation, and since the system as a whole has not yet been completed and implemented, the use of it as a management tool has not yet begun. Furthermore, as the organizational structure of the Bank does not fully coincide with the reported segments of operations, the model used for providing the data is based on various assumptions and estimates. In the future, once the information produced by the system is studied and analyzed over a period of time, and concurrently with the process of implementation of the system, certain changes in the said assumptions and estimates may be required.

It should also be noted that the consolidation of the segments of operations of the banking subsidiaries has been made based on the segments of operation reported by them, without adjustment for the differences, if any, that exist between the characteristics of operation of customers of the Bank and those of customers of the subsidiaries in the same segment, except for the segmentation of the data relating to the retail and middle market banking segments of Mercantile Discount Bank, as detailed below.

31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

Until 2003, as it was not possible at that stage to provide information regarding the results of operations of the Bank according to segments, the Bank, with the approval of the Supervisor of Banks, provided partial data only. With the absence of comparative data for the segment information provided for 2004, the Supervisor of Banks instructed that the partial data presented in the Note concerning segment information included in the financial statements for the years 2002 and 2003, respectively, should be presented separately. Accordingly, partial data is presented hereunder as to the segment operations of the Bank in 2002 and 2003 (sections (d) and (e) hereunder), as well as details regarding segments of operations of Mercantile Discount Bank Ltd. for the years 2002 and 2003 (section (f) hereunder) and details regarding segments operations of Discount Mortgage Bank Ltd. (section (g) hereunder).

B. BUSINESS SEGMENTS OF THE BANK'S OPERATIONS – 2004

The operations of the Group are divided into twelve principal segments, as detailed hereunder:

It should be noted that these segments are not congruent with the organizational structure of the Bank, mainly because certain operations are presented separately, such as the construction and real estate segment, the capital market activity and the credit card activity.

- **Corporate banking:** This segment includes customers of the Bank's Corporate Division (except for construction and real estate customers and customers of the private international banking centers). The segment in the Bank includes mainly companies with annual turnovers of over NIS 150 million and/or total indebtedness exceeding NIS 40 million. The segment also includes customers of the business segment of the Mercantile Discount Bank.
- **Retail banking - General:** This segment includes customers of the Banking Division of the Bank, except for the real estate and construction industry customers and customers of the international private banking centers. In accordance with a directive of the Supervisor of Banks issued towards the preparation of the financial statements for 2004, this segment was divided into "households" and "small business" segments.

  The segment also includes customers of the middle market and retail banking of Mercantile Discount Bank. The Supervisor of Banks has agreed that Mercantile Discount Bank will present in its financial statements for 2004, the said data, until it is ready to divide them into at least two segments (households and middle market segments). The data for this segment have been divided between the household segment and the small business segment, for the purpose of the segment data of the Discount Group, on the basis of an estimate, on the basis of the relevant weighting accorded to this segment at the Discount Bank.
- **Retail Banking– Household Segment:** This segment includes customers of the Bank's Banking Division who are private customers, who are defined as customers who are either salaried employees, possess the potential for growth, or may be viewed as VIP customers (the definition excludes customers of the international private banking centers). The segment also includes on an estimated basis the customers of the Mercantile Discount Bank in that bank's household segment and commercial banking segment.
- **Retail Banking - Small Business Segment -** This segment includes customers of the Bank's Banking Division which are defined as small companies and small businesses with borrowings of up to NIS 4 million (except for customers of the construction and real estate segment). The segment also includes, on an estimated basis, the customers of Mercantile Discount Bank in that bank's small business and commercial banking segments, on the basis of the relevant weighting accorded to this segment at the Discount Bank.
- **Middle Market banking:** This segment includes customers of the Bank's Commercial Banking Division (except for construction and real estate customers). This segment in the Bank includes mainly companies with annual turnovers of NIS 15 – 150 million and/or total indebtedness of NIS 4 – 40 million.

31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

- **Private banking:** This segment includes customers of the Bank's banking division (individuals and corporations) who maintain their accounts at the international private banking centers (excluding customers from the construction and real estate segment) and customers of the center for private banking.
- **International activity:** This segment includes the overseas operations of the Discount Group. These operations are mainly carried out by the Bank's subsidiaries in the United States, South America (including the Bank's representative offices) and Switzerland, and by the Bank's branch in the U.K. The international operations are characterized by commercial business activity and by private banking.

  During the preparation of the financial statements for 2004, the Supervisor of Banks advised that the Bank is required to devide the data relating to the international operations segment between the segments relating to the Group's domestic operations. In view of the fact that, at this stage, the Bank's subsidiary in New York is not in a position to provide the required information, the Supervisor has agreed that, for the time being, the Bank may continue to present details of international operations in one column
- **Construction and real estate[(1)]:** This segment includes customers of the Bank's various divisions whose industry classification is construction and real estate. This segment also includes customers of the construction and real estate segment of the Mercantile Discount Bank and the contractor loans segment of the Discount Mortgage Bank.
- **Mortgages – housing loans**: This segment includes the mortgage operations of the Discount Group in Israel (Mercantile Discount Bank and Discount Mortgage Bank). At this stage, housing loans made by the Bank are excluded. This segment includes the granting of loans for housing purposes (purchase, construction etc.) and the granting of business loans and loans for any purpose secured by a mortgage on a residential apartment or other property.
- **Credit card activity[(1)]:** This segment includes the credit card operations of the Bank's customers, and includes credit-financing income from transactions carried out by credit card and various commissions relating to credit card activity. The operations are principally conducted through Israel Credit Cards Ltd.
- **Capital market activity[(1)]:** This segment includes securities activity (excluding activity for the Bank's own account), portfolio management, mutual funds, supplementary training funds, provident funds and severance pay funds. The segment includes the activity of the Bank's securities department, as well as the operations of specialized subsidiaries: Tachlit, Ilanot Discount, Discount Management of Provident Fund and Kahal. In addition, the segment includes the equivalent segment of Mercantile Discount Bank.
- **Non-financial companies:** This segment includes the Group's operations with respect to non-financial investments. The greater part of the segment's operations relate to investments of the Bank in Harel Ltd., and investments undertaken by a subsidiary, Israel Discount Capital Markets and Investments Ltd.
- **Financial Management Segment -** This segment includes activities that are characterized as banking operations, but do not involve customers of the Group. These activities are mainly comprised of for their own account operations of the Bank and Mercantile Discount Bank involving securities and other banks, as well as exposure management (the Consumer Price Index and foreign exchange) and dealing room operations, including those involving financial sectors. This segment also includes the Bank's share in the income of the First International Bank and its share in the income of its affiliated companies which operate in a supporting capacity.

(1) This segment constitutes inter-segment activity (activity of other segments of the Bank)

31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

C. THE PRINCIPAL ASSUMPTIONS, ESTIMATES AND PRINCIPLES USED IN THE PREPARATION OF SEGMENT INFORMATION - 2004

The classification of the business results of the Group into the various segments of activity, as stated above, was prepared based on the principles, assumptions and estimates detailed hereunder:

1) Income

Income from financing operations before provision for doubtful debts. The segment is credited with the margin resulting from the difference between interest on loans granted to customers of the segment and the interest paid on deposits of customers of the segment and the transfer prices.

The transfer prices reflect the marginal alternative cost of financing sources or the application thereof.

The margins are set at the date the transaction is entered into and stay in effect for the duration of the transaction free of market risks.

According to this methodology, earning or losses from financing operations resulting from changes in market conditions, are taken to the "Financial Management" segment.

Income earned on the nostro securities of the Bank is also reflected in the "Financial Management" segment.

Provision for doubtful debts. This is included in the segment in which the activity of the customer is reflected, in respect of which the provision has been created. In the same manner, collection in respect of a debt provided for or the decrease in the provision is also reflected in the segment in which the activity of the customer is reflected.

Operational income. All the operational and other income, which the bank collects from customers, are reflected directly in the segment in which the activity of the customer is reflected, excluding commissions in respect of operations included in a different segment (capital market activity and credit card activity), and excluding certain operations, such as buying or selling foreign currency, the commissions for which are partially reflected in the "Financial Management" segment.

2) Expenses

Identifiable direct expenses are specifically and directly reflected in the related segments.

Overhead expenses (mainly head office expenses), which cannot be related to a specific segment, are charged to the segments using an estimate based on various charging formulas, most of them based on volume of operation indices and some of them based on estimates and assessments of the various units of the Bank.

Depreciation and amortization expenses are charged as part of the overhead expenses.

The model for the charging of expenses used in calculating the data includes the allocation of inter segment expenses, mainly in relation to operational services provided by the branch setup to customers related to other segments by charging all the branches' expenses to customers of these branches, even if these customers are not amongst the customers of the Banking Division.

As stated above, this charge is made by way of an estimate based mainly upon indices for the volume of operations of customers of the Bank's branches.

Taxes on income. In order to exclude the effect of brought forwards tax losses in respect of which deferred tax assets had not been recorded, on the measurement of the profitability according to segments of operation, the following tax computation was made:

The provision for taxes of the various segments of operation was computed on the basis of the statutory tax rate (44.44%). Segments showing a loss recorded a tax income computed also on the basis of the statutory tax rate.

The difference between the net taxes attributed to the segments of operation and the provision for taxes recorded in the income statement, s charged to the "Financial Management" segment.

31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

3) Allocation of capital and computation of the return

Shareholders' equity and subordinated capital notes, being part of the financing sources of credit, are being allocated to each segment in respect of its risk assets. No cost is charged to a segment in respect of the shareholders' equity allocated, while the allocated capital notes bear the actual interest expense attributed to them.

