

**ANNUAL  
REPORT**

2006

## REPORT OF THE BOARD OF DIRECTORS TO THE GENERAL MEETING OF THE SHAREHOLDERS

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## BOARD OF DIRECTORS

**SHLOMO ZOHAR** Chairman, the Bank; Mercantile Discount Bank Ltd.; Israel Credit Cards Ltd.; Israel Discount Capital Markets & Investments Ltd.; The Provident Fund of the Staff of Israel Discount Bank Ltd. Vice Chairman of the Board, Israel Discount Bank of New York; Director, Discount Bancorp Inc.; S. Zohar Consulting & Management Ltd.

**GAD ARBEL** Economic Financial Consultant. Director, Discount Bancorp Inc.; Israel Discount Bank of New York. Outside Director, Psagot Mutual Funds Ltd. Member, Board of Trustees, Director and Chairman, Audit Committee, The College of Management and Academic Studies. Member, Administrative Committee, The Veteran Pension Funds.

**BETZALEL EIGER** Chairman & CEO, Dorea Investments & Development Ltd.; Chairman & CEO, Liberty Properties Ltd. Director, Comsec, Ltd.

**ITTAMAR GIVTON** Managing Director, Automotive Equipment Group. Director, Automotive Equipment Ltd.; Moto Parts Ltd.; Israel Automobile Corporation Ltd.; Automotive Equipment & Vehicles (2004) Ltd.; Metive Ltd.; Automotive Industries Ltd.; Advanced Vehicles C.R.M Ltd.; M.S.Y. Sport Cars Israel Ltd.; Metropolitan Public Transport Ltd.; Metrodan Beer Sheva Ltd. Member of Management Committee, Buxenbaum-Neta Fund (private fund); Member of Management, Sheba Fund (Endowment).

**BEN-ZION GRANIT** Management Consultant. Member of Management, Ilan - Israel Foundation for Handicapped Children.

**GENE KLEINHENDLER** Attorney-at-Law and Partner in Law Offices of Gross, Kleinhendler, Hodak, Halevy, Greenberg & Co. Director, K.H. Trustees Ltd.; Kleinhendler & Halevy Trustees Ltd.; Law Firm of Gene Kleinhendler.; Employees Remuneration Trust Company.; Gross, Kleinhendler, Hodak, Halevy, Greenberg, Trustees Ltd.; Jerack Inc.

**TSIPPI SAMET** (Outside Director) Outside Director, Menora Mivtachim Pensions Ltd.; Menora Mivtachim Gemel Ltd.; Sinai Insurance Holdings (1993) Ltd.; Ophir Optronics Ltd.; Chair, Investment Committee, Avner-Motor Vehicle Accident Victims Insurance Ltd. President, Adif College for Insurance, Pension and Financial Studies. Director, Merav—Yaniv Pension Consultants Ltd..

**TIDA SHAMIR** Attorney at Law and Director, Tida Shamir & Co.- Advocates. Outside Director, Gazit Globe Ltd. Director, Dikla Insurance Company Ltd.; G.M.S.L. Ltd.

**DR. YITZHAK SHARIR** Private Investments. Outside Director, Zur Shamir Holdings Ltd.

**PROF. EYTAN SHESHINSKY** Professor of Public Finance, Hebrew University, Jerusalem. Director, Psagot Mutual Funds Ltd.

**JOSEPH SINGER** (Outside 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.

**ZVI STREIGOLD** Attorney-at-Law and Director, Zvi Streigold - Law Company.

**ZEEV VUREMBRAND** CEO, Clalit Health Services. Chairman, Mor Institute for Medical Data Ltd.; Shila - Medical Services Ltd; Clalit - Medical Engineering Ltd.

**JORGE ZAFRAN** Director & CEO, Power Phone Marketing Ltd.; Power Dialing Ltd.; Inter-American Marketing Services Ltd.; Cadillac Properties and Building Company Ltd.; Israel Learning Systems Ltd. Joint Managing Director, T.M. Intertrom Ltd.

**PROF. BEN-ZION ZILBERFARB** Professor of Economics, Bar-Ilan University. Edmond de Rothschild Chair for Global Asset Management, School of Banking and Capital Markets, Netanya Academic College. Outside Director, Fundtech Ltd.; Brimag Digital Age Ltd.; Direct Capital Investments Ltd.; The Delek Group Ltd.; Perrigo Company. Director, Prof. Ben-Zion Zilberfarb Economic and Management Consultant Ltd.

## MANAGEMENT

**GIORA OFFER** President & Chief Executive Officer. **DORIT BEN SIMON** Executive Vice President \ Finance Division\ Risk Manager. **LINDA BENSOSHAN** Executive Vice President \ Asset Management Division. **JOSEPH BERESSI** Executive Vice President \ Chief Accountant \ Accounting Group. **ISRAEL DAVID** Executive Vice President \ Retail Banking Division. **ESTHER DEUTSCH** Legal Adviser \ Legal Advisory Group. **AMNON GIDEON** Executive Vice President \ Human Resources Group. **NOAM HANEGBI** Executive Vice President \ Operations & Information Systems Division. **ELI HOTER** Executive Vice President \ Marketing & Strategic Planning Division.

**SHLOMO PITCHON** Senior Executive Vice President \ Internal Auditor.

**RUTH MOSHKOVITZ** Corporate Secretary.

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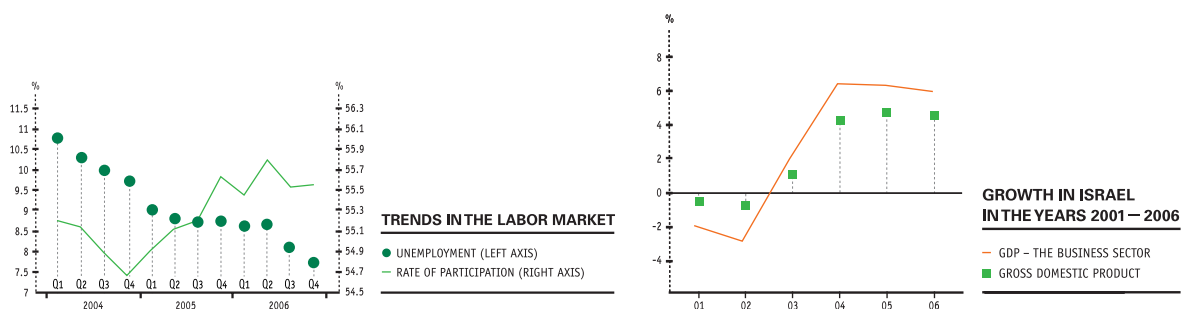
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The Board of Directors, on March 27, 2007, approved and authorized for publication the consolidated financial statements of the Bank and its subsidiaries for the year ended December 31, 2006.

## MAIN DEVELOPMENTS IN THE ISRAELI ECONOMY IN 2006

### GENERAL

The Israeli economy continued to grow in 2006 at an accelerated rate of 5.1%, similarly to the growth rates in the years 2004 and 2005 (which were 4.8% and 5.2% respectively), this despite the war in the North of Israel, which caused a significant decline in economic activity, particularly in the third quarter of the year. The business product increased in 2006 at a rate of 6.4%, compared to an increase of 6.7% in 2005. Increased growth rates were also recorded in investments in fixed assets (6.4% in 2006 compared to 2.9% in 2005) and in private



consumption expenditure (4.8% in 2006 compared to 3.4% in 2005). Exports increased at a rate of 4.9%, compared with 5.1% in 2005, among other things, due to the decline in tourist services exports as a result of the war in the North of Israel. Import grew at a lower rate of 3.1%, so that the goods and services balance improved and turned into a positive one. The accelerated growth continued to positively impact the labor market and the level of unemployment decreased from 8.9% in the last quarter of 2005 to 7.7% in the last quarter of 2006. The number of employee positions in the economy increased in 2006 at the rate of 2.3%, reaching 2.6 million positions in the last quarter of the year.

### DEVELOPMENTS IN GLOBAL ECONOMY

The growth trend of the global economy and of developed economies continued in 2006. The growth in the US economy was accelerated and amounted to 3.3% (compared to 3.2% in 2005), this despite a considerable slowdown in the residential property sector, which caused a decrease of 4.2% in housing construction investments. The interest rate in the US stabilized itself at a level of 5.25%, compared to 4.25% at the end of 2005. The economy of the Euro block grew in 2006 by 2.7%, compared to 1.4% in 2005, this due to the increase in private consumption expenditure and in investments. During the course of 2006, the European Central Bank increased the interest rate from 2.25% at the end of 2005 to 3.5% at the end of 2006. The Japanese economy continued to

grow in 2006 and the GDP increased by 2.2%, compared with 2.6% in 2005. In June 2006, the Central Bank of Japan increased the interest rate to 0.25%, the first time in six years in which the interest rate stood at 0%.

## DEVELOPMENTS IN THE ISRAELI ECONOMIC SECTORS

Industrial production expanded in 2006 at the rate of 10.5% compared with 3.7% in 2005. A particularly sharp increase at the rate of 23.5% was recorded in the high-technology industries (including the electronics, aircraft and pharmaceuticals), as compared to 5.4% during 2005. Expansion also continued on the demand side and revenues of the trading and services sectors increased in 2006 by 9.2%, in continuation to a growth of 7.8% in 2005

The war in the North caused a sharp decrease in the incoming tourist trade, and eliminating seasonality, the number of incoming tourists (by air) dropped from 149 thousand in the month of June 2006 to 94 thousand in September 2006. Concurrently, the number of tourist bed/nights dropped from 678 thousand in June 2006 to a low of 364 thousand bed/nights in September 2006. However, the recovery of this sector was swifter than expected at first, and the number of incoming tourists in December reached 121 thousand whereas the number of tourist bed/nights increased to 548 thousand. In total, a decrease of 4.5% was recorded in 2006 in the number of incoming tourists, which stood at 1.8 million. In contrast, the number of tourist bed/nights recorded an increase of 1.1% reaching 6.8 million. The said increase in the number of bed/nights derived from the increase in the first half of 2006 at an annualized rate of 33%, which offset the impact of the war in the North of Israel. Mixed trends continued to characterize the building trade in 2006. On the demand side, the number of apartments sold in 2006 increased by 3.6%, compared to 2005, reaching 13,282. In contrast, the number of new apartments, the construction of which began in 2006, dropped by 4.7% as compared to 2005, reaching 29,679 units. Trends in the construction industry also varied according to geographical regions. For example, the number of apartments sold in the reported year, increased by 27.8% in the Tel-Aviv area and by 8.2% in the central region. In contrast, a decline of 30.3% was recorded in the Jerusalem area, a decline of 261.3% was recorded in the northern region and a decline of 19.3% was recorded in the Haifa area.

## DEVELOPMENTS IN ECONOMIC ACTIVITY VIS-À-VIS FOREIGN MARKETS

According to the balance of payments data, export of goods and services in 2006 amounted to US\$62.6 billion, whereas the import of goods and services amounted to US\$61.7 billion. The balance of trade therefore, showed a surplus of US\$944 million, compared with a surplus of only US\$25 million in 2005. The growth trend in the income of Israelis from overseas investments and work continued, amounting to US\$6.6 billion, compared to US\$5.5 billion in 2005. The overall current account balance showed a surplus of US\$6.8 billion, compared with a surplus of US\$4.3 billion in 2005.

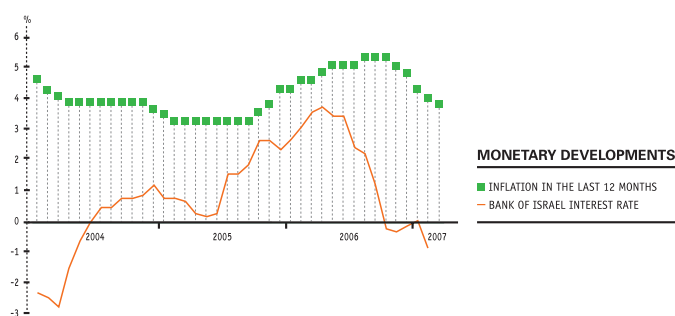
The flows of incoming and outgoing investments recorded a dramatic increase in 2006, when foreign investments in Israel amounted to US\$24.5 billion, of which US\$14.2 billion of direct investments and US\$8.6 billion of investments in marketable securities. In 2005, foreign investments in Israel amounted to US\$9.8 billion. Israeli investments overseas amounted in 2006 to US\$32.1 billion, of which US\$13.6 billion of direct investments and US\$8.8 billion in marketable securities. In 2005, Israeli investments abroad amounted to US\$18.5 billion.

## DEVELOPMENTS IN FOREIGN EXCHANGE RATES AND INFLATION RATES

The New Israel Shekel (NIS) appreciated as against the US dollar in the course of 2006 at a rate of 8.2%, following a devaluation of 6.8% in 2005. The NIS also appreciated against the currency basket at the rate of 5.2%, compared with a devaluation of 1.7% in 2005. The appreciation against the US dollar occurred on the background of the weakening dollar against the leading currencies in the world, the large surplus on current account attained by Israel, and the massive inflow of investments into the Israeli economy.

The Consumer Price Index (CPI) decreased during 2006 by 0.1%, compared to an increase of 2.4% recorded during 2005. This level is noticeably lower than the lower limit of inflation as targeted by the Government, being an annual increase of 1%-3%. In contrast, the CPI excluding housing and excluding fruit and vegetables, increased in 2006 by 0.9%, compared to 1.8% in 2005. The wholesale price index of industrial output for the local market decreased at the rate of 2.1%, following an increase of 5.2% in 2005.

The decline in the CPI in 2006 was largely the result of the strengthening NIS as against the US dollar. This



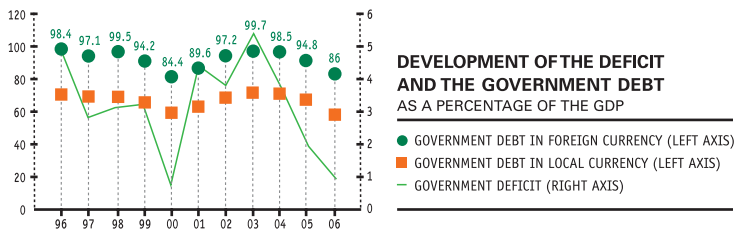
brought about a decrease in prices of products and services linked to the NIS/dollar exchange rate, in particular property owner services (which declined by 6.3%) and property rent (which declined by 5.7%). These constitute together some 22% of the CPI. The sharp drop in oil prices in the world recorded in the second half of 2006 also had its impact, which reduced the price of fuel and transportation services in Israel. However, the price levels at the end of the year were similar to those at the beginning of the year. A study of the principal consumer groups shows that the decrease in prices covered the housing item (-6.1%), footwear and apparel (-1.7%) and housing maintenance (-1.2%). On the other hand marked price increases were recorded in the fruit and vegetable item (12%), other foodstuff item (3.6%), health services (1.8%), and in the education, culture and entertainment items (1.2%). The other principal consumer groups remained relatively stable.

The money supply (the M1 total of cash and bank current accounts held by the public), which increased during 2005 by 23.9%, grew during 2006 by only 7.5%, reaching NIS 51.7 billion at the end of December 2006.

## FISCAL AND MONETARY POLICY

Actual performance data of the State's budget in 2006 indicate a deficit of NIS 5.5 billion (excluding the granting of credit), an amount comprising 0.9% of the GDP, compared to 1.9% in 2005. The low deficit in 2006 derives from revenues totaling NIS 211 billion (excluding the collection of debts), exceeding the planned amount by NIS 11.9 billion. Despite the increase in expenditure of the Defense Ministry, resulting from the war in Lebanon, the original framework of expenditure in the amount of NIS 216 billion (excluding the granting of credit) was maintained due to across the board cuts and the transfer to the budget of the Ministry of Defense of surplus resulting from under-performance or amounts kept in reserve.

Nearly all through the first nine months of the year, Bank of Israel maintained a margin of 0.25% over the US interest rate, and increased the interest rate in Israel in parallel to increases in the US interest rate, from a level of 4.5% in December 2005 to a level of 5.5% in August 2006. On the background of the strengthening NIS and the sharp drop in oil prices, the CPI dropped sharply in the months September-November forcing Bank of Israel



to reduce the interest rate by a cumulative rate of 0.5%, to a level of 5% in December 2006. As a result, the interest margin vis-à-vis the US turned into a negative margin of 0.25%.

## THE CAPITAL MARKET

In the course of the first eleven months of 2006, the asset portfolio of the public grew by 11.6% reaching at the end of this period a total amount of NIS 1,860 billion. Also in this year, out of the total asset portfolio, the growth trend in the weight of investments in foreign securities (from 3.2% to 3.5%) and in local securities (from 19.8% to 22.4%) continued. The corporation bonds market presented also this year a marked growth, the total registered amount of such bonds increasing from NIS 87.5 billion in December 2005 to NIS 122.7 billion in November 2006. Following sharp increases in 2005, share price increases were more moderate in 2006 and the general share index increased by 5.8%. The daily average trade turnover amounted to NIS 1.5 billion, compared to an average daily turnover of NIS 1 billion in 2005. Increases in share prices in 2006 covered all sectors, excluding the industrial sector, which dropped by 12.9%. Sharp increases were recorded in shares of real-estate companies (62.4%) and in shares of investment companies (37.7%). In 2006 the "TA 25" Index increased by 12.5%, the "TA 100" Index increased by 12%, while the "Tel Tech" Index decreased by 2.9%.

The market value of shares and convertible securities reached NIS 681.9 billion at the end of 2006, compared to NIS 564.3 billion at the end of 2005. Large withdrawals from mutual funds were recorded in the course of 2006,

amounting to NIS 18.4 billion, compared with deposits of NIS 16.3 billion in 2005. The withdrawals covered all classes of mutual funds: funds specializing in the stock market recorded withdrawals of NIS 376 million, funds specializing in the bond market recorded withdrawals of NIS 6.5 billion, funds specializing in NIS investments recorded withdrawals of NIS 9.4 billion, while funds specializing in foreign investments recorded withdrawals of NIS 2.1 billion.

Dynamic activity continued in 2006 in the trading in options on the "TA 25" Index and the average daily trade turnover amounted to some 305 thousand contracts, compared to 258 thousand contracts in 2005.

The general bond index covering all classes of bonds increased during the year by 4.6%, increases in market quotations being recorded in the non-linked and CPI linked channels while decreases in quotations being recorded in the foreign currency linked channels. The average daily trade turnover in bonds on the Tel-Aviv Stock Exchange increased from NIS 1.3 billion in 2005 to NIS 1.7 billion in 2006. A marked increase in trade turnover was recorded in non-linked Government bonds, which increased from NIS 759 million in 2005 to over NIS 1 billion in 2006. A fair increase occurred in the fourth quarter of the year when the Government bonds market makers reform was introduced.

The CPI linked Government bonds index increased in 2006 by 4.1%. Price increases of 2.3% were recorded in the redemption periods of up to two years and between two and five years, while price increases of 3.4% were recorded in the redemption periods of between five and seven years and price increases of 3.9% were recorded in the redemption periods of between seven and ten years.

The non-linked Government bonds index increased in 2006 by 6.4%. A price increase of 7.3% was recorded in the fixed interest bonds of the "Shachar" class, non-linked bonds of the "Galil" class recorded a price increase of 4.9%, while the short term loan (MAKAM) recorded a price increase of 5.7%.

## THE BANKING INDUSTRY

On the background of the continued economic growth in Israel and the world over and the expansion in the capital market activity, improvement in the profitability of the banking industry and the decrease in its risks also continued in 2006. This to a large extent being due to the decrease in the provisions for loan losses, the increase in financing income and in gains from the sale of investee companies, as part of the implementation of the capital market reform following the Bachar Committee recommendations. During the first three quarters of the year improvements were noticed both on the asset side and on the liabilities side of the five large banking groups. The volume of assets grew by 1.8% reaching NIS 875 billion. The growth on the asset side derived from a growth in the volume of securities held by the banks of 3.9% (NIS 5.7 billion), in the volume of credit to the public of 0.8% (NIS 4.5 billion) and in the volume of cash and deposits with banks of 3.5% (NIS 4.1 billion). In contrast, due to the implementation of the Bachar Committee recommendation, investments in investee companies decreased by 10.8% (NIS 3.9 billion). On the liabilities side a growth of 1.9% was recorded in deposits of the public (NIS 11.1 billion and 11.7% in shareholders' equity (NIS 5.6 billion).

A study of credit to the public according to linkage segments at the five large banking groups, in the first three quarters of 2006, indicates an increase in the non-linked credit from 36.9% to 39.2%, as compared with a decline in the foreign currency linked segment (from 31.6% to 30.8%) and in the CPI linked segment (from 31.5% to 30.8%). On the deposit side the weight of the foreign currency linked segment increased (from 44.0% to 44.6%).

A minor growth took place in the non-linked segment (from 40.7% to 41%) and a decrease in the CPI linked segment (From 15.3% to 11.3%).

The effective average return on the total non-linked NIS use of funds at the seven largest banks increased during 2006 from a rate of 6.32% in December 2005 to a rate of 7.03% in December 2006.

The effective average cost of the total non-linked NIS resources at the seven largest banks increased during 2006 from a rate of 3.21% in December 2005 to a rate of 3.88% in December 2006.

The financial margin, including management fees, in the non-linked NIS segment at the seven largest banks declined during 2006, from a level of 3.7% in December 2005 to a level of 3.31% in December 2006.

### PRINCIPAL ECONOMIC DEVELOPMENTS IN JANUARY – MARCH 2007

The NIS weakened in January 2007 as against the US dollar by 0.8%, following a long period of strength, and the exchange rate stood at the end of January at NIS 4.26 to one US dollar. In February 2007, despite the continued decrease in interest rates, the NIS returned to its appreciation course and at the end of the month the exchange rate was NIS 4.21 to US dollar one.

The continued strengthening of the NIS caused Bank of Israel to reduce the interest rate three additional times since the beginning of 2007: to a level of 4.5% in January 2007, to a level of 4.25% in February 2007 and to a level of 4% in March 2007, resulting in the widening of the negative interest gap between Israel and the US to 1.25%.

In January 2007, the CPI dropped by 0.1% and in February 2007 it dropped further by 0.3%. In the 12 months ended February 2007, the inflation rate amounted to -0.8%, a rate lower by 1.2% than the official inflation rate targeted by the Government.

A surplus of NIS 4.3 billion (excluding the net granting of credit) was recorded in the Government budget in January 2007. State revenues reached a record high of NIS 17.4 billion (excluding the net granting of credit). February 2007 recorded a surplus of NIS 1.1 billion, and the cumulative balance sheet in the first two months of 2007 is positive amounting to NIS 5.4 billion.

### FORWARD-LOOKING INFORMATION

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

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

Forward-looking information is typified by terms and words like: "believe", "anticipate", "estimate", "intends", "prepares to...", "might" and similar expressions, in addition to nouns such as: "desire", "anticipation", "intention", "expectation", "assessment", "forecast", etc. Such forward-looking expressions involve risks and uncertainties as they are based on evaluations by management as to future events, which include, among other things, evaluations as to the state of the economy, public preferences, domestic and foreign interest rates, inflation rates, etc. as well as regarding the effects of new legislative and regulatory provisions relating to the

banking industry and the capital market and to other fields that have an impact on the activity of the Bank and on the environment in which it operates, and that by the nature of things, their realization is uncertain.

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

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

## 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 (hereinafter: “ the Banking Law (Licensing)”).

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

### DOMESTIC OPERATIONS

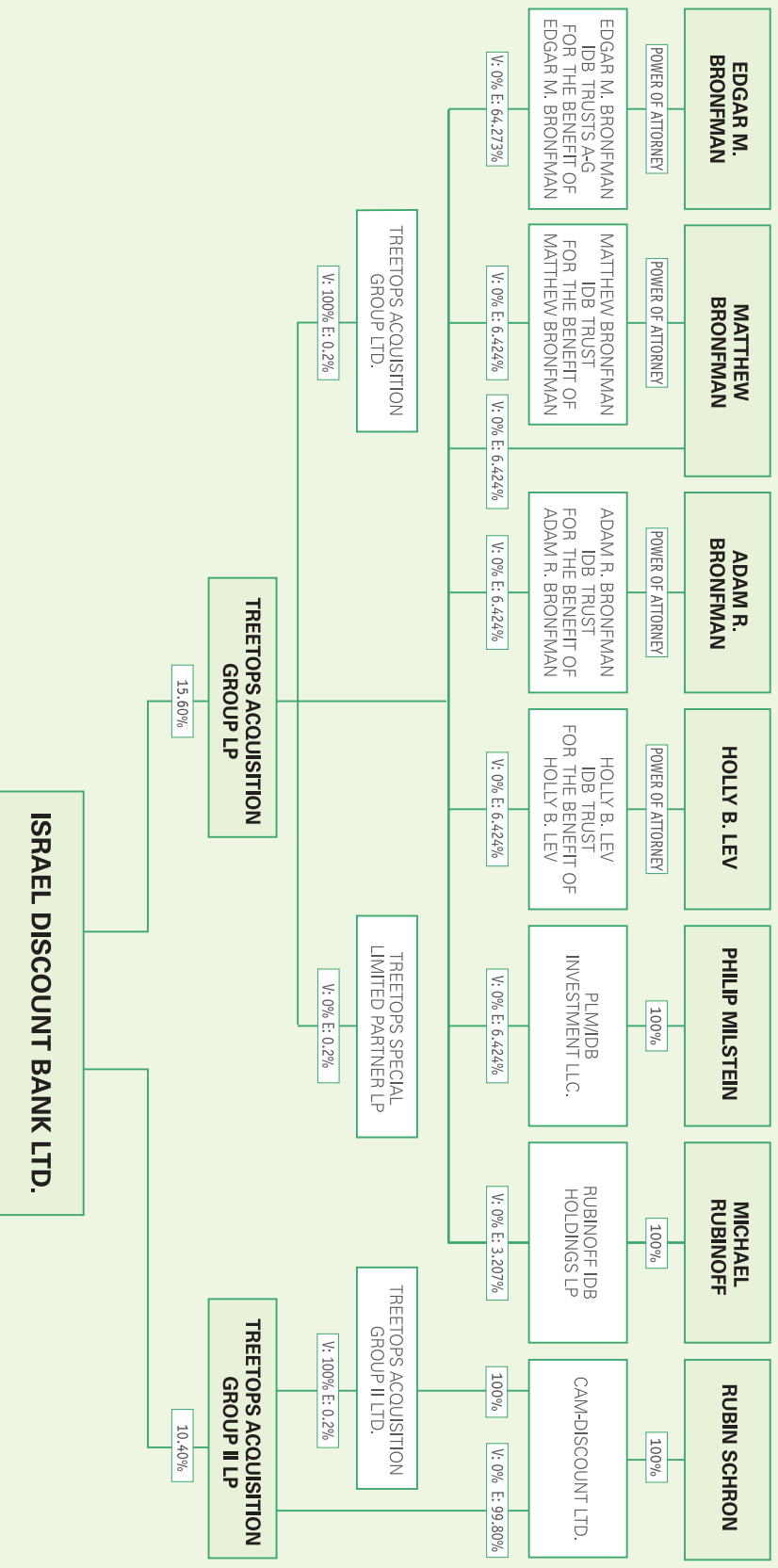
The Bank is a universal bank, which grants its customers comprehensive banking services in all areas of financial activity, through 125 branches in Israel. The Bank also offers its customers a variety of direct banking, on-line banking and Internet services.

The Bank has two banking subsidiaries in Israel – Mercantile Discount Bank Ltd. – a commercial bank serving customers in all fields of financial activity through 65 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., also being one of the five major banking groups in Israel.

The activities in Israel include additional areas, mainly:

- 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.
- Securities portfolio management – The subsidiary, Tachlit Investment House Ltd., which manages securities investment portfolios for private customers, corporations, not-for-profit organizations and institutional bodies.
- Investments, venture capital funds and underwriting – The subsidiary, Israel Discount Capital Markets and Investments Ltd., engages in investment banking, as well as investing in venture capital funds together with foreign institutional bodies and in securities issuance underwriting and management.
- Provident funds – The subsidiary, Discount Management of Provident Fund, manages at present a variety of provident funds and in the future, following sale of this activity, it will provide operating services to provident funds and mutual funds.

CONTROLLING SHAREHOLDERS OF ISRAEL DISCOUNT BANK AS OF MARCH 23, 2007



V = VOTING  
E = EQUITY

- 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. The Bank's activity in Israel is facing significant changes due to the implementation of the legislation passed in the wake of the Bachar Committee recommendations. These changes include the sale of shares of Ilanot Discount Ltd., the sale of the operations of the provident funds, decrease in the holdings in Harel Insurance Investments Ltd., the sale of holdings in the advanced training funds (Kahal) and the preparations for the entry into the pension consultancy field. Since these transactions were completed gradually during 2006, and in part will become effective in 2007, their impact has not yet been fully reflected. For details see hereunder "Operations in the capital market" under "Further details as to activity in certain products", "Legislation and supervision" and Notes 6 F and 33 to the financial statements.

### OVERSEAS EXTENSIONS OF THE BANK

The major part of the Bank's operations abroad is conducted by Israel Discount Bank of New York, which is the largest of all Israeli banks operating abroad. The Bank also holds a commercial bank in Montevideo, Uruguay and a bank in Switzerland, located in Geneva, which focuses on private banking. The Bank operates a London branch, which provides commercial and private banking services.

In addition, the Bank has representative offices in Paris, Berlin, Buenos Aires, Santiago and São Paulo.