The computation of the return in each segment is based on the amount of shareholders' equity allocated to the segment The allocation of capital and of the subordinated capital notes is based on a guideline of the Supervisor of Banks, which was received towards the preparation of the financial statements for 2004.

4) Presentation of inter-segment income and expenses

The accountability between the profit centers in the Bank is made by a mechanism that allocates the total amount of expenses to customers of the Bank, using various activity indices, and not by allocating the expenses to the profit centers (and the "sale" of inter-segment services). The method for the allocation expenses used by the Bank is a multi-stage one. In the first stage the direct expenses of the branch are allocated to all the customers keeping their accounts at the branch, (customers attached to various segments). In the second stage, the expenses of designated units are allocated based on an estimate of the distribution of the service to the various headquarters, and the total expenses of the headquarters and administrations to the customers whom they serve. Finally, the costs of the general headquarter units (management, human resources, comptroller, operations and computer services, etc.) to all the customers of the Bank.

According to the system described above, each customer "bears" its own relevant expenses, which are accumulated in the various segments according to the affiliation of customers to these segments.

The format described above does not allow the determination as to what expenses of one segment were charged to another segment (referred to in the reporting format as "inter-segment activity"). The Supervisor of Banks permitted the Bank to report in 2004 on the basis of the mechanism it developed for the purpose of allocating income and expenses, and inconsequence thereof not to report inter-segment transfers.

31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)

D. ACTIVITY SECTORS IN DISCOUNT BANK BUSINESS SEGMENTS

Reported Amounts[1]

	For the three months ended September 30, 2004					
	Households	Small businesses	Corporate banking	Middle Market banking	Private banking	International activity
	in NIS millions					
Income from financing activities before provision for doubtful debts	976	433	391	161	65	804
Non-financing and other income	469	219	112	68	9	125
Total Income	1,445	652	503	229	74	929
Provision for doubtful debts	56	118	217	42	-	35
Operating and other expenses	1,202	488	266	255	67	561
Operating Income (loss) before taxes	187	46	20	(68)	7	333
Provision for taxes on Operating Income	83	25	9	(29)	3	169
Operating Income (loss) after taxes	104	21	11	(39)	4	164
Bank's share in operating income of affiliated	-	-	-	-	-	-
Minority interest in the income of subsidiaries	-	-	-	-	-	-
Net operating income	104	21	11	(39)	4	164
Net gain (loss) from extraordinary items, netof taxes	-	-	-	-	-	-
Net income (loss)	104	21	11	(39)	4	164
Yield on capital (percentage)	25.3%	4.0%	0.6%	(7.4)%	14.9%	9.2%
Avarage Assets	5,592	11,595	19,886	6,985	1,051	41,144
Of which- Investment in Investee companies	-	-	-	-	-	-
Avarage Liabilities	55,761	8,852	6,496	4,859	10,271	36,663
Avarage Risk-assets	4,548	6,297	21,990	5,899	277	19,915
Avarage assets of provident and mutual funds	-	-	-	-	-	-
Avarage other assets under management	-	-	-	705	-	119
Margin from credits activity	189	324	299	112	12	
Margin from deposits activity	760	61	37	36	53	
Other	27	48	55	13	-	
Income from financing activities before provision for doubtful debts	976	433	391	161	65	804

Footnote:
(1) See Note 1 B.

For the three months ended September 30, 2004						
Construction and real estate	Mortgages	Credit card activity	Capital market activity	Non-financial companies	Financial management	Total consolidated
in NIS millions						
179	125	82	17	(22)	278	3,489
26	57	531	485	51	48	2,200
205	182	613	502	29	326	5,689
326	78	8	-	-	-	880
74	65	419	330	11	275	4,013
(195)	39	186	172	18	51	796
(81)	21	79	76	2	(15)	342
(114)	18	107	96	16	66	454
-	-	-	-	66	69	135
18	(6)	(60)	(8)	-	-	(56)
(96)	12	47	88	82	135	533
-	-	-	(1)	32	(8)	23
(96)	12	47	87	114	127	556
(6.4)%	1.8%	23.1%		235.2%	20.6%	9.3%
9,708	9,850	1,604	47	573	34,469	142,504
-	-	-	3	414	804	1,221
1,876	2,298	760	8	-	7,420	135,264
16,801	7,389	2,222	44	539	6,806	92,727
-	-	-	33,839	-	-	33,839
-	2,362	-	1,773	-	-	4,959
138	124	82	-			
15	-	-	-			
26	1	-	17			
179	125	82	17	(22)	278	3,489

31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)

E. INFORMATION ON GEOGRAPHICAL AREAS

	Income[(1)]			Net Income			Assets	
	For the year end December 31						As at December 31	
	2004	2003	2002	2004	2003	2002	2004	2003
	in NIS millions							
Israel	5,002	4,729	3,883	407	244	(253)	104,068	103,798
Europe	67	44	46	11	(50)	5	2,738	2,078
North America	755	438	786	137	(33)	201	34,929	32,490
Sout America	76	33	101	1	(7)	9	1,316	1,336
Total Overseas	898	515	933	149	(90)	215	38,983	35,904
Total Consolidated	5,900	5,244	4,816	556	154	(38)	143,051	139,702

Footnote:
(1) Income-earnings from financing operations before provision for doubtful debts and other operating income.

F. BUSINESS SEGMENTS OF THE BANK'S OPERATIONS - IN THE YEARS 2002-2003

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

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

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 corporations 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 the small corporations 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 customers of the Private International Banking Centers (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.

31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)

F. BUSINESS SEGMENTS OF THE BANK'S OPERATIONS - IN THE YEARS 2002-2003 (CONTINUED)

	Average balances of 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

31. BUSINESS SEGMENT AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

F. BUSINESS SEGMENTS OF THE DISCOUNT GROUP OPERATIONS - IN THE YEARS 2002-2003 (CONTINUED)

	Year ended on December 31					
	2003			2002		
	Credit cards[1]	Capital market activity[2]	Non banking activity[3]	Credit cards[1]	Capital market activity[2]	Non banking activity[3]
	In NIS millions					
Statement of Income						
Income from financing activities	53	8	6	20	(6)	(4)
Non-financing income	409	189	19	385	195	15
Total income	462	197	25	405	189	11
Provision for doubtful debts	16	-	-	*19	-	-
Non-financing expenses	321	175	21	*351	179	18
Total expenses	337	175	21	370	179	18
Operating income (loss) before taxes	125	22	4	35	10	(7)
Provision for taxes on operating income	50	11	1	13	8	-
Operating income (loss) after taxes	75	11	3	22	2	(7)
Bank's share in the income of investee companies	-	-	69	-	-	17
Minority Shareholders' interest	(50)	(2)	-	(15)	-	2
Net cumulative effect as of the beginning of the year of change in accounting	-	-	(17)	-	-	-
Net income	25	9	55	7	2	12
Balance Sheet						
Assets	1,504	126	888	*903	109	620
Liabilities	1,258	21	105	*691	15	101

* Reclassified

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 recorded as an expense in the financial statements of ICC, and also granted credit to credit card holders, the volume of which is detailed in B. 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 Provident Funds Management Company, as reflected in their financial statements. Due to immateriality, the above presented data do not include data concerning the capital market activity of certain subsidiaries of Mercantile Discount Bank.In addition, the Bank and its banking subsidiaries earned commission income 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 in the investment in Harel. In addition, it includes data concerning Israel Discount Capital Markets and Investments.

31. BUSINESS SEGMENT AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

G. SEGMENT INFORMATION AT MERCANTILE DISCOUNT BANK LTD. - IN THE YEARS 2002-2003

1. General

The Mercantile Discount Bank ("MDB") integrated in 2003 a managerial information system that provides Management with segment information as regards the operating results of MDB, in accordance with Management's definition of the segments, as follows:

Business banking – Banking services offered to large customers of MBD.

Retail and commercial banking – Banking services offered to commercial and retail customers.

Mortgage loans – Banking services offered to customers for housing and business purposes.

Real estate and building projects – Banking services offered to construction companies and to real estate development projects.

Capital market – Banking services offered to customers involved in off-balance sheet investments, including: securities operations, investment portfolio management, mutual funds and provident and severance pay funds.

It should be noted that in view of the short period that has elapsed since the system was integrated at the MDB, the use of it as a managerial tool has only been partly implemented. Furthermore, as the organizational structure of the MDB does not fully coincide with the reported segments, the data reported at this stage is based upon various assumptions and assessments (particularly as regards the allocation of costs and resources). In the future, once the data provided by the system is analyzed and studied over a period of time, changes to the said assumptions and assessments may be required.

2. The principal assumptions and assessments used in the preparation of the data

The classification of the operating results of MDB by the various segments of operation as above, has been made based on the following methodology:

Profits from financing activities – To each segment was attributed a "financing operation" margin, being the summation of the following components:

- The difference between interest income attributed to the particular segment (relating to credit operations) and the cost of the interest income calculated according to the "transfer price".
- The difference between the cost of interest (relating to deposit operations) and the interest income relating to the said deposits, such income being calculated according to the "transfer price".

The "transfer price" is determined based on quoted prices of deposits in the institutional market, and it approximately resembles the marginal cost of deposits raised by the bank.

According to this methodology - which fits a specific transfer price for each credit or deposit product in each of the linkage segments – only credit risk is attributed to the segments of operation but not market risk.