### MARKET SHARE

Based on data relating to the banking industry as of September 30, 2006, published by the Bank of Israel, the Discount Bank Group's share in the total of the five largest banking groups in Israel was as follows:

	September 30, 2006	December 31, 2005	December 31, 2004
	In %		
Total assets	17.9	18.0	17.5
Credit to the public	15.3	15.1	14.5
Deposits of the public	18.4	18.6	18.3
Earnings from financing operations	16.7	17.2	17.4
Provision for doubtful debts	17.5	17.5	17.7
Operating income	17.1	18.7	19.0
Operating expenses	20.8	22.3	22.3

### MAJOR FIGURES FROM THE CONDENSED FINANCIAL STATEMENTS

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

- **Retail Banking – Household Segment:** This segment includes customers of the Bank's Retail Division who are private customers, who are defined as customers who are either salaried employees, possess the potential for growth, or may be viewed as VIP customers (the definition excludes customers of the private banking centers). The segment also includes the customers of Mercantile Discount Bank in that bank's household segment – private customers of Mercantile Discount Bank, whose activities are typical of those of households, including

- credit of a volume not exceeding NIS 200 thousand and deposits of a volume not exceeding NIS 500 thousand.
- **Retail Banking – Small Business Segment:** This segment includes customers of the Bank's Retail Division which are defined as small companies and small businesses with borrowings of up to NIS 4 million. The segment also includes the customers of Mercantile Discount Bank in that bank's small business segment – that bank's small business segment customers (individuals and corporations) whose granted volume of credit does not generally exceed NIS 1 million.
  - **Corporate banking:** 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 – corporations whose annual business turnover generally exceeds NIS 100 million and public companies handled by the corporate division of Mercantile Discount Bank.
  - **Middle Market banking:** 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. The segment also includes customers of the Middle Market banking of Mercantile Discount Bank – business customers (individuals and corporations) having a medium level of activity, whose granted volume of credit exceeds NIS 1 million and who do not belong to the corporate banking segment of Mercantile Discount Bank.
  - **Private banking:** This segment includes customers of the Bank's Retail Division (individuals and corporations) who maintain their accounts at the private banking centers.
  - **Financial Management Segment.** 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 management of market and liquidity risks and dealing room operations, including those involving derivatives. This segment also includes the Bank's share in the income of the First International Bank and its share in the income of its affiliated companies which operate in a supporting capacity. The segment also includes the non-financial corporations sub-segment, which includes the Discount Group activity in non-financial investments.

Starting with the year 2006, these segments include also the related part of the international operations of the Discount Group. This Report includes a chapter describing the international operations of the Discount Group.

These segments include also the related part of the operations of the product segments: credit cards, capital market activity, mortgages, construction and real estate.

- **Credit card Operations** The activity of the Bank in the credit card field is being conducted both through Israel Credit Cards Ltd. (hereinafter – "ICC"), a credit card company owned as to 65% by the Bank, and by the issue as co-issuers of ICC credit cards to customers of the Bank, as part of the services and products basket offered by the Bank.

The income of the Bank from the credit card operations includes, primarily, various commissions related to the credit card activity of ICC (both as an issuer of credit cards and as a clearing agent for credit cards), as well as the financing income from credit granted to transactions effected through off-banking credit cards. In addition, the bank derives income from payments transferred to it in respect of credit cards issued to its customers by ICC, at the initiative of the Bank.

- **Operations in the Capital Market:** The operations in the capital market 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 operations include the activity of the Bank's securities department, as well as the operations of specialized subsidiaries: Tachlit Investment House, Discount Management of Provident Fund and Kahal, and the operations in the capital market of Mercantile Discount Bank. Until June 30, 2006, the activities included those of the specialized subsidiary Ilanot Discount, that has been sold.

- **Mortgage and Housing Loan Activity:** his 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.
- **Construction and Real Estate Activity:** This activity includes customers of the Bank's various divisions whose industry classification is construction and real estate. This activity also includes customers of the construction and real estate segment of the Mercantile Discount Bank and the loans for the purchase or building of commercial property segment at Discount Mortgage Bank and the building project finance segment at Discount Mortgage Bank.

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

For details regarding the assumptions, assessments and reporting principles used in the preparations of the data, see Note 31 to the financial statements.

**PRINCIPAL DATA TAKEN FROM THE CONSOLIDATED FINANCIAL STATEMENTS**
**PROFITABILITY**

For the year ended December 31	Rate of change in %			2006	2005
	2006	2005	2004		
	In NIS millions			Compared with 2005	Compared with 2004
Income from financing activities before provision for doubtful debts	3,790	3,697	3,473	2.5	6.4
Provision for doubtful debts	570	691	880	(17.5)	(21.5)
Income from financing activities after provision for doubtful debts	3,220	3,006	2,593	7.1	15.9
Non-financing income	2,359	2,401	2,226	(2.0)	7.9
Non-financing expenses	5,020	4,724	4,023	6.2	17.4
Operating income before taxes	559	683	796	(18.26)	(14.2)
Operating income after taxes	209	359	454	(41.8)	(20.9)
Net income	836	458	556	82.5	(17.6)
Net income disregarding certain components*	666	693	659	(3.9)	5.2
Net earnings per share of NIS 0.1 par value	0.85	0.47	0.57		
The return on shareholders' equity	12.2	7.2	9.3		
The return on shareholders' equity disregarding certain components*	9.7	10.9	11.1		

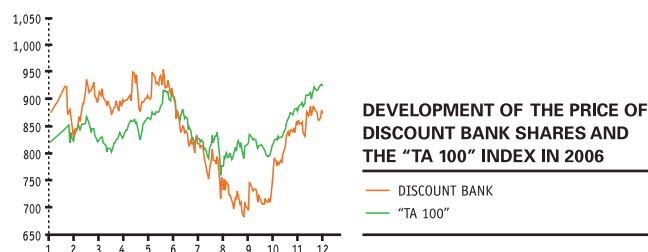
\* For details regarding the components that had been eliminated, see "Income and Profitability" hereinafter.

**BALANCE SHEET**

	As at December 31		Rate of change
	2006	2005	
	In NIS millions		in %
Total assets	162,538	158,720	2.4
Credit granted to the public	90,175	87,816	2.7
Securities	38,914	42,188	(7.8)
Deposits from the public	130,517	130,285	0.2
Shareholders' equity including minority interests	8,367	7,185	16.5
Shareholders' equity	7,965	6,718	18.6

## FINANCIAL RATIOS

	As at December 31	
	2006	2005
	In %	
Capital resources in relation to total assets	5.1	4.5
Ratio of capital to risk assets	10.45	9.38
Ratio of the provision for doubtful debts to credit to the public	0.59	0.74
Ratio of credit to the public to total assets	55.5	55.3
Ratio of credit to the public to deposits of the public	69.1	67.4
Ratio of deposits of the public to total assets	80.3	82.1
Ratio of operating income to operating expenses	47.0	50.8
Total income relative to operating expenses.	122.5	129.1



## THE STRATEGIC PLAN

In March 2007, the bank adopted a multi-annual strategic plan intended to bring the Bank onto an accelerated growth route.

### BACKGROUND – PREVIOUS STRATEGIC PLANS

The strategic plan for the years 2007-2011 constitutes a direct continuation of the two previous strategic plans: **A recovery plan (2001)** that reached most of its targets and which reverted the bank to a route of profitability. During the period of this plan, 100 thousand new customers were attracted to the bank.

**A differentiation and leadership plan (2004)** that determined the vision of humane banking and the strategic backbone of the Bank, which guide the Bank's operations and forms the basis for its strategic plans:

- **The mission:** Humane banking;
- **The purpose:** Combining humaneness with professionalism;
- **The assignment:** Leading the personal and humane service experience;
- **Basic values:** The love of humanity, professionalism, integrity, initiative and commitment;
- **Market identity:** Discount Bank leading the personal and humane service experience, based on attentiveness and understanding of the customer's needs, creating innovative and clear solutions and rated by customer satisfaction;

- **The strategic pledge:** Taking you personally;
- **The strategic focus:** Satisfying every customer, whether an external or an internal one.

### THE STRATEGIC PLAN FOR THE YEARS 2007-2011

The strategic plan for the years 2007-2011 – the accelerated growth plan – determines a strategic framework for increasing the value of the Bank and is based on growth engines in addition to the growth in current operations of the Bank. The strategic plan engulfs all areas of operation at the Bank and is measurable and controllable. Two moves comprising the necessary infrastructure for growth, were completed in 2006: stabilization of the new computer system (the Ofek Project) and the significant improvement in capital adequacy to a level that allows the expansion of banking operations.

#### THE TARGETS OF THE STRATEGIC PLAN:

- Double digit annual growth in net operating income;
- Return on equity of at least 13% as from 2010;
- Consistent improvement in operating indices.

It should be noted that the said minimum return assumes a distribution of dividend as from the year 2009, from the income of 2008, even though the Bank's Board of Directors has not yet adopted a dividend policy and has not decided on any dividend distribution.

#### HUMANE BANKING

The Bank is to continue operating in line with the humane banking vision as regards its customers and staff, with social responsibility and involvement.

#### THE RETAIL BANKING SEGMENT

The differentiation and leadership moves in retail banking will continue to be based on the expansion of the retail service model unique to Discount Bank: tens of branches all over the country opened 10-12 hours per day, every day, offering new service norms in Israel.

Intensifying the activity with Bank customers is to be achieved by improving the ability to adapt to each customer the product package preferred by him. This concurrently with the improvement in the management information systems of the Bank, including the measurement of customer profitability.

#### THE CORPORATE AND MIDDLE MARKET BANKING SEGMENT

The merger of the corporate and middle market divisions is to be completed in 2007. This merger will improve the preparation and focusing on the risk management field, the efficiency of the system and the decision making process, while reorganizing the business layout of the Bank

Following the improvement in the business results of the Bank and in its capital adequacy it would be also possible in future years to act towards increasing the income from credit.

#### FINANCIAL MANAGEMENT SEGMENT

In the coming years, the financial segment is to serve as a profit growth engine with the establishment of the

global treasury layout (the group asset and liability management and dealing room), which is to act with a view of realizing the advantages of the international disposition of the Discount group. The dealing rooms, risk management and the asset and liability management will gradually be converted into group management. The improvement in the Bank's capital adequacy brought about an increased ability to take on risks. In view of this, the bank intends to increase in a controlled manner the risk level of the Bank's own investments (Nostro investments) in order to achieve higher rates of return.

#### NON-FINANCIAL INVESTMENTS

Non-financial investments are to be managed centrally by the subsidiary Israel Discount Capital Markets and Investments Ltd., which is to be reinforced and will become the non-financial investments arm of the Bank.

#### SALE OF FINANCIAL PRODUCTS AND PREPARATION FOR PENSION ADVISORY SERVICES

The investments consulting services layout is to be expanded and reinforced in order to provide a professional and timely response to the changing needs of customers. This expansion is to contribute to the improvement of professional service to customers and to the increase of the Bank's income from the sale of capital market products. A pension advisory service layout is being established, which will enlarge the circle of customers seeking this service as well as the variety of services to customers, will strengthen relations with customers and will increase the Bank's income from the sale of pension products.

#### CORPORATE OUTLOOK

In the coming years, the Bank will act towards strengthening the corporate outlook and improving the synergy in the Group by way of intensifying the cooperation between Group companies.

#### EFFICIENCY AND IMPROVED EFFECTIVENESS

An effort to improve efficiency began in 2006 by improving operating methods and the strategic preference of assignments and resources. In 2007 the effort would be focused on the development of the information systems at the Bank with a view of increasing productivity, concurrently with diverting the center of gravity of the operations from the Ofek Project to the support of the business units and the implementation of the strategy.

#### EXPANDING THE BANKING ACTIVITY ABROAD

The plan for the expansion of the banking activity abroad will be completed in 2007. In the first stage, the effort is focused on expanding the private banking activities in Switzerland through the acquisition of a local bank. Concurrently, the Bank plans the expansion of activities and increase in income of IDB New York and of the London Branch of the Bank.

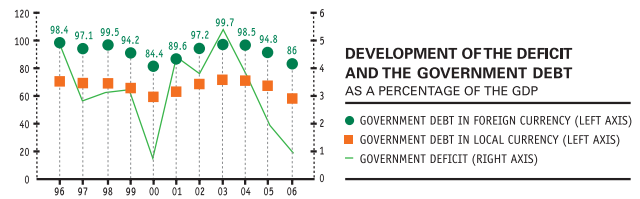
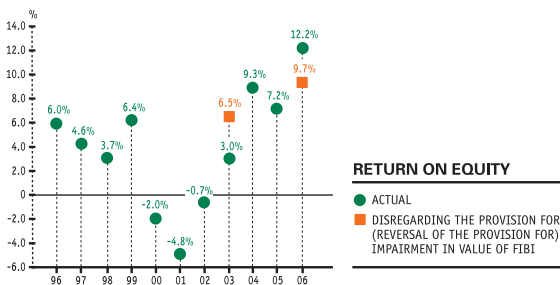
#### CORPORATE GOVERNANCE

The Bank is to prepare the adoption of a corporate governance code intended to maintain at group level, a "best practice" policy regarding corporate governance. Among other things, the code is to be formed in the light of the rules and regulations applying to the Bank as a banking corporation and in the light of the Goshen Commission recommendations and of practices adopted in other countries around the world, while modifying it to the characteristics and the unique requirements of the Discount Group.

The code is to include a risk management policy (including Basel II), a compliance policy and response to the requirements stemming from the application of SOX 404.

**Forward-looking information.** The essence of the strategic plan as discussed above, include evaluations that constitute forward-looking information, such as the estimate of return to equity, earnings, targets that had been set, etc. These evaluations are based on the up to date information and assessments in the hands of Bank at date of issue of the Report.

The strategic plan is based on assumptions regarding the continued growth of the economy, the stability of the regulatory environment and the stability of the banking industry. Material changes in the state of the economy and in the position of customers, changes in regulation having a significant effect, or material changes in the structure of competition may affect the extent of achieving the targets of the strategic plan. An additional uncertainty factor derives from the limited ability to forecast precisely the implications of certain of the future processes and their impact on profitability.



## INCOME AND PROFITABILITY

The Group's net income in 2006 totalled NIS 836 million, compared with NIS 458 million in the preceding year, an increase of 82.5%.

**Net Income** disregarding the bonus paid to the employees in respect of the sale of the controlling interest in the Bank (see Note 32 to the financial statements), early retirement incentives, payments to regulatory authorities in the U.S. and the cost of implementing the improvements and the examinations in IDB New York (see Note 6D to the financial statements) the reversal of the provision for impairment in value of the investment in the First International Bank of Israel ("FIBI") recorded in 2003 (see Note 6F to the financial statements), the profit on the sale of shares of Ilanot Discount (see Note 6E to the financial statements), the profit on the sale of shares of Harel Insurance Investments (see Note 6H to the financial statements) (hereinafter: "certain components") would have amounted in 2006 to NIS 666 million, compared to NIS 693 million in 2005, a decrease of 3.9% (2005: disregarding expenses in respect of encouragement of early retirement and payments to regulatory authorities in the U.S.).

**The Bank alone** had an income from ordinary operations after taxes amounting to NIS 95 million in 2006, compared with a loss from ordinary operations after taxes of NIS 228 million in the previous year.

Disregarding the bonus paid to the employees in respect of the sale of the controlling interest in the Bank and expenses in respect of encouragement of early retirement, the Bank would have recorded in 2006 operating

earnings after taxes of NIS 355 million, compared with operating loss after taxes of NIS 56 million in 2005.

Disregarding the hedging of the investment of the Bank in overseas extensions, the bonus paid to the employees in respect of the sale of the controlling interest in the Bank and expenses in respect of encouragement of early retirement, the Bank would have recorded in 2006 operating income after taxes of NIS 232 million, compared with income of NIS 29 million in 2005.