Profits or losses on financing activities resulting from changes in market conditions, are taken to the asset and liability management center, to which are also credited the income on the management of the active capital of the MDB as well as the adjustment to the CPI of the financial results of MDB. Such profits or losses are presented in the "Other" segment.

Provision for doubtful debts – this is attributed to the various segments of operation, in accordance with the classification of the specific customer.

Operating income – Commission and other operating income is attributed to the various segments of operation, in accordance with the classification of the customer.

Operating expenses – direct expenses that can be identified are attributed to the relevant segment. Indirect expenses, or direct expenses that cannot be accurately attributed are charged to the various segments based on assessments made by the various operating units of the MDB.

31. BUSINESS SEGMENT AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

G. SEGMENT INFORMATION AT MERCANTILE DISCOUNT BANK LTD. - IN THE YEARS 2002-2003 (CONTINUED)

3. Composition (in NIS millions)

	For the year ended December 31, 2003						
	Retail and commercial banking	Business banking	Real estate and building	Mortgage loans	Capital market*	Non allocated amounts and adjustments	Total consolidated
Profit from financing operations before provision for doubtful debts	373.8	41.6	19.9	21.0	3.5	22.1	481.9
Operating and other expenses	209.9	9.7	3.6	4.8	34.1	4.6	266.7
Total income	583.7	51.3	23.5	25.8	37.6	26.7	748.6
Provision for doubtful debts	70.2	8.3	7.4	1.8	-	-	87.7
Operating and other expenses, excluding depreciation	356.9	23.3	7.3	7.3	27.8	38.8	461.4
Depreciation	19.6	1.5	0.5	0.5	1.6	2.3	26.0
Operating income (loss), before taxes on income	137.0	18.2	8.3	16.2	8.2	(14.4)	173.5
Provision for taxes on operating income	(67.2)	(9.7)	(3.9)	(7.7)	(3.9)	6.0	(86.4)
Operating income (loss), after taxes on income	69.8	8.5	4.4	8.5	4.3	(8.4)	87.1
Bank's share in net operating losses of affiliated companies, after tax	-	-	-	-	-	(0.3)	(0.3)
Net operating loss	69.8	8.5	4.4	8.5	4.3	(8.7)	86.8
Loss on extraordinary items, net	-	-	-	-	-	(0.7)	(0.7)
Cumulative effect of change in accounting	-	-	-	-	-	(0.3)	(0.3)
Net income (loss)	69.8	8.5	4.4	8.5	4.3	(9.7)	85.8
Average balance of assets	6,144.5	3,216.8	855.9	1,886.2	15.5	2,742.0	14,860.9
Average balance of liabilities	13,007.2	-	-	-	-	1,021.4	14,028.6
Average balance of risk assets	5,255.8	3,123.7	1,173.8	1,546.5	15.5	868.3	11,983.6
Margin on credit operations	253.6	39.8	15.8	20.6	-		
Margin on deposit operations	109.7	-	-	-	-		
Other	10.5	1.8	4.1	0.4	3.5		
Income from financing operations before provision for doubtful debts	373.8	41.6	19.9	21.0	3.5		

* Expenses in this segment derive from the operations of Mercantile Discount Bank in securities and in the management of provident funds and mutual funds.

Footnotes:

1. The column "Non-allocated amounts and adjustments" includes income and expenses not deriving from banking activity with customers of the MDB (such as: management of the active capital, activities with other banks, activity of the dealing room, management of the investment portfolio of the bank, etc.) as well as amounts resulting from adjustment to the CPI.
2. The segment information of MDB was presented for the first time in 2003 and therefore, no comparative figures have been included.

31. BUSINESS SEGMENT AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

G. SEGMENT INFORMATION AT DISCOUNT MORTGAGE BANK LTD.- IN THE YEARS 2002-2003 (CONTINUED)

1. General

The division into segments and the segment information presented hereunder have been determined by the Management of Discount Mortgage Bank ("DMB"), on the basis of the information existing at present and in accordance with internal reports serving the Management of DMB.

2. The principal assumptions and assessments used in the preparation of the data

- Income, provisions for doubtful debts and the provision for taxes on income were allocated specifically in respect of each segment.
- The average balance of liabilities and financing expenses was allocates on the basis of the volume of credit in each segment in proportion to the total balance of credit.
- Operating expenses were in part allocated specifically and in part were allocated according to the volume of operations in each segment.
- The return on capital was computed on the basis of net profit as compared with the capital of DMB in 2003. At this stage it was impossible to allocate the capital which served the operations in each segment.

3. Composition (in NIS millions)

	For the year ended December 31, 2003				
	Housing loans	Loans to building contractors	Other loans	Loans secured by mortgages on dwelling units	Total
Profit from financing operations before provision for doubtful debts	75	24	14	14	127
Operating and other Income	52	-	2	3	57
Total income	127	24	16	17	184
Provision for doubtful debts	24	29	14	3	70
Operating and other expenses, excluding maintenance and depreciation	44	4	4	5	57
Maintenance and Depreciation	4	1	-	1	6
Operating profit before taxes on income	55	(10)	(2)	8	51
Provision for taxes on operating profit	26	(5)	(1)	4	24
Net profit	29	(5)	(1)	4	27
Return on equity	3.6%	(0.7%)	(0.1%)	0.6%	3.4%
Average balance of risk assets	4,607	1,427	1,008	928	7,970
Average balance of assets	6,830	692	1,008	928	9,458
Average balance of liabilities	6,213	629	918	845	8,605
Average balance of managed assets (extent of collection)	2,406	-	-	-	2,406

31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)

G. SEGMENT INFORMATION AT DISCOUNT MORTGAGE BANK LTD. - IN THE YEARS 2002-2003 (CONTINUED)

3. Composition (in NIS millions) (continued)

	For the year ended December 31, 2002				
	Housing loans	Loans to building contractors	Other loans	Loans secured by mortgages on dwelling units	Total
Profit from financing operations before provision for doubtful debts	88	(4)	11	20	115
Operating and other income	60	-	1	5	66
Total income	148	(4)	12	25	181
Provision for doubtful debts	12	27	5	4	48
Operating and other expenses, excluding maintenance and depreciation	41	5	3	5	54
Maintenance and depreciation	4	1	-	1	6
Operating profit before taxes on income	91	(37)	4	15	73
Provision for taxes on operating profit	40	(18)	2	7	31
Net profit	51	(19)	2	8	42
Return on equity	6.8%	(2.5%)	0.3%	1.0%	5.6%
Average balance of risk assets	4,411	1,466	904	819	7,600
Average balance of assets	6,729	760	904	819	9,212
Average balance of liabilities	6,137	693	823	748	8,401
Average balance of managed assets (extent of collection)	2,495	-	-	-	2,495

32. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS CLASSIFIED IN ACCORDANCE WITH THE STRUCTURE OF THE BANKING GROUP

	December 31, 2004					
	Operations in Israel				Overseas Operations	
	Ordinary Banking				Ordinary Banking	
	The Bank	Consolidated Subsidiaries	Mortgage Bank	Others	Extensions Abroad[2]	Total Consolidated
	Reported Amounts[1]					
	in NIS millions					
Balance Sheet Assets						
Cash and deposits with banks	13,495	1,191	22	4	3,039	17,751
Securities	15,855	1,142	1	194	22,876	40,068
Credit granted to the public	41,966	12,697	9,519	1,342	11,984	77,508
Credit granted to Governments	268	1	-	-	2	271
Investment in affiliated companies	1,293	2	-	25	-	1,320
Buildings and equipment	1,428	298	15	125	112	1,978
Other assets	2,730	109	68	279	969	4,155
Total assets	77,035	15,440	9,625	1,969	38,982	143,051
Assets deriving from inter-company transactions[3]	7,710	328	121	888	33	9,080
Companies' balance sheet totals	84,745	15,768	9,746	2,857	39,015	152,131
Liabilities						
Deposits from the public	75,458	13,893	2,105	-	30,236	121,692
Deposits from banks	728	101	368	85	3,796	5,078
Deposits from the Government	38	46	45	-	15	144
Debentures and subordinated capital notes	3,516	483	128	682	-	4,809
Other liabilities	2,862	167	67	696	701	4,493
Total liabilities	82,602	14,690	2,713	1,463	34,748	136,216
Minority interest	-	-	274	175	-	449
Shareholders' equity	6,386	-	-	-	-	6,386
Total liabilities and shareholders equity	88,988	14,690	2,987	1,638	34,748	143,051
Liabilities deriving from inter-company transactions[3]	(4,243)	1,078	6,759	1,219	4,267	9,080
Companies' balance sheet total	84,745	15,768	9,746	2,857	39,015	152,131

Footnotes:
(1) See Note 1 B.
(2) Subsidiaries and branches of the Bank which are "extensions" of the Bank.
(3) Items reflecting inter-company transactions are eliminated in the consolidated data.

32.CONDENSED CONSOLIDATED FINANCIAL STATEMENTS CLASSIFIED IN ACCORDANCE WITH THE STRUCTURE OF THE BANKING GROUP (CONTINUED)

	December 31, 2003					
	Operations in Israel				Overseas Operations	
	Ordinary Banking				Ordinary Banking	
	The Bank	Consolidated Subsidiaries	Mortgage Bank	Others	Extensions Abroad[2]	Total Consolidated
	Adjusted Amounts[1]					
	in NIS millions					
Balance Sheet Assets						
Cash and deposits with banks	12,725	1,099	4	7	3,053	16,888
Securities	15,954	1,052	1	190	21,577	38,774
Credit granted to the public	43,215	12,294	9,371	[4]1,343	10,241	76,464
Credit granted to Governments	322	2	-	-	43	367
Investment in affiliated companies	1,217	3	-	18	-	1,238
Buildings and equipment	[4]1,540	288	13	134	127	2,102
Other assets	[5][4]2,584	121	22	[4]279	[5]863	[5]3,869
Total assets	[5]77,557	14,859	9,411	1,971	[5]35,904	[5]139,702
Assets deriving from inter - company transactions[3]	6,784	207	123	202	59	7,375
Companies' balance sheet totals	[5]84,341	15,066	9,534	2,173	[5]35,963	[5]147,077
Liabilities						
Deposits from the public	76,202	13,264	2,279	-	[5]28,208	[5]119,953
Deposits from banks	920	146	442	585	3,004	5,097
Deposits from the Government	54	49	49	-	19	171
Debentures and subordinated capital notes	3,591	466	142	24	-	4,223
Other liabilities	[4]2,458	169	43	[4]603	546	3,819
Total liabilities	83,225	14,094	2,955	1,212	[5]31,777	[5]133,263
Minority interest	-	-	286	198	-	484
Shareholders' equity	[5]5,955	-	-	-	-	[5]5,955
Total liabilities and shareholders equity	[5]89,180	14,094	3,241	1,410	[5]31,777	[5]139,702
Liabilities deriving from inter-company transactions[3]	(4,839)	972	6,293	763	4,186	7,375
Companies' balance sheet total	[5]84,341	15,066	9,534	2,173	[5]35,963	[5]147,077

Footnotes:
(1) See Note 1 B.
(2) Subsidiaries and branches of the Bank which are "extensions" of the Bank.
(3) Items reflecting inter-company transactions are eliminated in the consolidated data.
(4) Reclassified.
(5) Restated - see Note 1 X.

32. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS CLASSIFIED ACCORDING TO MAIN OPERATING SEGMENTS (CONTINUED)

	December 31, 2004					
	Operations in Israel				Overseas Operations	
	Ordinary Banking				Ordinary Banking	
	The Bank	Consolidated Subsidiaries	Mortgage Bank	Others	Extensions Abroad[2]	Total Consolidated
	Reported Amounts[1]					
	in NIS millions					
Statement of Income						
Income from financing activities before provision for doubtful debts	1,991	515	128	85	770	3,489
Profit (loss) from inter-company activities[3]	(274)	8	284	(13)	(5)	-
Total	1,717	523	412	72	765	3,489
Provision for doubtful debts	577	95	165	9	34	880
Income from financing activities, after provision for doubtful debts	1,140	428	247	63	731	2,609
Non-financing income	1,170	279	55	779	128	2,411
Non-financing expenses	(2,465)	(504)	(71)	(623)	(561)	(4,224)
Operating income and expenses from inter-company activities[3]	(202)	44	6	155	(3)	-
Operating income (loss) before taxes	(357)	247	237	374	295	796
Provision for taxes on operating income	23	92	(18)	91	154	342
Operating income (loss) after taxes	(380)	155	255	283	141	454
Net cumulative effect as of the beginning of the year of change in accounting	(1)	-	-	-	-	(1)
Net loss from extraordinary items, net of taxes	26	(1)	-	(1)	-	24
Net income (loss) after elimination of intercompany balances	(355)	154	255	282	141	477
Intercompany balances eliminated	476	(52)	(290)	(142)	8	-
Net operating income (loss) before elimination of intercompany balances	121	102	(35)	140	149	477
Bank's share in net operating income (loss) of affiliated companies, net of tax effect	137	-	-	(2)	-	135
Net operating income (loss) before minority interest	258	102	(35)	138	149	612
Minority interest in operating income after taxes, of consolidated subsidiaries	-	-	12	(68)	-	(56)
Net income (loss)	258	102	(23)	70	149	556

Footnotes:
(1) See Note 1 B.
(2) Subsidiaries and branches of the Bank which are "extensions" of the Bank.
(3) Items reflecting inter-company transactions are eliminated in the consolidated data.

32. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS CLASSIFIED ACCORDING TO MAIN OPERATING SEGMENTS (CONTINUED)

	December 31, 2003					
	Operations in Israel				Overseas Operations	
	Ordinary Banking				Ordinary Banking	
	The Bank	Consolidated Subsidiaries	Mortgage Bank	Others	Extensions Abroad[3]	Total Consolidated
	Adjusted Amounts[1]					
	in NIS millions					
Statement of Income						
Income from financing activities before provision for doubtful debts	1,928	477	112	76	[2]390	[2]2,983
Profit (loss) from inter-company activities[3]	(85)	(8)	127	2	(36)	-
Total	1,843	469	239	78	[2]354	[2]2,983
Provision for doubtful debts	605	87	70	16	67	845
Income from financing activities, after provision for doubtful debts	1,238	382	169	62	[2]287	[2]2,138
Non-financing income	1,186	269	57	624	125	2,261
Non-financing expenses	(2,165)	(493)	(63)	(537)	(517)	(3,775)
Operating income and expenses from inter-company activities[3]	(171)	43	5	123	-	-
Operating income (loss) before taxes in reported amounts	88	201	168	272	[2](105)	[2]624
Erosions and adjustments[1]	(36)	7	15	5	39	30
Operating income (loss) before taxes	52	208	183	277	[2](66)	[2]654
Provision for taxes on operating income	116	86	24	66	[2]79	[2]371
Operating income (loss) after taxes	(64)	122	159	211	[2](145)	[2]283
Net cumulative effect as of the beginning of the year of change in accounting	8	-	-	(17)	19	10
Net income, before extraordinary loss after tax	(56)	122	159	194	[2](126)	[2]293
Provision for impairment in value of investment in affiliated companies	(173)	-	-	-	-	(173)
Net loss from extraordinary items, net of taxes	(22)	(1)	-	-	-	(23)
Net income (loss) after elimination of intercompany balances	(251)	121	159	194	[2](126)	[2]97
Intercompany balances eliminated	256	(35)	(132)	(125)	36	-
Net operating income (loss) before elimination of intercompany balances	5	86	27	69	[2](90)	[2]97
Bank's share in net operating income of affiliated companies, net of tax effect	121	-	-	(4)	-	117
Net operating income (loss) before minority interest	126	86	27	65	[2](90)	[2]214
Minority interest in operating income after taxes, of consolidated subsidiaries	-	-	(9)	(51)	-	(60)
Net income (loss)	126	86	18	14	[2](90)	[2]154

Footnotes:
(1) See Note 1 B.
(2) Restated - see Note 1 X.
(3) Subsidiaries and branches of the Bank which are "extensions" of the Bank.
(4) Items reflecting inter-company transactions are eliminated in the consolidated data.

33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE

General: 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 was**, inter-alia, published. The law was designed to regulate the holding of such shares and the exercise of the voting rights attached thereto, and other ancillary matters.

Set out below are certain details of the law:

(a) By virtue of the law, 86.78% of the shares of the Bank were transferred into the ownership of the State on October 31, 1993. It has been stipulated however, that the Government Corporations Law,1975, will not apply to the Bank, and that the Bank will not be treated as a Government Corporation or a corporation under the management of the Government (For details regarding the State's holdings of shares in the Bank at the balance sheet date, see Note 22G. For details regarding the transaction for the sale of a controlling interest in the Bank, see Note 37 hereunder).

(b) The law provides that the exercise of the voting rights attached to the shares be exercised on behalf of the State by the Committee for the Shares of the Bank (hereinafter - "the Committee"), which was appointed for this purpose.

(c) Section 28 of the Bank Shares in Arrangement Law stipulates that the Minister of Finance, with the approval of the Government or with the approval of a ministerial committee empowered by the Government, will be entitled to instruct the Committee to summon a general meeting of the Bank and to attend such a meeting and to vote in accordance with his instructions, if required, in his opinion, in order to effect a sale of the shares, and other ancillary actions; to prevent or reduce the actual impairment, directly or indirectly, of the rights attached to the shares, the ability to sell them or adversely affect the consideration which will be received on the sale thereof; to effect structural changes, including the sale of significant assets of the Bank, or a reorganization of the Bank and companies under its control, which are required according to law, or on which the Government resolved prior to October 31, 1993; setting of a policy for the distribution of dividends; delegate the powers and authority on matters mentioned above to the general meeting.

(d) Section 34(a) of the Bank Shares in Arrangement Law prescribes that resolutions of a general meeting and their implementation as referred in Section 28 of this law, as well as cooperation and the passing-on of information as required under Section 33 of this law, will not constitute grounds for a civil lawsuit, provided that implementation of the resolutions and the actions were carried out by the Bank, a company under the control of the Bank, an officer of either of them or one of their employees, as the case may be, at a level of skill at which a reasonable person of the same status and standing would have acted in the same circumstances, and in a manner which will to the extent possible, reduce damage to the Bank, to a company under the control of the Bank, or to a third party. However, with regard to a claim based on a cause of action pursuant to the Securities Law, 1968, the provisions of that law will apply.

Splitting-off other banking institutions and sale of blocks of shares: The Government decision of May 2, 1993, states that the Government and the Bank of Israel would ,inter alia, work towards splitting off small and medium sized banks from the banks which hold them", and in relation to the Bank, it was decided on the separation of Mercantile Discount Bank (see hereunder). The Government decision also deals with the possibility of the "split-off of additional banking corporations, including the sale of blocks of shares which one bank holds in another", without any further clarification.

Separation of Mercantile Discount Bank Ltd.: The Government resolutions specify, inter alia, that the Government and

33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

Bank of Israel would take action to separate Mercantile Discount Bank Ltd. from the Israel Discount Bank Ltd.