**Return on shareholders' equity** for 2005 was 12.2%, compared with 7.2% in the preceding year.

**The return on shareholders' equity**, disregarding certain components, as detailed above, would have reached in 2006 a rate of 9.7% compared with 10.9% in 2005.

**Net earnings per one share of NIS 0.1 par value** amounted in 2006 to NIS 0.85, compared with NIS 0.47 in 2005.

**Net earnings per one share of NIS 0.1 par value**, disregarding certain components, as detailed above, would have reached in of 2006 NIS 0.68 compared to NIS 0.71 in 2005.

The following are the main factors, having a positive effect on the business results of the Group in 2006, as compared with 2005:

- (a) An increase of 2.5% in income from financing activities before provision for doubtful debts.
- (b) A decline of 17.5% in the provision for doubtful debts.
- (c) The Bank's share in earnings from ordinary operations of affiliates in 2006 totalled NIS 188 million, compared with NIS 174 million in 2005, an increase of 8.0 %.
- (d) Reversal of a provision for impairment in value of NIS 173 million, recorded in 2003 in respect of the investment in the FIBI.
- (e) Net profit on the sale of shares in Ilanot Discount, which amounted to NIS 256 million.
- (f) Net profit on the sale of shares in Harel Insurance Investments, which amounted to NIS 104 million.

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

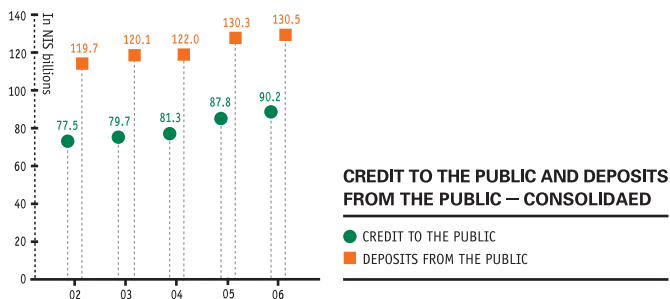
- (a) A decline in operating and other income at the rate of 2%, affected mainly by a decrease in other income (at a rate of 29.1%), deriving mostly from the decrease in the Bank's profits from severance pay funds, which was partly setoff by an increase in income from operating commissions (at a rate of 2.6%) and an increase in gains on investments in securities.
- (b) an increase in the operating and other expenses of 6.2%, affected mostly by an increase of 7.9% in payroll and related expenses, which in 2006 include a bonus to employees in respect of the sale of the controlling interest in the Bank and expenses in respect of early retirement incentive as well as an increase of 4.3% in other expenses.

## DEVELOPMENTS IN INCOME AND EXPENSES

Income from financing activities before provision for doubtful debts amounted to NIS 3,790 million in 2006, compared with NIS 3,697 million in the preceding year, an increase of 2.5%.

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

- An increase of 6% in the average outstanding balance of financial assets generating financing income.
- An increase in the overall financial margin (including the effect of derivative financial instruments), which in 2006 reached a rate of 1.85%, compared with 1.77% in 2005.
- A decrease in other financing income in the amount of NIS 136 million, derived mainly from net negative exchange differences recorded in respect to outstanding monetary asset and liability balances of a foreign consolidated subsidiary, the income in respect of which is recognized as part of other financing income.
- Increase in other financing expenses in the amount of NIS 44 million, resulting mainly from increase in expenses of a foreign consolidated subsidiary, mainly because of activity in derivatives.



## 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						
	2006			2005			Changes in contribution in NIS millions
	Volume of activity* in %	in NIS millions	in %	Volume of activity* in %	in NIS millions	in %	
Israeli Currency	31.3	1,692	44.6	29.4	1,508	40.8	184
Unlinked shekels	11.4	347	9.2	12.1	460	12.4	(113)
CPI-linked shekels	57.3	1,456	38.4	58.5	1,378	37.3	78
Foreign Currency	100.0	3,495	92.2	100.0	3,346	90.5	149
Options		120	3.2		(16)	(0.4)	124
Other derivative financial instruments (not including hedged derivatives and ALM)		4	(0.1)		-	-	(4)
Financing commissions		123	3.2		138	3.7	(15)
Other financing income (expenses), net		6.8	1.8		6.2	(161)	-
<b>Total</b>		<b>3,790</b>	<b>100.0</b>		<b>3,697</b>	<b>100.0</b>	<b>93</b>

\* According to the average balance of the assets.

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

**Other net financing income** totalled NIS 191 million in 2006, compared with NIS 367 million in 2005, a decrease of 48.0%. The decrease results mostly from the net negative exchange differences recorded in respect of monetary asset and liability balances in a consolidated subsidiary abroad, the income in respect of which is recorded as a part of the commission from financing operations and other financing income.

**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, 2006, was NIS 2.5 billion, compared with NIS 2.76 billion in the preceding year. (The average rate of return on credit in the different linkage segments in 2006 was between 0.1% and 8.3%).

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

**In the non-linked shekel segment,** net interest income totalled NIS 1,692 million in 2006, compared with NIS 1,508 million in the preceding year, an increase of 12.2%. Income from this segment constituted 44.6% of total net interest income in 2006, compared with 40.8% in the preceding year.

In 2006, assets exceeded liabilities in this segment by NIS 1,890 million, compared with 2005, where assets exceeded liabilities by NIS 1,210 million, contributing to the increase in earnings from financing operations in this segment.

The average balance of assets in this segment increased in 2006 by 12.8% compared with the preceding year.

In 2006 the interest margin reached 2.75% compared with 2.80% in the previous year.

**In the CPI-linked shekel segment,** net interest income totalled NIS 347 million in 2006, compared with NIS 460 million in the preceding year, a decrease of 24.6%. Its proportion of total net interest income in 2006 was 9.2%, compared with 12.4% in the previous year.

The average asset balance in this segment in 2006, fell by 0.7% compared with the preceding year.

The interest margin in 2006 reached the rate of 1.32%, compared with a rate of 1.51% 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 1,456 million in 2006, compared with NIS 1,378 million in the preceding year, an increase of 5.7%. Its proportion of all net interest income was 38.4% in 2006, compared with 37.3% in the preceding year.

In 2006, the average balance of assets in this segment increased by 4.2% compared with the preceding year.

The interest margin in this segment in 2006 was 1.42%, compared with 1.30% in the preceding year.

**Commissions and other net financing income** totalled NIS 191 million in 2006, compared with NIS 367 million in the preceding year.

**Total interest margin** in 2005 was 2.4%, compared with 2.08% in the preceding year (not including the effect of hedge transactions).

**The interest margin, including the effect of other derivatives (in hedge transactions and ALM),** reached a rate of 1.85% in 2006, compared with a rate of 1.77% in the preceding year.

**Provision for doubtful debts** totalled NIS 570 million in 2006, compared with a provision of NIS 691 million in the preceding year, a decrease of 17.5%, of which a decrease of NIS 35 million, derived from the impact of the

changes in the rates of exchange of the US dollar on the provisions for doubtful debts of a foreign consolidates subsidiary. In 2006, the provision constituted 15.0% of the income from financing activities before provision for doubtful debts, compared with 18.7% of this income in the preceding year.

The annual provision for doubtful debts, as a ratio of credit to the public, not including off-balance sheet credit risk, was 0.59% in 2006 (0.36% - including off-balance sheet credit risk), compared with 0.74% (0.47% - including off-balance sheet credit risk) in 2005.

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 5,979 million in 2006 (NIS 6,114 million - including provision for off-balance sheet credit risk). The balance of this provision constitutes 6.22% of the credit to the public (3.82% - including off-balance sheet credit risk), compared with a balance of the provision in the amount of NIS 5,770 million, not including provision for off-balance sheet credit risk (NIS 5,903 million - including provision off-balance sheet credit risk), constituting 6.17% of the credit to the public (4% - including off-balance sheet credit risk) at the end of the preceding year. **The specific provision for doubtful debts** amounted to NIS 643 million in 2006, compared with NIS 642 million in the preceding year, a decrease of 0.16%.

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 2006 relates to the following industries: construction and real estate industries 22.1% in 2006, compared with 29.2% in 2005; hotel industry 1.4% in 2006, compared with 3.2% in 2005; communications and computer services 2.2% in 2006, compared with 8.5% in 2005; commercial sector 7.6% in 2006, compared with 19.2% in 2005; various industrial sectors 29.5% in 2006, compared with 18.9% in 2005.

**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 0.5% in 2006, compared with 1.1% in 2005.

The Bank's specific provision for the hotel sector, as a ratio of credit to the public in this sector, was 0.2% in 2006, compared with 0.5% in 2005.

The Bank's specific provision for the commercial sectors, was 0.4% in 2006, compared with 1.2% in 2005.

The Bank's specific provision for the various industrial sectors, was 0.9% in 2006, compared with 0.8% in 2005.

The Bank's specific provision for the communications and computer services, was 0.3% in 2006, compared with 1.3% in 2005.

The specific provision in the Bank, in respect of all other economic sectors, as a ratio of the credit granted to such sectors, was 0.6% in 2006, compared with 0.5% in 2005.

**The supplemental provision for doubtful debts** of the Bank and the banking subsidiaries in Israel, in 2006, totalled NIS 5.7 million, compared with a supplemental provision of NIS 2.3 million in the previous year. The supplemental provision for doubtful debts is based on the quality of the credit portfolio in accordance with risk factors, as determined by the directives for proper banking procedures.

**Income from financing activities after provision for doubtful debts** amounted to NIS 3,220 million in 2006, compared with NIS 3,006 million in the preceding year, an increase of 7.1%.

**Non-financing income** in 2006 amounted to NIS 2,359 million, compared with NIS 2,406 million in the preceding year, a decrease increase of 2.0%.

**Commissions** totalled NIS 1,911 million in 2006, compared with NIS 1,863 million in the preceding year, an increase of 2.6%. 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 increase in income was partly offset by a decrease in income from ledger fees and a decrease in income from the payments order system services charges.

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

Income from credit card operating activities amounted to NIS 640 million in 2006, compared with NIS 570 million in 2005, an increase of 12.3%. Interest income on credit to customers via credit cards amounted to NIS 82 million in 2006, compared with NIS 57 million in 2005, an increase of 43.9%.

**Gains on investment in shares, net**, amounted to NIS 65 million in 2006, compared with NIS 3 million in 2005. The said earnings include, among other things, a dividend of NIS 39 million received by the Bank and Mercantile Discount Bank from a company, the shares of which served as security for a loan granted to a certain borrower. In addition, subsequent to balance sheet date an additional dividend has been received in the amount of NIS 52 million, which shall be recognized in the first quarter of 2007. (For details of the directive of the Supervisor of Banks, which required that the balance of the loan to the said borrower be classified as a "security" being part of the "available-for-sale securities portfolio", see Note 3 C to the financial statements).

**Other income** in 2006 totalled NIS 383 million, compared with NIS 540 million in the preceding year, a decrease of 29.1%. This increase derives mainly from a decline in profits of severance pay funds, which amounted to NIS 49 million in 2006, compared with NIS 160 million in 2005.

Following are the main components comprising non-financing income:

	2006	2005	2004
	%	%	%
Revenue from management fees	9.6	11.2	12.3
Payment order system services	18.0	18.3	18.9
Revenue from credit cards	27.1	23.5	23.3
Revenue from capital market activities	25.5	24.0	26.8
Profits of the severance pay fund	2.1	6.7	1.3
Computerized services, information and confirmations	1.9	1.7	1.9
Foreign trade activity	3.9	3.4	3.4
Margins and collection fees on loans out of deposits refundable according to collection	0.8	0.8	0.9
Other	11.1	10.4	11.2
Total	100.0	100.0	100.0

**Non-financing expenses** totalled NIS 5,020 million in 2006, compared with NIS 4,729 million in 2005, an increase of 6.2%.

**Salaries and related expenses** amounted to NIS 3,201 million in 2006, compared with NIS 2,966 in the preceding year, an increase of 7.9%.

Salaries expenses in 2006 include a bonus paid to employees in respect of sale of the controlling interest of the Bank in the amount of NIS 232 million.

In 2006, 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. In July 2006, the Board of Directors of IDB New York decided on a plan for the encouragement of early retirement of employees (see "Discount Bancorp Inc." under "Main Investee Companies" below). The financial statements for 2006, include an expense of NIS 164 million in respect of early retirement (2005: NIS 196 million). For additional details, including details on employees retired in 2004-2006, see "Human Resources" below.

Salaries and related expenses disregarding the bonus paid in respect of the sale of the controlling interest in the Bank and expenses in respect of encouragement of early retirement (2005 – disregarding expenses in respect of the sale of the controlling interest in the Bank, expenses in respect of encouragement of early retirement, an additional grant in respect of 2004, expenses in respect of change in the definition of salary in the Value Added Tax Law, and a provision in respect of change in mortality tables utilized for actuarial calculations) amounted to NIS 2,805 million in 2006, compared with NIS 2,697 million in 2005, an increase of 4%, deriving mainly from the wage agreement for 2006 signed by the Bank, and from the increase in payroll of a foreign subsidiary.

Salaries expenses, excluding related expenses, amounted in 2006 to NIS 2,208 million, compared with NIS 1,919 million in 2005, an increase of 15.1%.

Salaries expenses excluding related expenses disregarding the bonus in respect of the sale of the controlling interest in the Bank, amounted in 2006 to NIS 2,018 million, compared to NIS 1,919 million in 2005, an increase of 5.2%.

**Salary and related expenses in the Bank** alone amounted to NIS 2,082 million in 2006, compared with NIS 2,032 million in the preceding year, an increase of 2.5%.

Salary and related expenses of the Bank, disregarding the bonus in respect of the sale of the controlling interest in the Bank and expenses in respect of encouragement of early retirement amounted in 2006 to NIS 1,802 million, compared with NIS 1,763 million in 2005, an increase of 2.2%. The increase derives mainly from the increase is derived mainly from the salary agreement for 2006.

Salary expenses, excluding related expenses and disregarding the bonus in respect of the sale of the controlling interest amounted in 2006 to NIS 1,231 million, compared with NIS 1,236 million in 2005, a decrease of 0.4%.

Salary expenses, excluding related expenses, in the Bank alone, amounted to NIS 1,388 million in 2006, compared with NIS 1,236 million in the preceding year, an increase of 12.3%.

Salary related expenses in the Bank alone, amounted in 2006 to NIS 595 million, compared with NIS 600 million in 2005, a decrease of 0.8%.

**Depreciation and maintenance of building and equipment** totalled NIS 679 million in 2006, compared with NIS 670 million in the previous year, an increase of 1.3%.

Other expenses totalled NIS 1,140 million in 2006, compared with NIS 1,093 million in the preceding year, an increase of 4.3%. This results mainly from an increase in advertising costs, computer costs, and professional

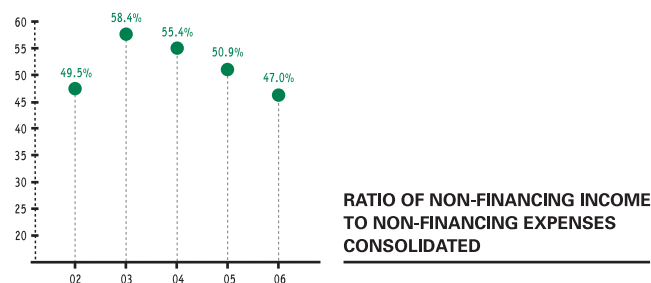
services. Other expenses in 2005 include a provision of NIS 113 million in respect of the arrangement signed by IDB New York and the regulatory authorities in the United States. The increase in professional services expenses results, mainly, from payments to consultants at IDB New York.