In the financial statements issued by the Bank up to the date of the Government's decision as aforesaid, the Bank considered its investment in Mercantile Discount Bank as a fixed investment. Accordingly, prior to the Government's decision, no provision was recorded in the past for tax on the Bank's share in the retained earnings of Mercantile Discount Bank. As a result of the aforesaid Government resolution, the Bank no longer treated the investment in Mercantile Discount Bank as a fixed investment. Thus, the Bank recorded adequate provisions for tax in respect of its share in earnings of Mercantile Discount Bank.

On May 20 2004, the decision of the socio-economic cabinet received the authority of a Government decision to erase the first paragraph of section b(1) of the decision of May 2, 1993, regarding the separation of Barclays-Discount Bank Ltd. (in its present name of Mercantile Discount Bank Ltd.) from Israel Discount Bank Ltd. In view of the said decision, the provision for tax in respect of the Bank's share in the profits of Mercantile Discount Bank' created in the past and amounted to NIS 33 million, became superfluous, and its reversal is reflected in the financial statements as of December 31, 2004.

As regards the sale of the Mercantile Discount Bank shares that Discount Bank had purchased from Barclays Bank PLC, and which the Governor of Bank of Israel instructed their sale until December 31, 1995, the Governor of Bank of Israel extended from time to time the date fixed for the sale of these shares. On July 1, 2004, the Governor of Bank of Israel granted the Bank a permit under Section 34 of the Banking Law (Licensing)-1981, to control and hold all the means of control of any sort whatsoever, in the Mercantile Discount Bank.

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 team's recommendations have not been accepted by the Government.

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.

In August 2004, the Income Tax Regulations (Rules for the Approval and Management of Provident Funds)-1964, were extensively amended so that, inter-alia, they require provident funds to calculate the daily return, they regularize the specialized funds and they impose limitations on related party transactions and require the purchase of professional liability

33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

insurance. As part of these Regulations various duties were imposed on provident funds in respect of their members, including the duty to trace members, to provide notices and to facilitate the transfer of members' funds from one fund to another.

Most of the said instructions came into effect in September 2004, while certain of which will become effective in January 2005, or at a later date

The subject of the holdings of banks in provident funds is among the principal issues discussed in the Bachar Committee Report, and of the law proposals tabled in its wake, as detailed hereunder.

Changes in the structure of the capital market. In April 2004 the Minister of Finance formed a team, headed by the Director General of the Ministry, with the object of recommending measures for the actions required for basing a competitive structure in the capital market ("the Bachar Commission").

At the beginning of November, the Bachar Committee published its report, the principal recommendations of which are as follows:

- A banking corporation shall not be permitted to own means of control in a company managing provident funds, or in a provident fund, and in a company managing mutual investment trust funds, neither will a banking corporation or whoever controls it or is controlled by it be permitted to be an interested party in a provident fund or in a mutual investment trust fund or in a corporation that is an interested party in such an entity. The Committee suggested a timetable for the gradual application of this recommendation over a period of three years (in respect of provident funds) and four years (in respect of mutual investment trust funds).
- An underwriter shall not be qualified to act as a pricing underwriter in a public offer of securities if the outstanding cumulative balance of debt of the issuer or of the offeror and entities controlled by them to the banking group to which the underwriter belongs, exceeds NIS 5 million and such balance comprises over 10% of the total financial liabilities of the issuer or offeror.
- An underwriter shall not be permitted to sell over 5% of the value of the securities offered in the issue or in the offer for sale in respect of which he acts as an underwriter, to himself, and to all the institutional bodies and to customers of the portfolio management companies that are controlled by him, control him or controlled by them
- A provident funds law should be enacted, which would regulate the control and enforcement principles regarding provident funds, including the rule that control and ownership at a certain percentage of the means of control in an institutional body will require receiving a permit.
- An acquisition of a provident fund or an insurer shall not be permitted if subsequent to the acquisition the market share of the purchaser, its controlling entities and entities controlled by them, will exceed 15% of the long-term savings market (i.e., the cumulative total amount of assets being managed by provident funds, new pension funds and the profit sharing portfolio of life assurance policies).
- An acquisition of a provident fund or an insurer shall not be permitted if subsequent to the acquisition the market share of the purchaser, its controlling entities and entities controlled by them, will exceed 20% of the mutual investment trust fund market.
- The legislation pertaining to the capital market is to define two occupations, which will require qualification and licensing, and which will be subject to regulation and supervision – consulting and marketing, both as regards financial products (including securities, mutual investment trust funds, structured bank deposits) and as regards pension products (including provident funds, profit sharing life assurance and pensions). A banking corporation the equity of the banking group to which it belongs exceeds NIS 10 billion, shall be required to complete the sale of all its holdings in mutual

33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

investment trust funds.

- A banking corporation shall not be permitted to engage in the marketing of certain financial products, in respect of which it will be permitted to provide consulting services only.
- On the other hand, a banking corporation shall be permitted to provide consulting services or to sell life assurance and pension products, after having completed the sale of all his holdings in provident funds and as long as it is not an interested party in an insurer (including a pension fund). A banking corporation the equity of the banking group to which it belongs exceeds NIS 10 billion, shall be required to complete the sale of all its holdings in mutual investment trust funds.
- Entities engaged in consulting, including a banking corporation, shall not be permitted to accept any consideration from the owner of the financial or pension instruments in respect of activities conducted in such products, including distribution fees.
- In addition, the team desires to examine and form recommendations for the further intensification of competition in the capital market, by way of examination and general arrangements regarding commercial papers, Repo, Money Market Funds, distribution of mutual investment trust funds by non-members of the Stock Exchange, facilitating the movement of customers from one bank to another, deposit insurance, nostro investments, banks acting as market makers and implementing securitization schemes in the banking industry. Recommendation on these matters will be submitted to the Minister of Finance until June 30, 2005.

On November 14, 2004, the Government discussed the recommendations of the Committee and approved them. However, the Director General of the Prime Minister's Office and the Director General of the Ministry of Finance were assigned with the task to form a framework for the implementation of the recommendations of the Committee, after having examined the comments of the Government Ministers and of the public and after consulting with the members of the "Bachar Committee", and if required, suggest adjustments to the proposed Reform.

In February 2005, as a result of the recommendations of the Bachar Committee, the Ministry of Finance published three law proposal memorandums, which declared object is to bring about improvement of competition in the capital market, reduction of centralization and minimization of conflict of interests.

Following are the principal proposed amendments to existing legislation and the new proposed laws:

Banking laws (Banking Law (licensing), Banking Ordinance and Banking Law (customer service))

- Banks shall have to gradually dispose of their holdings in mutual funds and in provident funds over a period of 3 to 4 years.
- Restrictions are to be imposed on the holdings of banks in a corporation that holds provident funds, mutual funds or a corporation that manages investment portfolios of institutional bodies.
- Banks shall be allowed to provide pension advisory services, though material limitations are to apply in this respect.
- The consent of the Supervisor of Banks will have to be obtained for the formation of an auxiliary corporation for a bank.
- The Supervisor of Banks shall be authorized to impose monetary fines (civilian) on a bank that would violate certain provisions of the Banking Law (Licensing), the Banking Ordinance and the Banking Law (Customer service).
- The Supervisor of Banks shall be authorized by legislation to issue proper banking management directives.
- The Supervisor of Banks shall be authorized to pass on to other regulatory authorities information that reached him while performing his duties.

Legislating relating to the supervision of financial services (provident funds, insurance and financial products)

33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

Amendments to the Supervision of Insurance Business Law are proposed, as well as two law proposal memorandums dealing with investment consulting, marketing of pension products and provident funds.

- The Supervision of Insurance Business Law – The power of those engaging in insurance brokerage are to be extended to include also pension consulting, and the authority of the Supervisor of Insurance Business is to be extended both as to the licensing of insurers and insurance agents and to the determination of rules as to insurers and, and also as to enforcement powers.
- The memorandum of the law proposal for the supervision of financial services (engagement in consultancy and in the marketing of pension products) determines the differentiation between consulting and the sale of pension products.

  A bank shall be entitled to provide consulting services as to pension products, with the exception of products managed by institutional bodies, where those who control them or are being controlled by them, are interested parties in the bank, and where they are connected with that body as far as operating management services are concerned.

  A bank shall not be allowed to market pension products.

  Pension consulting shall be provided exclusively at the branches of the bank, and it should not include pension consulting to an employer in respect of his employees.

  A bank shall not be permitted to receive a distribution commission from the manager of the pension product, but only from the customer.
- The memorandum of the law proposal for the supervision of financial services (provident funds) includes all the provisions existing at present in the Income Tax Regulations and regularizes also additional issues. As proposed, a provident fund is to be managed as a trust fund and the rights of the members therein will not be available for pledge or mortgage; the conditions for the establishment of a provident fund management company will be regularized as well as various other issues connected to the activity of such a company and the activity of its organs. The Minister of Finance shall be authorized to determine rules for the management of the fund's moneys, the transfer of the management of a provident fund to another company, merger, etc.

The Law for Regularization of Investment Consulting and Investment Portfolio Management Business

The proposed amendment differentiates between an investment consultant and a marketer. Banks will not be permitted to market financial products. Therefore banks have been defined as consultants; in addition it is proposed that banks would not be permitted to engage in consulting if they hold 5% or more of an institutional body (including an insurer).

A bank holding a consultant license shall not be allowed to offer consultation as regards financial assets of an institutional body, which is controlled by the bank, which controls the bank or which is an interested party in the bank.

A holder of a consultant license shall not be permitted to issue basket certificates.

Banks shall be permitted to market structured products owned by it.

The engagement of a bank with an institutional body for the provision of banking services, which is not part of the ordinary course of business of the bank shall require approval of the Supervisor of Banks, the Chairman of the Securities Authority, and in the coming years also the approval of the Commissioner of Restrictive Trade Practices.

Portfolio managers would be allowed to provide investment consulting and market investments, however, a portfolio manager who is connected to a bank shall not be permitted to engage in marketing.

Anyone who is not a marketer shall not be allowed to receive benefits for consultation, except for fees and reimbursement of expenses from the customer.

33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

Mutual Trust Investments Law

In this respect it is proposed that the Chairman of the Securities Authority would be authorized to approve the holdings of means of control in a fund manager, and restrictions would apply to the acquisition of such means.

A distributor would be allowed to receive a uniform distribution commission from various fund managers in accordance with the types of funds managed by them.

The Minister of Finance shall be authorized to determine the distribution commission that a distributor may charge the customer in the event that the distributor could not reach an arrangement with the fund manager.

The above law proposal memorandums include additional rules to those recommended by the Bachar Committee, and in many cases such rules are even stricter as regards the banks than the rules proposed by the Bachar Committee. The said proposals even increase the supervision and regulation of the operations of banks in a manner that certain of the business areas in which banks engage would require involvement and licensing by two or three Regulators.

It should be noted that at this stage there is no certainty that the said legislation will in fact be passed, and if so, in which format. The scope of the proposed legislation and the implications that changes in certain parts thereof might have, may be most significant to the analysis of the possible implications it might have on the Bank.

The damage to the Bank from detachment of the provident funds and mutual funds is mostly the loss of income and from the difficulty to receive an appropriate price under the constraints of a forced sale, in particular under the circumstances that might be created in the market when all banks would be forced to sell their holdings in provident funds and in mutual funds within a set period, and in view of the intention that holdings at certain rates would require the approval of various Regulators.

The distribution model devised by the proposed legislation is an innovative model that has not as yet been tried by other capital markets in western countries, and the implications that it might have on the income of the Bank and its volume of operations is unclear.

The proposed limitations to be imposed on the additional business in which the Bank may engage in, and which it is unclear whether they would in fact be adopted by legislation, make it difficult to assess, at this stage, the income that the Bank may earn as a result of the implementation of the proposed legislation, including the consideration to be received from the sale of ownership of the provident and mutual funds, the income to be earned from the new areas of operation on the one hand, and the loss of income from provident and mutual funds on the other hand.

Therefore, the Bank believes that the implementation of the Bachar Committee recommendations as well as the adoption of the legislation proposed in its wake, may have a material adverse effect on the business position of the Bank and on its results of operations. However, in view of everything stated above, the probability that all this happen and the future implications of implementation of the proposed capital market reform on the business position and the results of its operations of the Bank cannot be evaluated or quantified at this stage.

It should be noted in this respect that in addition to that stated above regarding a private law proposal regarding provident funds, a private law proposal was tabled before the Knesset on June 7, 2004, which forbids banks to control or to manage mutual funds. This law proposal passed its preliminary reading on July 28, 2004. A private bill was also tabled before the Knesset, the object of which is to preclude banks from acting, directly or indirectly, in the fields of underwriting and investment management.

As to the income of the Group from fees for the management of provident and mutual funds, see Note 26.

34. CREDIT CARD ACTIVITY

A. ACQUISITION OF MEANS OF CONTROL IN ISRAEL CREDIT CARD LTD. (HEREINAFTER – "ICC")

1) On January 3, 2000, the Bank entered into an agreement with Leumi Financial Holdings Ltd. (hereinafter: "LFH") for the purchase of shares in ICC and in Diners Club Israel Ltd. (hereinafter: "Diners") held by LFH, namely shares constituting 65% of the equity capital and 50% of the voting rights in ICC, and shares constituting 28.4% of the equity capital and 50% of the voting rights in Diners.

2) LFH has undertaken to indemnify the Bank for certain claims detailed in the agreement (several of which are discussed in Note 19C.22 above). The amount of the indemnity shall equal the amount resulting from multiplying the amount for which ICC or Diners may become liable, as the case may be, by the rate of holding of LFH. The maximum amount of the indemnity is based on the price paid to LFH for its shares.

   The Bank assigned to its strategic partners in ICC (named in sections 3 and 4 below), a proportionate part of its right to indemnification by Leumi Holdings, in relation to the ratio of the shares held by them to the total number of shares acquired from Leumi Holdings, provided that the cumulative amount of the indemnification should not exceed the amount of the consideration for the shares.

3) During 2000, several agreements were signed with a number of strategic partners – Fishman Chain Stores Ltd., the First international Bank Ltd. And Harel Insurance Investments Ltd. - for the sale of equity shares and voting rights in ICC and in Diners, based on their value as determined in the agreement of January 3, 2000, whereby the Bank purchased those shares from LFH.

   In total, agreements have been signed for the sale of ICC shares granting a 40% equity interest and 31% of the voting rights as well as a right to appoint directors as well as shares in diners constituting 17.46% of the equity and 31% of voting rights, and additional shares granting the right to appoint Directors. The sale of the shares was effected in December 2000.

4) In May 2001, the Bank reached an agreement with Fishman Chain Stores Ltd. According to which the latter will acquire additional shares in ICC granting a 9% equity interest and 6% of the voting rights, as well as additional shares in diners granting 3.92% of the equity interest and 6% of the voting rights. The sale of these shares took effect in December 2001. The approval of Diners International for the sale of the shares in Diners was received in March 2002, and the shares were transferred in June 2002.

5) During the years 2002-2003, the Bank held 51% of the equity and 63% of the voting rights in ICC and Diners. In view of the Bank's intention to sell part of the shares purchased, while maintaining the control over ICC and Diners, the Bank did not taken into account, in computing equity in the earnings of ICC and Diners during the years 2000-2003, the balance of the shares acquired but designated to be sold.

   The minority shareholders' interest in ICC and Diners as of December 31, 2003 and December 31, 2002, was computed at 65% and 28.4%, respectively. The balance of the shares designated as above for sale but not yet sold at December 31, 2003, amounting to 16% in ICC and to 7% in Diners, is included in the financial statements in the item "Available-for-sale securities".

6) The said shares, which are intended for sale, were classified as such since their acquisition from Leumi Holdings in view of the fact that from the beginning they were purchased and held for the purpose of sale.

   In his letter dated June 17, 2004, the Supervisor of Banks informed the bank that in view of the long time that had passed since their acquisition, he feels uneasy with the said continued classification, therefore, if until the date of publication of the financial statements as of September 30, 2004, a draft agreement for their sale is not reached, or alternatively, an offer for sale of the said shares is not published, then, as from the financial statements of September 30, 2004, onwards,

34. CREDIT CARD ACTIVITY (CONTIUED)

the bank will have to state all its holdings in ICC and Diners by the equity value method. The bank implemented the said instruction in its financial statements as of September 30, 2004, this having no material effect upon the financial statements.

Accordingly, the outside shareholders' interest in ICC and Diners as of December 31, 2004, was calculated at 49% and 21.4%, respectively.

B. CHANGES IN THE ARRANGEMENTS CONCERNING THE CREDIT CARD MARKET

1) a. In July, 1998, an agreement was signed between ICC, Bank Leumi and the Bank, on the one part, and Alpha Card, the First International Bank an Oreq, on the other part, regarding the principles applying to the issue and clearing of credit cards in Israel, within the framework of a local agreement.

The Commissioner of Restrictive Trade Practices granted an exemption from having the agreement approved by the Restrictive Trade Practices Court, in terms of the provisions of Section 14 of the Restrictive Practices Law – 1988. This exemption is valid for a period of four years beginning July 7, 1998.

The exemption includes certain restrictive conditions determined by the Commissioner, which regulate the mode of operation in the VISA credit card market.

Among the terms determined in the agreement between the parties and in the exemption granted by the Commissioner, a mechanism has been determined for determining the structure of issuer commissions (hereinafter: "cross commissions") to be paid by those clearing the vouchers to the issuers, their allocation and rates for the transitional period and thereafter.

b. In May 2000, an agreement was signed between ICC, BLL, Leumi Card Ltd., FIBI and Oreq, whereby the parties agree that the local agreement dated July 1998 will apply also to the relations between Leumi Card Ltd. And ICC, except for certain changes. The Commissioner of Restrictive Trade Practices has also granted an exemption also to this agreement, which is valid until July 7, 2002.

c. In July 2000, the Commissioner advised that the first period with regards to the structure of issuer commission to be paid by those who clear voucher to the issuers, is to terminate on August 31, 2000.

On November 12, 2000, the Commissioner advised that the period of the exemption regarding the rate of the cross commission, is to terminate on March 1, 2001, and until that date another relevant rate of commission is to be determined.

On March 8, 2001, the Commissioner decided to grant ICC and Leumi Card (hereinafter: "the VISA companies"), to BLL, the Bank and FIBI (hereinafter: "the banks") an exemption from the requirement to receive an approval from the Restrictive Practices Court to their being parties to a restrictive agreement regarding the cross commission and its rate as applies according to the agreement dated May 18, 2000.