**The cover rate** of non-financing income to non-financing expenses reached 47.0% in 2005, compared with 50.9% in the preceding year. The increase in professional services expenses derives mainly from payments to advisors of IDB New York.

**The cover rate** of non-financing expenses by non-financing income, disregarding the expenses detailed above, would have reached 51.4% in 2006, compared with 55.3% in 2005.

**Operating income before taxes** totalled NIS 559 million in 2006, compared with NIS 683 million in the preceding year, a decrease of 18.2%.

**Provision for taxes on operating income** totalled NIS 350 million in 2006, compared with NIS 324 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.

In 2006, the Bank did not record a current tax expense in respect of taxable current income of NIS 191 million due to the utilization of carry forward tax losses in respect of which no deferred tax assets had been recorded in the past, compared with 2005 in which the Bank did not record income from deferred tax assets in respect of current losses for tax purposes and timing differences in the amount of NIS 47 million.

It should be noted that during 2006, the Bank exhausted the tax losses carried forward, in respect of which deferred tax assets were not recognized in the past.

**Operating income after taxes** totalled NIS 209 million in 2006, compared with NIS 359 million in the preceding year, a decrease of 41.8%.

**The Bank's share in operating income of affiliated companies after taxes** totalled in NIS 188 million in 2006, compared with NIS 174 million in the preceding year, an increase of 8.0%.

**Net operating income** totalled NIS 315 million in 2006, compared with NIS 458 million in the preceding year, a decrease of 31.2%.

**The ratio of operating income before taxes** to shareholders' equity, including minority interest, was 9.6% in 2006, compared with a ratio of 12.4% in the preceding year.

**The ratio of operating income after taxes** to shareholders' equity, including minority interest, was 3.6% in 2006,

compared with a ratio of 6.5% in the preceding year.

**The ratio of earnings from ordinary operations after taxes on income** in relation to shareholders' equity, disregarding "certain components", would have reached 9.9% compared to 10.8% in the previous year.

**Net earnings from extraordinary operations, after taxes**, amounted, in 2006, to NIS 521 million, due to an amount of NIS 173 million being the reversal of a provision for impairment in value of the Bank's investment in FIBI, which was recorded in 2003 in accordance with the instructions of the Supervisor of Banks (see Note 6F to the financial statements), net earnings of NIS 256 million from the sale of Ilanot Discount (see Note 6E to the financial statements) and net earnings of NIS 104 million from the sale of shares in Harel Insurance Investments (see note 6H to the financial statements). This compared with earnings of NIS 12 million recorded in 2005, resulting from the realization of additional building rights in the "Discount Tower".

**Net income** in 2006 amounted to NIS 836 million, compared with of NIS 458 million in the preceding year, a decrease of 82.5%.

**Net income** disregarding the bonus paid to the employees in respect of the sale of the controlling interest in the Bank, early retirement incentive, payments to regulatory authorities in the U.S. and the cost of implementing the improvements and the examinations in IDB New York, the reversal of the provision for impairment in value of the investment in the FIBI recorded in 2003, the profit from the sale of shares in Ilanot Discount and the profit from the sale of shares in Harel Insurance Investments (hereinafter: "certain components"), would have amounted to NIS 666 million in 2006, compared with NIS 693 million in 2005, a decrease of 3.9%.

**Return on shareholders' equity** reached a rate of 12.2% in 2006, compared with a rate of 7.2% in the preceding year.

**The return on shareholders' equity, disregarding certain components** as detailed above, would have reached in 2006 a rate of 9.7% compared with 10.9% in 2005.

**Net earnings per one share of NIS 0.1 par value** amounted in 2006 to NIS 0.85, compared with a loss of NIS 0.47 in the preceding year.

**Net earnings per one share of NIS 0.1 par value**, disregarding certain components as detailed above, would have reached in 2006 NIS 0.68, compared with NIS 0.71 in 2005.

**Net income in the fourth quarter** of 2006 amounted to NIS 148, compared with NIS 244 in the third quarter of 2006, a decrease of 39.3%, and compared with a loss of NIS 111 million in the corresponding quarter last year.

**Net income in the fourth quarter** of 2006 disregarding certain components, as detailed above, amounted to NIS 115 million, compared with NIS 221 million in the third quarter of 2006, a decrease of 48.0%, and compared with a loss of NIS 124 million in the corresponding quarter last year, a decrease of 7.3%.

**Return on shareholders' equity in the fourth quarter** of 2006 reached an annualized rate of 8.1%, compared with a rate of 14.4% in the third quarter of 2006, and compared with a negative rate of 6.2% in the corresponding quarter last year.

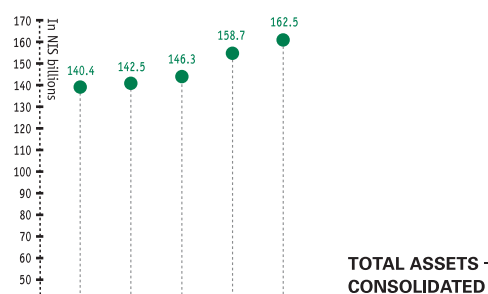
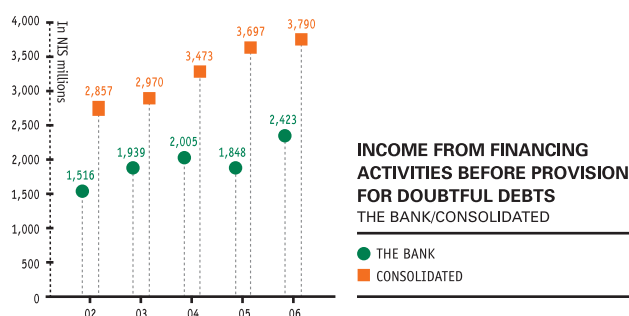
**Return on shareholders' equity in the fourth quarter** of 2006 disregarding certain components, as detailed above reached an annualized rate of 6.2%, compared with a rate of 13.0% in the third quarter of 2006, and compared with 7.3% in the corresponding quarter last year.

## DEVELOPMENT OF ASSETS AND LIABILITIES

**Total assets** as at December 31, 2006 amounted to NIS 162,538 million, compared with NIS 158,720 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 change in %
	2006	2005	
	In NIS millions		
<b>Assets</b>			
Cash and deposits with banks	25,406	20,586	23.4
Securities	38,914	42,188	(7.8)
Credit granted to the public	90,175	87,816	2.7



### Liabilities

Deposits from the public	130,517	130,285	0.2
Deposits from banks	8,099	6,518	24.3
Debentures and subordinated capital notes	6,302	5,342	18.0
Shareholders' equity	7,965	6,718	18.6

**Credit granted to the public** as at December 31, 2006, totalled NIS 90,175 million, compared with NIS 87,816 million on December 31, 2005, an increase of 2.7%. The ratio of credit granted to the public to total assets reached 55.5% at the end of 2006, compared with 55.3% at the end of 2005.

Following publication of the public reporting format for credit card companies, the definition of "credit to the public" in the public reporting directive was amended to include also "debit balances of the public resulting from credit card transactions" (for additional details, see Note 1 Z to the financial statements). The said amendment resulted in an increase in the balance of "credit to the public" as of December 31, 2006 and 2005 in an amount of NIS 4,229 million and NIS 3,926 million, respectively, with a concurrent increase in the "other liabilities" item.

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

	December 31, 2006		December 31, 2005		Rate of changes in %
	In NIS millions	% of total	In NIS millions	% of total	
		credit to		credit to	
		public		public	
Non-linked shekels	40,520	44.9	35,712	40.7	13.5
CPI-linked shekels	17,793	19.7	19,196	21.9	(7.3)
Foreign currency and foreign currency-linked shekels	31,862	35.4	32,908	37.4	(3.2)
<b>Total</b>	<b>90,175</b>	<b>100.0</b>	<b>87,816</b>	<b>100.0</b>	<b>2.7</b>

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

	December 31	
	2006	*2005
Non-performing debts	2,529	2,710
Reorganized debts <sup>(2)</sup>	286	457
Debts due for reorganization <sup>(3)</sup>	143	92
Debts temporarily in arrears	327	556
Debts under special supervision <sup>(4)</sup>	3,771	4,063
<b>Total balance sheet credit to borrowers</b>	<b>7,056</b>	<b>7,878</b>
Off-balance sheet credit risk regarding problematic borrowers <sup>(5)</sup>	928	745
Debentures of problematic borrowers	1	1
Other assets in respect of derivative instruments of problematic borrowers	10	1
<b>Total overall credit risk concerning problematic borrowers</b>	<b>7,995</b>	<b>8,625</b>

\* Reclassified

- (1) Not including problem debts for which the collateral received is available for set-off with respect to the limitations on indebtedness of a single borrower or of a group of borrowers (Proper Banking Management Directive No. 313).
- (2) Credit reorganized during the current year as well as credit reorganized in prior years with waiver of income.
- (3) Credit to borrowers, which per Management decision is to be reorganized, but which reorganization has not yet been implemented.
- (4) Of which: debts of NIS 1,325 million, presented net of specific provision made thereof, and housing loans of NIS 210 million, in respect of which a provision according to the period of default exists (December 31, 2005: NIS 1,537 million and NIS 232 million, respectively).
- (5) As computed for the purpose of limitations on indebtedness of a single borrower or of a group of borrowers, except for guarantees granted by a borrower to secure a third party indebtedness.

The major part of the growth in credit risk (including in respect of problematic debts) is in the hotel, communications, computer services and the industrial sectors, which was partly offset by the decrease in other economic sectors.

**Creditors arrangement regarding the "Tevel" group.** During 2005 and in the subsequent months of 2006, the banks conducted intensive negotiations with the shareholders of the TV cable companies for the merger of these companies, as part of the creditors arrangement regarding the "Tevel group". On May 7, 2006, an agreement was

signed for the merger of the TV cable companies, according to which HOT Cable Communication Systems Ltd. (Formerly named Matav; hereinafter – “HOT”) is to purchase from the other TV cable companies all their operations in the broadcasting field and in the field of inland cable communications.

The merger transaction of the cable companies was consummated on December 31, 2006. With the completion of the merger transaction, HOT transferred the infrastructure of the cable network, including end-equipment and broadcasting centers, to the ownership of HOT Telecom. With the completion of the merger HOT will supply to customers all over the country multi-channel television services, while HOT Telecom will provide communication services, Internet connection, telephone and other services to subscribers all over the country.

Upon consummation of the merger, HOT allotted 45,649,567 shares to the shareholders of the cable companies, which operations and assets had been transferred to HOT. As part of this allotment of shares, the banks (as shareholders of Tevel) received 28.1% of the shares in HOT (of which the share of the Bank is approximately 2.7%). The shares are being held separately by each bank.

The merger transaction represents a gross value of NIS 6,277.5 per subscriber.

It should be noted that the HOT shares are listed for trade on the Stock Exchange. The merger agreement includes provisions limiting the maximum volume of shares that may be disposed of on the market. The agreement provides also for the right of first refusal upon sale of shares.

Concurrently with the consummation of the merger agreement, a loan agreement came into effect between HOT and a consortium of banks (including the Bank and Mercantile Discount Bank).

The shares received are presented in “securities” (for additional details see Note 3 D to the financial statements).

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

At June 30, 2003, the market value of the proportionate share of the Bank and Mercantile Discount Bank in the said collateral exceeded the outstanding balance of the loan, net of existing provisions for doubtful debts 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 directive 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 directive, 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. The market value as aforementioned as of December 31, 2006, amounted to NIS 444 million.

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

**A draft of a directive 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 a directive regarding the "Measurement and disclosure of problematic debts and provision for doubtful debts in financial statements of banking corporations".

The principal subject of this directive, which is intended to replace the existing directive, 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 Basel International Committee on Supervision of Banks.

Inter-alia, the draft directive 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 directive the Bank has begun to study and analyze it, including attempts to assess its effect upon the Bank. In March 2005 a draft of "Questions & Answers" was published regarding this issue.

On June 29, 2006, the Bank of Israel provided the banking corporations with an updated draft on the matter for their review.

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. It should be mentioned that the proposed model assumes the completion of the anticipated change in the management of credit lines in accordance with the directives of the Supervisor of Banks in this respect.

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 the Bank is 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, as a result of their being defined as delinquent debts. This relates, inter-alia, to debts defined at present as partly doubtful but income bearing, and to debts defined at present as temporarily in arrears.

**THE FOLLOWING IS A REVIEW OF THE DEVELOPMENT OF CREDIT TO THE PUBLIC BY ECONOMIC SECTORS:**

Balance sheet credit risk for the construction and real estate sector totalled NIS 16.1 billion as at December 31, 2006, compared with NIS 15.2 billion on December 31, 2005, an increase of 6.4%, which constituted about 17.2% of the total balance sheet credit risk to the public, compared with 16.4% on December 31, 2005. Off-balance sheet credit risk for the construction and real estate sector (mostly sales guarantees and non-utilized credit lines) amounted to NIS 11.9 billion as at December 31, 2006, compared with NIS 9.1 billion on December 31, 2005, and it constituted 18.8% of the off-balance sheet credit risk, compared with 17.5% as at December 31, 2005.

Total credit risk for the construction and real estate sector constituted 17.8% of the total credit risk to the public as at December 31, 2006, compared with 16.8% on December 31, 2005.

Total credit risk for the industrial sectors totalled NIS 29.0 billion as at December 31, 2006, compared with NIS 27.2 billion at December 31, 2005, an increase of 6.7%, and it constituted 18.4% of the total credit risk to the public under the Group's responsibility, compared with 18.8% as at December 31, 2005. 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, 2006 totalled NIS 3.9 billion, similar to December 31, 2005.

Total credit risk for the commercial sector amounted to NIS 21.1 billion as at December 31, 2006, compared with NIS 29.5 billion as at December 31, 2005, an increase of 8.1%, and it constituted 13.4% of the total credit risk to the public, compared with 13.5% the preceding year.

Total credit risk to individuals was NIS 34.7 billion as at December 31, 2006, compared with NIS 31.4 billion as at December 31, 2005, an increase of 10.2%, and it constituted 22% of the total credit risk to the public, as compared with 21.8% as at December 31, 2005.

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

	December 31, 2006		December 31, 2005		Rate of change in %
	In NIS Million	% of total credit to public	In NIS million	% of total credit to public	
Retail – household segment	16,140	19.1	14,956	18.6	7.9
Retail – small business segment	10,968	12.9	10,741	13.4	2.1
Middle market segment	38,230	45.1	36,537	45.5	4.6
Corporate market segment	16,131	19.1	14,809	18.5	8.9
Private banking segment	3,228	3.8	3,224	4	0.1
Total	84,697	100	80,266	100	5.5

**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 26.8% of total credit to the public as at December 31, 2006, compared with 26.7% as at December 31, 2005.

The credit bracket between NIS 1.2 million and NIS 200 million constitutes about 55.2% of all credit as at

December 31, 2006, compared with 58.7% as at December 31, 2005.