The exemption was granted in terms of the provisions of Section 14 of the Restrictive Trade Practices Law, and is in effect until September 1, 2001. Among the terms determined are: immediate reduction of the cross commission in one of the categories, from a rate of 2.25% to 2%; a reduction of the cross commission so that the average cross commission for all the categories would not exceed 1.25%, and such being by no later than September 1, 2001; cancellation of existing categories of business enterprises relating to the issue of the cross commission and the conversion of businesses to another structure of categories to be agreed upon, with the approval of the Commissioner, all this not later than July 1, 2001. In the absence of consent as aforesaid, the structure of categories will be as determined in an annex to the exemption letter.

In addition, it has been stipulated in the exemption letter that not later than August 1, 2001, the VISA companies and

34. CREDIT CARD ACTIVITY (CONTIUED)

the banks shall commence issuing credit cards of the MasterCard type, in a quantity required for the clearing of such cards, and not later than October 1, 2001, the VISA companies shall clear MasterCard credit cards.

It was further provided that the VISA companies will do everything that is required to diligently base, on a reasoned methodology and full and detailed data, which will be submitted for examination by the Commissioner not later than May 1, 2001, the rate of the cross commission, which in their opinion should apply in Israel. In case that during the period of the exemption, the Commissioner will not be convinced that the rate of the cross commission proposed by the VISA companies is justified, the VISA companies shall, by no later than 30 days of the exemption date, apply to the Restrictive Trade Practices Court for an approval of a restrictive arrangement for the cross commission, at the rate and upon the terms and conditions which were submitted to the Commissioner.

It was further provided in the exemption letter, that a delay in compliance with the terms of the exemption, which does not exceed 30 days, will not be considered violation of those terms.

At the request of the VISA companies, the Commissioner granted an extension until September 16, 2001, for submission of their opinion as to the rate of the cross commission. The said opinion has been submitted.

The Commissioner has declared that in his opinion, a reasoned methodology for determining the rate and structure of the cross commission requested by the VISA companies, has not been presented to the Authorities, as required by the terms of the exemption of March 2001. However, considering the timetable, the Commissioner did not find it proper to decide at this stage, the question as to whether the terms of the exemption of March 2001, have been violated. Furthermore, the Commissioner recommended that the parties to the exemption will apply to the Restrictive Trade Practices Court for approval of a binding arrangement and request a temporary permit to act in accordance with the binding arrangement. The Commissioner emphasized that all this does not derogate from the obligation of the parties to comply with all the other terms of the exemption of March 2001.

d. At the beginning of September 2001 the Bank, ICC, the First International Bank, BLL and Leumi Card (hereinafter – "the Parties") submitted to the Restrictive Trade Practices Court requests for approval of a binding arrangement between themselves and for temporary permits to act in accordance with such an arrangement. In these requests, the Court was asked to approve the rates of issuer commission agreed between the parties on September 9, 2001.

The Commissioner's recommendation for the issue of a temporary permit, was, inter-alia, conditional upon compliance with provisions for protecting competition between clearing and issuing bodies. In this respect, obligations were imposed on the banks, including: avoidance of discrimination between customers based on the identity of the clearing body to which the customer is related, prohibition on relating banking service to a customer to the identity of the clearing body to which the customer is related and prohibition on the granting of benefits in respect of clearing operations.

On September 9, 2001 the Restrictive Trade Practices Court issued a temporary permit to the parties allowing them to act in accordance with the agreement between them of September 9, 2001. ICC and the Bank are acting at present in accordance with the agreement and subject to the provisions determined by the Commissioner.

Since then four objections were filed with the Court opposing the approval of a binding arrangement. In addition, pleas were filed for the cancellation of the temporary permit granted by the Court. ICC and the Bank responded to the said objections and pleas.

On December 22, 2002, the Court, in a reasoned decision, dismissed the pleas of the opponents to cancel the temporary permit, and granted the appellants a temporary permit to operate according to the agreement, until a decision is given in the plea for approval of a binding arrangement in the principal process.

34. CREDIT CARD ACTIVITY (CONTIUED)

On February 12, 2003, within the framework of hearing proofs, the Court requested to receive the response of the Commissioner regarding the arguments raised in the hearing, according to which the Commissioner discriminates between the parties acting in the VISA market and Bank Hapoalim Ltd. and Isracard Ltd. ("Hapoalim Group"). The discrimination argument relates mainly to the rates of commission of the issuer approved for the VISA companies as against the traders commissions that the Hapoalim Group was permitted to collect as part of the agreed Order. The Commissioner rejected the discrimination claims.

The Bank, ICC and the First International Bank in their response to the Court reiterated the said discrimination claim. The hearing of the proofs stages is finished and the hearing is at the stage of summing-up the first stage.

e. On August 11, 2002, the Commissioner extended the validity of the exemption mentioned in sections a and c above by eighteen months, or until the termination of the proceedings at the Restrictive Practices Court (section d above), whichever is earlier, and everything subject to changes made within the framework of the exemption granted in September 2000, and to the extent that the temporary permit given by the Court remains in force.

On February 10, 2004, the Commissioner once again extended the period of the said exemption for one year or until the conclusion of the proceedings at the Restraint of Trade Court.

f. Within the framework of the proceedings at the Restraint of Trade Court, as described in section d above, the Commissioner of Restrictive Trade Practices applied to the Court for an order instructing the appellants to reduce the issuer commissions during the coming months, and also requested the Court to instruct the appellants to inform business houses of the anticipated reduction, so that they are aware of it. These requests of the Commissioner rely on the argument that the appellants deviated from the issuer commissions specified in the provisions of the temporary permit granted by the Court.

In November 2003, ICC and the Bank responded to the plea of the Commissioner, arguing, inter-alia, that the Commissioner is prevented from acting against the appellants, as the alleged deviation had been known to the Commissioner and to anyone on his behalf, and that the computation and presentation of the average issuer commission, as presented by him, are incorrect.

On November 25, 2003, ICC and the Bank received a further request of the Commissioner amending his previous request so that it would apply to longer periods.

ICC has filed a response, following which the Court requested the parties to try and reach a compromise agreement.

On February 25, 2004, the Restraint of Trade Court approved the compromise agreement reached between the Commissioner and the other parties, according to which the average cross commission would be reduced in the course of the year, so that it would not exceed a rate of 1.21% (instead of 1.25%). The parties also agreed to the mode of computation of the average commission and to the manner in which the present agreement could be amended under certain circumstances and the Supreme Court admitted the appeal against the decision of approval

g. On August 4, 2003, the Commissioner of Restrictive Trade Practices informed the three credit card companies in Israel, ICC, LeumiCard and IsraCard, that before taking legal action against them under the Restraint of Trade Law, he offers the companies to reach, within 30 days, a local clearing agreement for the cross-clearing of MasterCard credit cards, on the basis of cross commissions approved as part of the temporary permit granted to the appellants by the Court.

On March 25, 2004, the Commissioner approached the company suggesting a draft arrangement for cross-clearing of MasterCard and VISA credit cards, between the three clearing companies operating in Israel. ICC responded to the Controller that prior to the entering into an arrangement regarding cross clearing the Restrictive Business Practices

34. CREDIT CARD ACTIVITY (CONTIUED)

Authority should enforce the undertaking of IsraCard Ltd. to open for competition the brand name "IsraCard", or to amend the terms of the proposed arrangement, so as to resolve failures that might arise in case the brand name "IsraCard" will not be open for competition. On July 12, 2004, the Controller presented to the parties an updated draft of the arrangement and held a joint meeting in the matter with the parties. According to a letter of the Controller of July 18,2004, and based on the clarifications presented at the above meeting, the three credit card companies were requested to submit their final response to the proposed arrangement by August 8, 2004. ICC has responded to the Controller, however the negotiations regarding the draft arrangement continued. The decision is being implemented as from the beginning of March 2004.

2) According to the requirements of the Commissioner, within the framework of the exemption discussed in B.1c. above, that the MasterCard market shall be opened also to issuance and clearing by companies not related to Bank Hapoalim group, ICC acted to prepare itself for entry into issuance and clearing operations of MasterCard credit cards. ICC approached Eauropay, which owns the franchise for issuing MasterCard credit cards for a license to issue such cards. This request had been approved and accordingly an agreement was signed by the parties.

   As from October 2001, ICC and the Bank commenced the issuance of MasterCard cards, while their clearing by ICC began in February 2002.

3) ICC and Yatzil Finance (a consolidated subsidiary of ICC) were approached on April 14, 2004, by the Restrictive Business Practices Authority regarding a complaint that had been received from various companies engaged in discount services, alleging that ICC refused to enter into agreements for the provision of discount services for credit cards issued by ICC., this being contrary to the merger terms between ICC and Yatzil Finance. In its response ICC provided the reasons for not engaging in the said agreements. On June 3, 2004, the Restrictive Business Practices Authority instructed ICC to publish until June 23, 2004, guiding criteria for entering into agreements with companies discounting and financing credit card vouchers, in order to avoid further complaints. Accordingly, ICC informed the Restrictive Business Practices Authority that in view of the nature of discounting credit card vouchers, any entity wishing to enter into such an agreement with it must abide by the following criteria: financial stability, reliability and suitable technological means and manpower.

   Following discussions held with the Commissioner in this respect, the Commissioner issued a letter on November 18, 2004, according to which, in view of the lack of a positive response on the part of all the parties to the proposed arrangement, he is of the opinion that there is no sense any more in trying to advance the arrangement, and the parties are to await the decision of the Restrictive Trade Practices Court (as stated in subsection (d) above). ICC continues to discuss the said arrangement with the Commissioner, while asking that certain amendments should be made to the proposed arrangement, inter-alia, that the rates of issuer commission determined in the arrangement should be approved by the Restrictive Trade Practices Court, within the framework of the process described above.

   It is not possible to assess at this stage the effect of the new arrangements being formulated as a result of the initiative of the Commissioner of Restrictive Trade Practices on the results of operations of ICC.

   See Note 19 C. 16.3 regarding requests to approve actions against the Bank and against CAL as class action suits, including one request that had been approved and the Supreme Court admitted the appeal against the decision of approval.

35. LEGISLATION INITIATIVES

Several legislation issues exist (laws, regulations and administrative instructions) which are at different stages of the enactment proceedings. Certain of these issues are liable to have an adverse effect on the operations of the Bank and of its consolidated subsidiaries and their business results in the future. The Bank is not able to evaluate the scope of such effect.

36. INFORMATION BASED ON NOMINAL DATA - THE BANK (IN NIS MILLIONS)

	December 31,	December 31,
	2004	2003
Balance Sheet		
Total assets	91,192	(1)(2)90,126
Total liabilities	85,216	(1)84,611
Shareholders' equity	5,976	(2)5,514
	For the Year Ended on December 31	
	2004	2003
Statement of Income		
Net income	586	(2)323

Footnotes:
(1) Reclassified.
(2) Restated - see Note 1 X.

37. SALE OF A CONTROLLING INTEREST IN THE BANK

A. AGREEMENT FOR THE SALE OF A CONTROLLING INTEREST IN THE BANK

On February 1, 2005, the Bank was informed by the State of Israel and by M.I. Holdings Ltd., that on that date an agreement was signed between M.I. Holdings and the Government of Israel (hereinafter: "the Government") on the one hand, and a corporation, which to the best knowledge of M.I. Holdings and the Government is controlled by the Bronfman Family and others, and another corporation, which to the best knowledge of M.I. Holdings and the Government is controlled by Mr. Rubin Schron (hereinafter together: "the Buyers") on the other hand, for the sale of a controlling interest in the Bank (hereinafter – "the Agreement for the Sale of a Controlling Interest in the Bank").

According to the information provided to the Bank, the terms of the Agreement for the Sale of a Controlling Interest in the Bank are as follows:

- The Buyers will purchase shares of the Bank comprising 26% of the outstanding capital of the Bank, and will also receive an option, for a period of three years from the completion of the transaction, to purchase additional shares comprising up to 25% of the outstanding capital of the Bank.
- Arrangements between the Government and the Buyers will be prepared for coordinating their manner of voting and for exercising control of the Bank, and for cooperation and limits which will be imposed with regard to the future sale of shares of the parties in the Bank.
- The completion of the transaction is subject to conditions which were determined, including receipt of various regulatory approvals in Israel and overseas.
- The Employees Agreement, as defined hereunder, was annexed to the Agreement for the sale of a Controlling Interest in the Bank. Pursuant to the Agreement for the Sale of a Controlling Interest in the Bank, if the Bank will not enter into the Employees Agreement or into another arrangement with the employees, which will be in a form not significantly different from the Employees Agreement, and subject to the terms agreed in this matter in the Agreement for the Sale of a Controlling Interest in the Bank, then each of the parties to the Agreement for the Sale of a Controlling Interest in the Bank would be entitled to notify the other parties of the cancellation of the transaction.

B. EMPLOYEES AGREEMENT

On February 1, 2005, concurrently with the signing of the Agreement for the Sale of a Controlling Interest in the Bank, an agreement was signed between the New Histadrut Federation of Labor (hereinafter: "the Histadrut"), the Representative Committee of Discount Bank Employees and the Accountant General of the Ministry of Finance (hereinafter – "the Employees Agreement"), which among other things, is subject to the approval of the Bank. The Employees Agreement is intended to settle several demands raised on behalf of the employees of the Bank in connection with their rights in light of the sale of the controlling interest in the Bank by the State.

Setout below are the provisions of this Agreement:

- The Histadrut, as the organization representing the workers, conceded, on behalf of the employees, their right to purchase the balance of 10% of the shares of the Bank which are held by the State, at a 25% discount, and to a subsidized loan by the Bank to finance this purchase, as is customary in privatization of banks being part of the "Share Arrangement".
- In exchange for the concession, as above-mentioned, the employees will receive from the Government cash amount equivalent to a value of 30% of the value of the 10% of the Bank shares which were not offered at a discount to the employees. In the Employees Agreement it was declared that the value of the benefit for conceding the purchase of the shares as aforesaid is NIS 120 million (hereinafter – "the State Grant to Employees").
- The employees would be entitled to receive from the Bank a bonus on account of 2004, of one salary to each employee

37. SALE OF A CONTROLLING INTEREST IN THE BANK (CONTINUED)

B. EMPLOYEES AGREEMENT (CONTINUED)

(hereinafter – "the Bonus for 2004"), as well as a special grant with regard to conceding of the right to receive a subsidized loan for which they would have been entitled as is customary for the privatization of the banks being a part of the "Share Arrangement" (hereinafter – "the Special Grant").

- The total value of the Special Grant and the Bonus for 2004 is approximately NIS 130 million (hereinafter together: "the Bank Grant to Employees").

  It should be clarified that in a conversation held between the President & CEO of the Bank and the Deputy Accountant General at the Ministry of Finance, it was made clear to the Bank that the amount of the Bank Grant to Employees (amounting as stated above to NIS 130 million) reflects the total cost to the Bank as the employer of these employees. The content of this discussion has been put in writing in a letter sent by the Bank to the Deputy Accountant General. Amounts in excess of the said NIS 130 million, will be paid by the Government.
- The State Grant to Employees and the Bank Grant to Employees (hereinafter – "the Total Grant") amount to NIS 250 million. The Total Grant shall be paid to the employees subject to the closing of the Agreement for the Sale of the Controlling Interest in the Bank, and on dates determined in the agreement.
- The power of the Labor Charter as a collective labor agreement at Discount Bank, shall be extended for a period of five years, namely until December 31, 2009. At the end of this period, the parties shall act with regards to the power of the Labor Charter, in accordance with Section 3 to the Charter.
- The Agreement for the Sale of a Controlling Interest in the Bank is to include a provision that in the event that the control of Discount Bank of New York is sold, then the full cash proceeds of such a sale will be transferred to the Bank, and that no dividend shall be distributed out of such proceeds in the period of five years from date of signing the Agreement for the Sale of a Controlling Interest in the Bank, unless otherwise agreed with the Representative Committee of the Employees.
- The labor dispute announced on March 11, 2004, with regard to the privatization of the Bank, shall be terminated immediately upon the approval of the Employees Agreement.
- Immediately following the approval of the Employees Agreement, the employees will cooperate in any matter or action required for the closing of the transaction for the Sale of the Controlling Interest in the Bank, and for the sale of the balance of the shares remaining in the hands of the State, and in any other required process, if at all.
- Subject to the approval of the Employees Agreement, the parties to the Employees Agreement have mutually committed that in the period until the closing date of the transaction or until September 30, 2005, whichever is later, they will mutually maintain "industrial peace". No one-sided actions will be taken or one-sided organizational changes made by any of the parties that are not compatible with the Labor Charter. No strike or closing-down measures, in part or in full, will be taken, neither will anything that might impair labor relations and orderly work procedures be brought into effect.

The employees entitled to the Total Grant are those who at date of closing are employees of the Bank, of Mercantile Discount Bank and of the wholly owned subsidiaries in Israel, and who are tenured and permanently employed, and also those employed under personal employment agreements, which at closing date have been with the Bank for at least one year.

The Employees Agreement is subject to the approval of the authorized organs of the Bank. On February 7, 2005, the Audit Committee of the Bank and the Board of Directors of the Bank approved the Bank joining the Agreement. The resolution emphasized that the total cost to the Bank (employer's cost) will be NIS 130 million (and shall not exceed that amount). Joining the Agreement is also subject to approval of the General Meeting of Shareholders of the Bank. A general meeting

37. SALE OF A CONTROLLING INTEREST IN THE BANK (CONTINUED)

B. EMPLOYEES AGREEMENT (CONTINUED)

was convened for April 5, 2005.

The Employees Agreement is also subject to the approval of the Finance Committee of the Knesset. The Employees Agreement provides that the Government shall request the approval of the Finance Committee to this Agreement together with the request for approval of the transaction for the Sale of a Controlling Interest in the Bank as one package.

C. THE ACCOUNTING TREATMENT OF THE EMPLOYEE AGREEMENT

The financial statements for 2004 include a provision in respect of the bonus for 2004, to the tune of one salary, based on the assessment that in view of the results for the year 2004, the Bank and its other relevant subsidiaries in the Group would have in any case paid such a bonus to their employees. The amount of the said bonus is NIS 73 million.

The provision in respect of the balance of the Bank Grant to Employees in the amount of NIS 57 million, comprising the said special bonus, will be reflected in 2005, in the financial statements for the quarter in which the conditions precedent in the Employees Agreement are fulfilled, and in particular the closing of the transaction for the sale of a Controlling Interest in the Bank.

As to the State Grant to Employees, the Bank was informed by the Supervisor of Banks that the Grant to be paid by the State (an amount of NIS 120 million, and under certain circumstances even higher, if the State will have to bear further amounts in respect of the addition of employer related costs) is considered "a transaction with a controlling party", therefore the grant paid by the State is to be recorded as part of payroll expenses against a capital reserve.

The expense regarding the State Grant to Employees will be recorded in the financial statements of the Bank, in accordance with the said directive of the Supervisor of Banks, at the time of recording the provision for the special bonus.

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