The 71 largest borrowers, in the credit bracket between NIS 200 million and NIS 1,200 million, were granted credit constituting 16.6% of total credit as at December 31, 2006, compared with 70 borrowers that were granted credit constituting 13.3% of the total credit as at December 31, 2005.

**Credit granted to the Government** - totalled NIS 18 million as at December 31, 2006, compared with 92 million as at end of 2005, a decrease of NIS 74 million (80.4).

**Securities** totalled NIS 38,914 million as at December 31, 2006, compared with NIS 42,188 million at the end of 2005, a decrease of 7.8%.

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

	December 31		Rate of change in %
	2006	2005	
	(in NIS millions)		
Non-linked shekels	13,668	15,089	(9.4)
CPI-linked shekels	1,946	708,174.9	
Foreign currency and foreign currency-linked shekels	22,092	25,328	(12.8)
Shares - non-monetary items	1,208	1,063	13.6
<b>Total</b>	<b>38,914</b>	<b>42,188</b>	<b>(7.8)</b>

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, 2006			December 31, 2005		
	Net adjusted cost	Fair value	Book value	Net adjusted cost	Fair value	Book value
	In NIS millions					
<b>Bonds</b>						
Held-to-maturity	4,824	4,790	4,824	5,833	5,784	5,833
Available-for-sale	29,809	29,832	29,832	32,657	32,617	32,617
Trading	2,917	3,051	3,051	2,659	2,675	2,675
<b>Shares</b>						
Available-for-sale	941	1,193	1,193	994	1,060	1,060
Trading	13	14	14	4	3	3
<b>Total Securities</b>	<b>38,504</b>	<b>38,880</b>	<b>38,914</b>	<b>42,147</b>	<b>42,139</b>	<b>42,188</b>

For additional details see Note 3 to the financial statements.

**Deposits from the public** as at December 31, 2006, totalled NIS 130,517 million, compared with NIS 130,285 million at the end of the preceding year, an increase of 0.2%.

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

	December 31, 2006		December 31, 2005		Rate of change in %
	In NIS millions	% of total deposits from public	In NIS millions	% of total deposits from public	
Non-linked shekels	49,722	38.1	46,221	35.5	7.6
CPI-linked shekels	12,095	9.3	12,947	9.9	(6.6)
Foreign currency and foreign currency-linked shekels	68,700	52.6	71,117	54.6	(3.4)
<b>Total</b>	<b>130,517</b>	<b>100.0</b>	<b>130,285</b>	<b>100.0</b>	<b>0.2</b>

The following is data on the composition of deposits from the public, by segments of operations:

	December 31, 2006		December 31, 2005		Rate of change in %
	In NIS Million	% of total credit to public	In NIS million	% of total credit to public	
Retail – household segment	53,946	41.2	55,824	43.5	9.7
Retail – small business segment	7,562	5.8	8,882	6.9	(14.9)
Middle market segment	16,545	12.6	11,914	9.3	38.9
Corporate market segment	10,322	7.9	6,891	5.4	49.8
Private banking segment	37,478	28.6	28,114	21.9	33.3
Other	5,188	3.9	16,696	13.0	(68.9)
<b>Total</b>	<b>130,041</b>	<b>100%</b>	<b>128,320</b>	<b>100%</b>	<b>2.1</b>

The ratio of total credit to the public to deposits from the public was 69.1% at the end of 2006, compared with 67.4% at the end of the previous year.

## FIXED ASSETS AND INSTALLATIONS BUILDINGS AND EQUIPMENT

At the end of 2006, the investment in buildings and equipment amounted to NIS 2,614 million, compared with NIS 2,268 million at the end of 2005, an increase of 15.3%.

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

The total office space at the Bank's disposal at December 31, 2006, was 163 thousand square meters, compared with 141 thousand square meters at the end of 2005. Of this area, 104 thousand square meters were freehold property and 59 thousand square meters leasehold property (2005: 85 thousand square meters were freehold property and 55 thousand square meters leasehold property). At the end of 2006, some 72 thousand square meters served the Bank's branches and the balance served the head office, compared with 71 thousand square meters in 2005.

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

**The acquisition of office space in the "Discount Tower" on Yehuda Halevi Street.** In July 2005, the Bank entered into an agreement with Meshulam Levinstein Buildings (1986) Ltd. (hereinafter – "the Company") for the purchase from the Company of office space of 12.5 thousand square meters, basement and parking areas with regard to the "Discount Tower" which is being constructed on Yehuda Halevi Street. Upon the signing of the said agreement, the commitment of the Bank, pursuant to an agreement dated June 2002, for the lease for a period of thirteen years of an office space of about 11.6 thousand square meters, basement and parking areas (hereinafter – "the Lease Agreement") was cancelled. For additional details as to the Lease Agreement, see Notes 19 C and 22 A to the financial statements.

The Bank has also entered into an agreement with Meshulam Levinstein Contracting Ltd. and Engineering (the parent company of the Company) to supply construction services in respect of an additional 4 thousand square meters in the "Discount Tower".

The total cost of the area, which the Bank received in the Tower, including betterment levy, acquisition tax and value added tax, amounts to US\$67 million.

According to the Lease Agreement, the lease payments would have been translated from US Dollars into Shekels at the Dollar exchange rate at date of delivery, and would have been linked to the CPI as of that date. In accordance with the provisions of FAS-133, the Bank has treated the Lease Agreement as a combined agreement comprised of a Shekel lease agreement (the host agreement) and a forward transaction (embedded derivative instrument). In view of the said annulment of the Lease Agreement, a loss of NIS 47 million was recognized in the financial statements for 2005, resulting from writing off the balance of the fair value of the said forward transaction.

In addition, and further to the said agreement of June 2002, the Bank and the Company have settled the scope of the building rights attached to the property to be acquired, which would enable the construction of 8.8 thousand square meters in the Discount Tower (deriving from the new Urban Planning Regulations published in March 2005 for taking effect), and also settled the accounts between them in respect of the adaptation of the areas.

In respect of the above, the Bank recognized a gain of NIS 11 million in the financial statements for 2005.

**Occupation of the "Discount Tower".** The central office building of the Discount Group – "Discount Tower" was inaugurated at a festive event on August 23, 2006. The Chief Rabbi of the City of Tel-Aviv-Yafo, Rabbi Israel Lau, was honored with fixing the Mezuzah, with the Chairman of the Board and the President and CEO of the Bank. Members of the Board of Directors and Management of the Bank also participated in the ceremony, as well as managements of subsidiaries and employees of the Bank.

Most of the Bank's Head Office units are now located at the "Discount Tower", which will facilitate the current operations of the Discount Group. Occupation of the tower serves as a landmark in the Bank's history and a clear sign of regeneration. The previous management building of the Bank was first occupied in 1939. The "Discount Tower" was built in continuation and adjacent thereto at the corner of Yehuda Halevi street and Herzl street in Tel-Aviv.

## INFORMATION AND COMPUTER SYSTEMS

### GENERAL

The information and control systems stand at the core of the operations of the Bank and comprise the backbone on which the Bank's operations are based. The Bank's data processing system is a central computerized system composed of main frame computers located at the Bank's computer center and work stations at the branches and at the head office units. The central system is currently based on IBM computers integrated with Unisys computers. Some 6,000 work stations (PC's) and 400 servers are installed at the branches and at head office units, providing service to both internal and external customers.

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

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

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

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

### "OFEK" PROJECT

**Background.** At the beginning of the 1970's, the Bank decided to base its business operations on Unisys computers. With the development of technology and business in Israel and around the world, additional systems and sub-systems were added over the years to the basic systems, comprising the "core system", which are connected to the central system and to one another through data communication. In addition, over the years, IBM established itself as the principal provider in the world of mega computers that support large organizations. Because of the Bank's estimate that it would remain the sole customer of Unisys central computer systems in Israel, a matter comprising a risk in itself, and in order to avoid dependence on a system provided by a supplier who has ceased to focus on central systems intended for large organizations, the Bank's Board of Directors decided, as early as 1998, to convert the computer systems to IBM.

**"Ofek" Project.** Following an unsatisfactory attempt made at the end of the 1990's, to effect the change to IBM computers by converting the existing systems, as they are, to IBM computers, the Bank began forming an alternative plan named the "Ofek" Project.

The main objective of the "Ofek" Project is the renewal of the Bank's central computer infrastructure while replacing the Unisys operating systems with IBM operating systems, converting data and computer software from Unisys computers to IBM computers as well as replacing most of the software used by the Bank to IBM compatible systems. After examining several alternatives, the Bank decided to base the change to an IBM environment on the AltaMira product, which was operational at that time in some 80 banks around the world, while relying on Accenture, a consulting company specializing in projects of this nature, to carry out the Project itself.

In 2001, the Bank entered into agreements with two companies of the Global Accenture Group, Accenture Ltd. and Alnova, Technologies Corporations S.L. for the purchase of core banking software systems, for adapting the said systems to the requirements of the Bank and for their integration at the Bank. Due to the complexity and scope of the project, it was initially divided into ten stages of execution called roll out. At each such stage, several systems have been released for operational use. Due to the gradual release of the systems, the project includes a material component of co-existence between the old and the new systems. It should be noted that, to the best knowledge of the Bank, such a large and complex software project has never been undertaken in Israel.

Except for Accenture, which led the project together with the Bank, several leading Israeli software houses participated in the project, the principal of which are: Matrix, Ness, Teldor, Tescom, Tesnet and IBM.

Several committees have been established by the Bank to currently supervise and monitor the progress of the project, among other things, by hiring independent experts.

The first roll out was launched in the second half of 2003 and included infrastructure systems and the customer management system. The second roll out was launched in the second half of 2004, and among other things, included a system relating to deposits.

In the course of 2006 the Bank successfully launched the third roll out at all the branches of the Bank and of Mercantile Discount Bank.

The principal modules of the system operating at the Bank after completing the third roll out are: IBM infrastructure, customers, current accounts, deposits, clearing, taxation, the main ledger, system schedules including the central commissions schedule, product system, central mailing, branch management, cash inventory management and more.

#### STATUS OF THE PROJECT AS OF DATE OF ISSUE OF THE ANNUAL REPORT

With the completion and integration of the third roll out systems, the principal assignments of integrating the core banking system purchased from Accenture and operating as the central system of the Bank, have been successfully achieved. These systems, developed as part of the Ofek Project, constitute, as stated, the center of the core banking operations. Such systems are of the most advanced in Israel, and are based upon state of the art technology. With the completion of the third roll out, the Bank has exhausted most of the potential embedded in the core systems purchased from Accenture, while completing about 70% of the project for renewal of the computer infrastructure. In view of this, the Ofek Project has been to de-facto completed. Completion of the conversion of systems from the Unisys to the IBM environment, and completion of development of systems that had begun within the framework of the Ofek Project, would now be carried out within the framework of the current development work of the Bank, as part of the regular development budget, while considering their preference within the general development assignments of the Bank.

Until December 31, 2006, an amount of approximately US\$159 million (excluding VAT) was invested in the project. The Bank capitalized development costs of the Ofek Project, the outstanding balance of which at December 31, 2006, was NIS 603 million (see Note 1 J and Note 7 to the financial statements). Development costs for the core systems ("Ofek Project) are amortized over a period of seven years. The Bank is considering the amortization period of the core systems in relation to the economic benefits anticipated from systems of this sort, and it may extend the period of amortization in the future. Development costs for the core systems ("Ofek Project) are amortized over a period of seven years. The Bank is considering the amortization period of the core systems in

relation to the economic benefits anticipated from systems of this sort, and it may extend the period of amortization in the future. The completion of the Project enables the Bank Group the long-term use of an advanced computer system, providing an infrastructure for the implementation of modern, integrated, customer directed banking that provides business and operating flexibility.

The Ofek Project earned the first prize of the "Mega Project" category for 2007, awarded by the Israeli Institute of Information Analysts.

### LOCATIONS OF THE OPERATION

The mainframe systems of the Bank are located at two different locals, the primary system in Tel-Aviv and the secondary system in Rishon LeTziyon. The fact that the two systems are located at a distance from one another adds to the survivability of the information systems of the Bank.

The two computer sites of the Bank, in Tel-Aviv and in Rishon LeTziyon, are connected by optical fibers in two different routes.

These sites also house the disc systems of EMC Company, cassette robots, central printers and additional peripheral equipment required for the operation of the Bank. Needless to say that this equipment is also backed-up at the two sites.

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

### BACK-UP AND DISASTER RECOVERY

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

### INFORMATION SECURITY

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

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

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

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

The Bank operates a data protection center the purpose of which is to identify risks and breach in the data protection system. In addition, the Bank conducts security reviews and controlled penetration attempts into the system in order to test its immunity.

Furthermore, as part of the internal audit operates a unit which specializes in the field of information systems, which conduct a current audit of this matters.

### MAIN FUTURE PROJECTS

1. The principal systems that are still in operation on the Unisys computer are: the credit system and the securities system. In order to complete the conversion of the principal systems to the IBM computers the Bank began the conversion of the software and data in these fields to the IBM computers.
2. In view of the regulatory provisions regarding credit and risk management (Basel II) matters and in the matters of securities, the Bank expects to be required to enter into additional projects relating to computer systems in the coming years.

This will involve a complex project requiring investments in the core systems in general and in the credit and securities systems in particular. The schedules for the execution of these projects depend, among other things, on guidelines that the Bank of Israel will issue in the matter.

The Bank's budget for 2007 in respect of projects for the development of information systems amounts to NIS 400 million. In view of existing and expected regulatory demands, business demands and the Bank's plans for the future, the Bank believes that its total computer expenditure is not expected to decrease significantly in the coming years.

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

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

### MAJOR SUPPLIERS

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

the Bank through IBM (Israel) Ltd., while Unisys is engaged to the Bank through Malam Company. The Bank has a letter of undertaking by Unisys U.K., being an annex to the agreement with Malam, whereby Unisys England is committed to providing maintenance services for the said systems in the event that Malam would not honor its obligations.

## INTANGIBLE ASSETS

The Bank has exclusive intellectual property rights in the following trademarks that are duly registered with the Registrar of Trademarks, and in the logo accompanying each of them: "Israel Discount Bank Ltd.", "Discount Bank", and "Discount". In addition, the Bank registers from time to time, for the purpose of its business and marketing operations, names of services and products such as: "Drive, you have the drive to live" and slogans such as "In Discount we take you personally", "banking from the heart", etc.

The Bank also has intellectual property rights in designated software systems and various modules used in its business, which the Bank develops in the course of its ongoing operations for its own use and/or the use of subsidiaries and affiliates. The development is conducted either by the staff of the Bank or by software houses hired by the Bank for this purpose.

## TAXATION

### GENERAL

The provisions of the Income Tax Law (Adjustments for inflation), 1985, apply to the Bank and its subsidiaries in Israel.

The Bank and most of its subsidiaries in Israel are considered a financial institution under the Value Added Tax Law, 1975, and as such are chargeable to payroll tax and to profit tax at the rate of 15.5% of the payroll expense and of the profit, respectively (until June 30, 2006 – a rate of 17%).

During the last years the Bank did not record current tax expenses in respect of current earnings for tax purposes and net timing differences, due to the utilization of tax losses, carry forward losses and deductions for tax purposes and the net timing differences (including in respect of earnings or losses, as the case may be respectively, that were taken to a capital reserve in respect of available-for-sale securities), in respect of which no deferred tax assets have been recorded. During 2006 the Bank exhausted the said tax losses, carry forward losses and deductions for tax purposes and net timing differences, in respect of which no deferred tax assets have been recorded.

### THE VALUE ADDED TAX LAW AMENDMENT – 1975 – AMENDMENT OF THE DEFINITION OF THE TERM "WAGES"

The Economic Policy Law for the fiscal year 2005 (Legislation Amendments) – 2005, passed the second and third readings by the Knesset on March 29, 2005, in which the definition of wages, in respect of the payment of payroll tax by financial institutions, was expanded to also include all the benefits that a financial institution pays its employees, such as: a grant payable upon retirement or death, excluding an award paid by a provident fund, or paid out of funds that had been deposited with a provident fund and later withdrawn by the employer for the purpose of payment of the award and any amount paid by an employer to a supplemental education fund or to a

provident fund on the employee's behalf even if they are exempt from tax upon transfer to the fund (and where no employee benefit value has been charged in their respect in accordance with Section 3 of the Ordinance). The Amendment is effective commencing January 1, 2005.

The said amendment has an effect on the payment of payroll tax in respect of amounts payable by the Bank to its employees, and on the increase in the payroll expense of the Group. The Bank and its subsidiaries recorded in 2006 an expense of NIS 37 million in respect of the above (2005: NIS 49 million).

### REDUCTION IN COMPANY TAX RATES

On June 29, 2004, the Knesset passed the Income Tax Ordinance Amendment Law (No 140 and provisional instruction), 2004 (hereinafter: "the Amendment"). The Amendment provides for a gradual rate of company tax, from a rate of 36% to a rate of 30%.

On July 25, 2005, the Knesset passed the Income Tax Ordinance Amendment Law (No.147 and Temporary Provision) – 2005 (hereinafter – "the Amendment"). The Amendment provides for an additional gradual reduction in the rate of company tax, as follows: a rate of 31% for 2006, a rate of 29% for 2007, a rate of 27% for 2008, a rate of 26% in 2009 and a rate of 25% for 2010 and thereafter.

For details regarding the effect of the change on the outstanding balances of deferred taxes as of December 31, 2005, see Note 29 to the financial statements.

### REDUCTION IN THE RATE OF "PAYROLL TAX" AND "PROFIT TAX"

On June 27, 2006, the Minister of Finance signed a Value Added Tax Order (The tax rate applying to not for profit organizations and financial institutions) (Amendment), 2006, whereby the "Profit tax" and "Payroll tax" rates applying to banking corporations were reduced as from July 1, 2006, from 17% to a rate of 15.5%. Following this amendment, the statutory tax rate applying to banking corporations had been reduced to 40.65% in 2006. The statutory tax rate will be reduced to 38.53% in 2007; 36.80% in 2008; 35.93% in 2009 and 35.06% as from 2010 onwards. The effect of the change on the balances of deferred taxes as of January 1, 2006, was not material.

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

### CAPITAL RESOURCES COMPONENTS OF CAPITAL

**The Bank's capital resources** as at December 31, 2006, including minority interest, totalled NIS 8,367 million, compared with NIS 7,185 million at the end of the preceding year, an increase of 16.5%.

**Shareholders' equity** as at December 31, 2006, totalled NIS 7,965 million, compared with NIS 6,718 million at the end of the preceding year, an increase of 18.6%.

The increase in shareholders' equity in 2006, resulted, inter-alia, from the current income and from an increase of NIS 231 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, 2006, stood at 5.1%, compared with 4.5% at the end of the preceding year.

**Ratio of tier I capital to risk assets** as of December 31, 2006, reached a rate of 7.91%, compared with 6.66% at the end of the preceding year.

**Ratio of original tier I capital to risk assets**, i.e., ratio after elimination of hybrid tier I capital (see hereunder), reached 7.22 % as of December 31, 2006, compared to 6.66 % at the end of the previous year. It should be noted that the Board of Directors of the Bank resolved, with respect to the issuance of subordinate capital notes, to adopt a capital adequacy policy according to which the Bank will maintain, at all times, an original primary capital adequacy ratio (excluding hybrid tier I capital) of at least 6.5%.

**The ratio of capital to risk assets** stood at 10.45% on December 31, 2006, compared with 9.38% at the end of 2005.

**Hybrid tier I capital** constitutes capital notes recognized as part of tier I capital (see hereunder). The Bank's hybrid tier I capital as of December 31, 2006 amounted to NIS 750 million. The amount of the hybrid tier I capital is limited to 15% of the overall primary capital (the total of the primary capital as defined in Proper Banking Management Directive No. 311, including the hybrid tier I capital). As of December 31, 2006, the compound primary capital amounted to 8.7% of the overall primary capital. The balance of the hybrid tier I capital that may be issued until the limit is reached was NIS 640 million as of December 31, 2006.

**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 4,036 million as at December 31, 2006, including NIS 3,779 million of subordinated capital notes and NIS 254 million of general provision for doubtful debts.

The extent of subordinated capital notes is limited to 50% of the tier I capital.

As of December 31, 2006, the said ratio was 43.8%. The balance of the subordinated capital notes, which the Bank may issue until reaching the limit amounted to approximately NIS 538 million as of December 31, 2006. Reaching this limit would have increased the capital adequacy ratio to 10.95%.

The said ratio does not include the effect of the expected gain from sale of the provident funds (see Note 6 E 5 to the financial statements) and from the agreement signed for the sale Kahal, on one hand (see Note 19 to the financial statements), and the effect of the acquisition of the ICC shares owned by Harel, on the other hand (see Note 34 A 3 to the financial statements). Taking into account these factors and raising additional NIS 250 million of the hybrid tier I capital and exhausting the limit for the raising of the tier II capital, the capital adequacy ratio, in terms of December 31, 2006, would have reached 11.4 %. On the other hand, the effect of consummating the acquisition offer at the price stated in the offer (see Note 6 I to the financial statements) is expected to reduce the said capital adequacy ratio by 0.4%.

**Tier III Capital** – According to the directives of the 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. As of December 31, 2006, capital notes amounting to NIS 10 million, which were deducted from the Tier II capital, were defined as Tier III capital, with the approval of the Bank of Israel, compared with 37 million at the end of 2005.

## ISSUE OF SUBORDINATED CAPITAL NOTES

**Issuance of subordinated capital notes in 2006.** During 2006 the Bank issued subordinated capital notes in the amount of of NIS 672 million, of which NIS 624 million were raised by the issue of marketable capital notes. Included in the above amount Manpikim issued to institutional investors, in September 2006, NIS 300 million par value of subordinated capital notes (series "B") for a total consideration of NIS 333 million. The issuance was an enlargement of the said series of notes, which was first issued to the public according to a prospectus dated November 2004.

**Issue of subordinated capital notes – Mercantile Issues Ltd.** On August 23, 2005, Mercantile Issues Ltd., a subsidiary of Mercantile Discount Bank, completed issuing NIS 200 million of deferred capital notes (series A), out of a series of a total of NIS 300 million which were listed for trading on the Tel-Aviv Stock Exchange.

Mercantile Discount Bank received the approval of the Supervisor of Banks to have the said capital notes included as Mercantile Discount Bank's second tier capital. (Accordingly, the said capital notes are considered second tier capital for the purpose of calculating the Bank's capital ratio).

Up to December 31, 2006, Mercantile Discount Bank raised additional secondary capital, out of the same series, of NIS 4 million.

**Issue of subordinated capital notes – Discount Mortgage Issues Ltd.** On November 23, 2005, Discount Mortgage Issues Ltd., a subsidiary of Discount Mortgage Bank, published a prospectus for issuing of NIS 125 million deferred capital notes (Series "A"), out of a total series of NIS 300 million. Discount Mortgage Bank received the approval of the Supervisor of Banks for inclusion of the said capital notes as part of Discount Mortgage Bank's secondary capital (Accordingly, the said capital notes are considered secondary tier capital for the purpose of calculating the Bank's capital ratio).

Up to December 31, 2006, Discount Mortgage Bank raised additional secondary capital, out of the same series, of NIS 59 million.

**The publication of a shelf prospectus.** On September 28 2006, Manpikim published a shelf prospectus for the issuance of up to NIS 4 billion par value, subordinated capital notes (series "C" – "F"), and for the listing for trade of NIS 300 million par value, capital notes (series "B").

At this stage, an issue of notes has been approved within the framework of the said shelf prospectus, in an amount not to exceed NIS 1.2 billion.

At the beginning of March 2007 Manpikim issued NIS 350 million par value subordinate capital notes (series "E") in accordance with a shelf offer report dated March 5, 2007.

**Issuance of Capital Notes in 2007.** An amount of NIS 402 million of capital notes issued in the past will be deducted in the course of 2007 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.

## RATING THE BANK'S LIABILITIES

Ma'alot – The Israeli Securities Rating Company Ltd., rated the Bank with an "AA-" rating with respect to deposits with the Bank and subordinated capital notes issued by the Bank, directly and through Discount Manpikim Ltd. Midroog Ltd. rated the Bank with an "Aa2" rating with respect to deposits with the Bank and subordinated capital

notes issued by the Bank, directly and through Discount Manpikim Ltd.

S&P rated the Bank, based on public information, with a "BBpi" long term local currency rating. Moody's rated the Bank, based on public information, with an "A2" rating with respect to long-term deposits, and with a "P1-" rating with respect to short-term deposits. Moody's also rated the Bank with a "D+" rating for the financial stability parameter. In May 2006, Moody's raised the forecasted rating of the Bank as regards to long-term deposits from "stable" to "positive".

Ma'alot ranked as "A" the subordinate capital notes (series "A"), constituting the hybrid tier I capital. Midroog ranked the said capital notes as "A1". Ma'alot and Midroog emphasized that this ranking is based, inter alia, on the decision of the Board of Directors of the Bank regarding the subordinate capital notes, in accordance with which the Board adopted a capital adequacy policy according to which the Bank will maintain, at all times, an original tier I capital adequacy ratio (excluding hybrid tier I capital) of at least 6.5%. Midrug also noted that the determined ranking is based on the Bank's overall capital adequacy ratio.

"Ma'alot" ranked an "AA-" rating to the subordinated capital notes (Series "A") issued by Mercantile Discount Bank. In its most recent update, "Ma'alot" subjected the present rating to the maintenance until December 31, 2007, of capital adequacy ratio of not less than 11%. As of December 31, 2006, the capital adequacy ratio of Mercantile Discount Bank was 12.7%.

## 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 13 B to the financial statements), which the Bank distributes regularly.

The main limitation affecting the ability of the Bank to distribute a dividend in the recent years was the capital base limitation.

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" under "Control of the Bank" hereunder. As to details regarding a limitation set by the Governor of the Bank of Israel in the permit issued to the Bronfman-Schron Group for the acquisition and holding of means of control in the Bank, see "The Governor of the Bank of Israel's permit for the control and holding of means of control in the Bank" under "Control of the Bank" hereunder and Note 32 B to the financial statements.

## LIQUIDITY AND THE RAISING OF SOURCES IN THE BANK GENERAL

In 2006, the Bank of Israel completed replacement of the monetary instrument for absorption of liquidity surplus in the economy – interest bearing deposits issued by tender to banks alone – with short-term borrowings (MAKAM) issued to the public at large under regular tenders. As a result, the volume of monetary deposits raised by the Bank of Israel from the banking industry decreased significantly. On the other hand, the activity in monetary borrowing tenders, which the Bank of Israel offers to the banking industry, increased significantly, following recent years in which this liquidity instrument was not utilized. It should be noted that quota loans, which the banking industry utilized extensively for liquidity purposes, were cancelled in 2005. The liquidity requirements of the

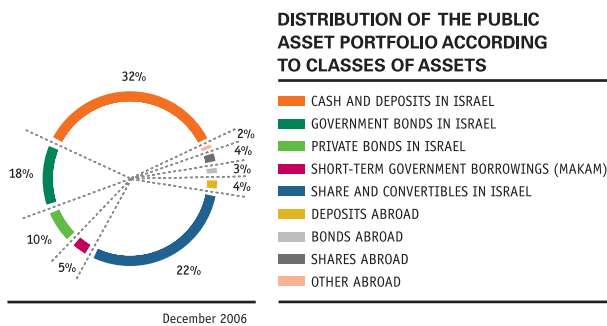
banking industry in 2006 were high and the volume of use of monetary loan tenders was larger than the volume of quota loans in recent years.

Despite the cancellation of the "RIPO" tenders at the end of 2006, the Bank of Israel declared its intention to implement such transactions in the future in order to match the liquidity requirements of the banking institutions. This, concurrently with promoting the establishment of a new system for the real-time clearing of large payments – RTGS - that would require the banking industry to conduct a daily liquidity market.

### ASSET PORTFOLIO HELD BY THE PUBLIC

The composition of the asset portfolio held by the public in 2006 reflects the impressive strength of Israel's financial markets, despite the instability at political and security levels. Following are the main influencing factors:

- Strength of the shekel reflected in appreciation of 8.9% as against the United States dollar, despite the war in the North of Israel in the third quarter of 2006, the political instability in Israel as from the general



elections at the beginning of the year and continuing with accusations with respect to corruption and the deficient performance of the Government at year-end, and despite the rise to power of the Hamas in the Palestinian Authority at the beginning of the year and the missile attacks into Israel during the year. The strength of the shekel was reflected, inter alia, in the appreciation and in the negative inflation rate of 0.1%. The inflationary environment declined sharply as from the second half of 2006.

- The Bank of Israel interest rate increased during 2006 by 0.50%, following an increase from 4.50% to 5.50% in the first three quarters of the year and a decrease back to a level of 5.0% in the last quarter. At the beginning of 2007, the Bank of Israel continued to decrease the interest rate to a level of 4.25%, in an effort to raise the low inflationary expectations. In contrast, the interest rate of the Federal Reserve Bank in the United States increased in 2006, to a level of 5.25%. As a result, a negative interest difference of 0.25% was recorded at the end of the year between the interest rates in the United States and in Israel.
- A continued decline in the volume of fundraising by the Government on the domestic bond market followed the continued decline in the State's budget deficit. In contrast, corporate bond issuances continued to surge in 2006.
- The continued price increase trend in the equity market, in high correlation with world markets, which started the year weakly but ended the year with price increases. In summary, the Tel Aviv Stock Exchange increased by approximately 12% during 2006.

Following the above described developments, and in continuation of the trend in previous years, in 2006 the public's preference for marketable securities rather than bank deposits increased. Following are the principal changes in the composition of the public's assets' portfolio in 2006:

- An increase in the weight of shares from 23.0% at the end of 2005 to a level of 26.3% at the end of 2006, including an increase in investment in foreign shares to a level of 3.9%;
- A decrease in the weight of non-linked assets from 30.2% at the end of 2005 to a level of 29.2% at the end of 2006.
- A decrease in the weight of CPI linked assets from 31.2% at the end of 2005 to a level of 29.6% at the end of 2006. In continuation of the trend in recent years, the weight of CPI linked assets, which in the past constituted a major component of the portfolio, is now equivalent to that of the non-linked assets.

## THE BANK

During the entire year, the Bank maintained liquid assets in a volume higher than its liquid liabilities.

**The non-linked segment.** The volume of non-linked deposits of the public with the Bank reached at the end of 2006 an amount of NIS 40.5 billion, compared with NIS 37.4 billion at the end of 2005, an increase of 8.3%.

**The CPI linked segment.** The total of CPI linked financial resources amounted to NIS 9.7 billion at the end of 2006, similar to the end of 2005,

**The foreign currency and foreign currency linked segment.** The volume of non-linked deposits of the public with the Bank reached US\$8.2 billion at the end of 2006, compared to US\$7.2 billion at the end of 2005.

**Raising of capital.** For details regarding the issuance of secondary capital and hybrid tier I capital in 2006 see "Capital resources" above.

## EXPOSURE TO RISKS AND RISK MANAGEMENT

### GENERAL

The Bank's activity as a financial broker involves risk taking, the principal of which are: credit risks, market risks and liquidity risks. Such risks are accompanied by operational and legal risks.

The risk management policy is intended to increase the profit expectancy as part of the means to attain the Bank's business targets, while maintaining an approved and controlled risk level.

In order to address all risks, the Bank adopted a risk management policy that defines the kind of risk exposure to the Bank, the units responsible for the risk exposure or for hedging against exposure, and their authorization. Also, tools and mechanisms were defined for the management, measurement and reporting of risk exposure. This policy addresses, inter alia, Proper Banking Management Directive No. 339 – "Risk Management", issued by the Supervisor of Banks, regarding management and control of financial risks.

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

The Bank has a committee of risk managers headed by the risk manager of the Bank. The committee's members are the following members of Management:

Ms. Dorit Ben-Simon – Risk Manager of the Bank, Market and Liquidity Risk Manager and Chairperson of the Committee

- Mr. Giora Offer – President and CEO – Sevrer temporarily as Credit risk manager of the Bank; (in place of Mr. Rony Hizkiyahu who retired from the Bank at the end of 2006);
- Mr. Noam Hanegbi – Operational risk manager;
- Ms. Esther Deutsch – Legal risk manager.

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

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

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

#### THE ESTABLISHMENT OF A RISK MANAGEMENT DEPARTMENT

Within the framework of the preparations by the Bank with respect to the management of the total risks at the Bank and the Group, including Basle II, and in view of the strategic importance that the Bank attributes to the issue of risk management and corporate governance, it has been decided to enlarge the framework involved in risk management and to define it as a department within the finance division.

The new department will act to absorb the risk management culture, to form a policy and a methodology and to implement procedures for advanced risk management at the Bank and at all companies in the Group. The department will engage in managing market risks, credit risks and operational risks, and will also coordinate the activities required for the implementation of the Basle II guidelines and the requirements of the Supervisor of Banks in the matter.

#### DESCRIPTION OF EXPOSURE TO AND MANAGEMENT OF MARKET RISKS

**General.** In accordance with Proper Banking Management Directive No. 339, the Bank is required to manage the market risk on a Group basis while, at this stage, market risks are managed on the basis of the Bank alone. The Boards of Directors of the banking subsidiaries have also determined policies regarding the maximum exposure to market risks, with each subsidiary managing its own market risks. The Bank is adopting the necessary measures to assess and measure the Group’s overall exposure to market risks. In recent months, the Bank has intensified its efforts in this respect and results are expected during 2007. This review presents market risks applicable to the Bank only.

The Bank distinguishes between exposure incurred during the Bank’s asset and liability management process and exposure incurred by trading. The trading exposure results from the Bank’s activity as a market maker and from “nostro” investments in financial assets.

The Board of Directors determined different limitations for trading and non-trading activity.

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

#### (1) BASE RISK EXPOSURE

The exposure to base risk is reflected in the loss which may incur as a result of changes in exchange rates or in the consumer price index, due to the difference between the value of assets and liabilities, including the effect of forward transactions and the effect of options embedded in the base exposure. The base risk 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 following is a summary of the net linkage balances of the Bank (in NIS millions)<sup>(1)</sup>:

	Non-linked shekels	CPI linked shekels	Foreign currency <sup>(2)(3)</sup>	Non-monetary asset	Total
As at December 31, 2006					
Assets	45,955	14,604	37,013	9,383	106,955
Liabilities	47,947	13,681	37,184	178	98,990
Balance sheet difference	(1,992)	923	(171)	9,205	7,965
Derivatives	2,374	(407)	(1,967)	-	-
Options	586	60	(646)	-	-
Total Difference	968	576	(2,784)	9,205	7,965
As at December 31, 2005					
Assets	41,064	14,508	34,652	8,513	98,737
Liabilities	42,916	13,259	35,771	73	92,019
Balance sheet difference	(1,852)	1,249	(1,119)	8,440	6,718
Futures contracts, net	2,180	(728)	(1,452)	-	-
Options	159	91	(250)	-	-
Total Difference	487	628	(2,281)	8,440	6,718

Footnotes:

(1) 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).

(2) Including foreign currency-linked shekels.

(3) Exposure to foreign currencies is permitted within the limitations approved by the Board of Directors of the Bank.

The base exposure is computed in accordance with generally accepted accounting principles, as stated in Note 17 to the financial statements. For current management purposes, certain changes have been implemented, which take into account the Bank's economic approach to base exposure.

The exposure to base risk is measured as a percentage of the Bank's available capital, defined as the Bank's equity, net of investments in investee companies, and with the addition of investments in foreign subsidiaries that are financed from foreign currency deposits and with the addition of adjustments required for the economic presentation of exposure to base risks. Available capital is defined by the Bank as a non-linked shekel resource.

Following is the actual base risk exposure at the level of the Bank (not consolidated) as compared to the limitations set by

the Board of Directors (The limitations and exposures are stated in relation to the available capital):

Segment of operations	2006					2005			
	Limitations	Year end	Average	Maximum	Minimum	Year End	Average	Maximum	Minimum
Non-linked Shekel	140%-(30%)	106%	113%	159%	61%	9%	83%	110%	43%
CPI linked Shekel	120%-(40%)	(6%)	(13%)	(59%)	0%	1%	17%	49%	0%
Foreign currency	50%-(50%)	0%	0%	4%	0%	0%	0%	9%	0%

As stated, the limits determined by the Board constitute a percentage of the available capital. As from September 2005, the available capital of the Bank decreased, mainly as a result of acquisitions implemented by the Bank (including acquisition of office space in Discount Tower and acquisition of 45% of the share capital of Ilanot Discount). These material transactions (including a material transaction for the sale of credit), on the background of the said decrease in the available capital, resulted in a deviation from the limits determined by the Board; the deviation which continued for only several days during March and April 2006.

As from the second half of 2006, the volume of the available capital resumed its growth.

The maximum linkage based exposure recorded in the current year reached NIS (815) million in the CPI linked segment, NIS 2,192 million in the non-linked segment, and US\$42 million in the foreign currency segment. This is in comparison to NIS (799) million in the CPI linked segment, NIS 1,973 million in the non-linked segment, and US\$150 million in the foreign currency segment in 2005.

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

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

	10%	5%	-5%	-10%
USD	(45.9)	(23.0)	23.0	45.9
EUR	(0.7)	(0.4)	0.4	0.7
GBP	4.7	2.4	(2.4)	(4.7)
CHE	1.2	0.6	(0.6)	(1.2)
JPY	(0.7)	(0.3)	0.3	0.7
Total	(41.4)	(20.7)	20.7	41.4
Influence of options*	(17.0)	(5.0)	15.0	38.0
Total Influence	(58.4)	(25.7)	35.7	79.4

\* Not including embedded options

This impact was calculated on the basis of the expected change in the Bank's economic positions in respect of various currencies, in accordance with scenarios determined by the Supervisor of Banks. The calculation is based on the Bank's economic position that is based, in turn, on the difference between assets and liabilities, with the addition of off-balance sheet items and economic adjustments.

## (2) INTEREST RISK EXPOSURE

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

Interest risk exposure data take into account early repayments and withdrawals from savings schemes as of "exit dates", and the assumed spread of a certain rate of current account balances. For details see "Behavioral assumptions applied in the assessment of market and liquidity risks" below.

The limitation determined by the Board for interest risk exposure in the various linkage segments relates to the maximum permitted erosion of economic capital as a result of concurrent movement in the yield curve of 1% in each segment.

Following is the actual exposure of the Bank alone (not consolidated) to interest risk compared to the limitations determined by the Board of Directors (not including trading activities; in NIS million):

Segment of operations	2006					2005			
	Limitations	Year end	Average	Maximum	Minimum	Year End	Average	Maximum	Minimum
Non-linked Shekel	180	96	102	121	79	81	64	81	45
CPI linked Shekel	180	58	20	58	3	31	14	33	1
Foreign currency	100	4	3	7	0	3	5	14	1
Total segments	320	158	121	158	93	115	84	115	55

During 2006, the Bank complied with the limitations on exposure to interest risk determined by the Board of Directors.

The analysis of exposure of the Bank (non-consolidated) to economic interest rates, presents the following findings:

**In the CPI linked segment** – The exposure in this segment increased as a result of the issue of the hybrid tier I capital at the end of 2006. The exposure in this segment as of the end of 2006 relates to the decline in the interest rate.

**The non-linked segment** – During 2006 the exposure to interest rate risk increased in this segment.

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 directives of the Bank of Israel, under "demand deposits and up to one month".

**In the foreign currency segment (including foreign currency linked)** – Most of the activity is on the basis of variable interest rates and the availability of varied financial instruments in international markets enables the reduction of exposure. The Bank decided to maintain low interest risk 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) Including assumptions regarding early repayments<sup>(1)</sup>:

	As at December 31, 2006			As at December 31, 2005		
	Non-linked shekels	CPI linked shekels	Foreign currency <sup>(2)</sup>	Non-linked shekels	CPI linked shekels	Foreign currency <sup>(2)</sup>
Total Assets	58,941	21,018	76,900	53,357	21,345	79,059
Total Liabilities	59,969	19,082	74,856	54,595	19,021	77,792
<b>Average maturity (years):</b>						
Assets	0.62	4.16	1.26	0.61	4.08	1.49
Liabilities	0.30	4.03	0.51	0.32	3.64	0.79
Average maturity gap	0.32	0.13	0.75	0.29	0.44	0.70
IRR gap	2.97	0.93	0.99	2.66	1.13	130

(1) For details see "Behavioral assumption applied in the assessment of market and liquidity risks.

(2) 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, 2006, between the average maturity of liabilities and the average maturity of assets, amounting to 0.32 years, compared with an average maturity gap on December 31, 2005 of 0.29 years.
- In the CPI-linked shekel segment, the average maturity gap between assets and liabilities as at December 31, 2006, was 0.13 years (about 2 months), compared with 0.44 years (about 5 months) on December 31, 2005. 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, 2006, was 0.75 years, compared with a gap of 0.7 years on December 31, 2005. 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) MANAGEMENT OF TRADING POSITIONS

The exposure to trading is the result of the Bank's activity as a market maker and a result of dynamic management of its liquid financial asset portfolio. The trading policy is intended to create an income channel, concurrently with enabling exposure within the approved risk range for this activity, and maintaining daily monitoring and control.

Limitations on trading activity were determined by the Board of Directors of the Bank in terms of scope of activity, sensitivity to risk factors and theoretical losses incurred, including in extreme scenarios, and in terms of the value at risk (VAR) in trading.

Compliance with these limitations is examined daily by the entity managing the trading portfolio, and is controlled on a daily and sub-daily basis by an independent control entity.

#### (4) 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 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. In addition, the dealing room procedures include limitations on maximum changes in the value of the option portfolio in terms of sensitivity indices ("GREEKS").

#### (5) ACTIVITY IN DERIVATIVE FINANCIAL INSTRUMENTS

The Board of Directors has determined the mode of operation of the Bank in derivative financial instruments, maximum volume of activity and the range of financial instruments in which the Bank may engage. 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.

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

The Bank is active in a wide range of derivative financial instruments both in shekels and in foreign currency, and acts also as a "market maker" for some of which including regular options and "exotic" options of various kinds, approved for by the Board of Directors. A substantial 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 with regard to linkage base and with regard to interest as a result of this activity, is included in the limitations set by the board of directors on exposure to linkage base, interest and options.

The exposure is measured and controlled by the Middle Office on a current basis.

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

	As at December 31, 2006	As at December 31, 2005
Hedging derivatives	3,409	4,483
ALM derivatives	48,367	40,301
Other derivatives	44,587	56,824
Credit derivatives and SPOT foreign currency	4,879	3,423

**Accounting aspects.** The accounting policy with regard 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 directives of the Supervisor of Banks, most of the transactions in derivative financial instruments made by the Bank for managing market risks resulting from its financial base assets (ALM) are

classified as "other transactions" and not as "hedging transactions". In terms of the said directives more stringent criteria have to be complied with so that transactions in derivative financial instruments could be considered as "hedging transactions".

The majority of base assets, the exposure of which to market risk, as stated, was hedged by derivative financial instruments, are not marketable. Income and expenses generated by such assets are recognized on the accrual basis while the results of the transactions in derivative financial instruments defined as "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 33 million in 2006, compared with a decrease of NIS 15 million in earnings from financing operations in 2005.

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 its obligations, net of the effect of enforceable setoff agreements.

The credit risk during the period of the engagement is assessed according to the cost of engagement in a similar transaction, had this been entered into at the reporting date with the same customer and for the remaining period until its expiration.

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 different kinds. Furthermore, the Bank may grant the customer a credit line without security, as the case may be. 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 continuously monitors the credit risk inherent the derivative financial instrument activity of major customers. At the end of 2006 the Bank commenced absorption of an advanced system for monitoring credit exposure relating to the activity of principal customers in derivative financial instruments.

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 (like stress tests) applying to the activity in specific instruments.

## (6) LIQUIDITY RISK

Liquidity is defined as a situation in which the Bank is able to meet its obligations in an acceptable course of business – to finance an increase in assets or repay liabilities without encountering difficulties and without sustaining a loss.

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

Whereas this is a situation of uncertainty where a liquidity risk always exists, the Bank has determined the maximum exposure to liquidity risk that it is ready to accept. The current measurement of the exposure to liquidity risk is intended to provide decision makers with indicators that forewarn the intensification of this risk, allowing the Bank a period of time in which it may counteract the risk without having to sustain material losses.

Liquidity is defined as the ability of the Bank to fulfill its obligations as to the repayment of liabilities. The ability to withstand the liquidity risk involves the uncertainty as to the possibility of raising funds or realizing assets unexpectedly and in a short time without sustaining a material loss.

The measurement of liquidity risks is intended to provide decision makers with indicators for the identification of situations in which this risk increases. 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.

**Liquidity risk management.** The Bank manages its liquidity risk according to an internal model for assessing liquidity risk, which examines the impact of various scenarios regarding developments in assets and liabilities on the liquidity of the Bank, as required in Proper Banking Management Directive No. 342.

The model is based, among other things, on the following principles:

- Separation between short-term and long-term liquidity;
- Separate management of the liquidity risks in the shekel segment (including the CPI linked segment) and in the foreign currency and foreign currency linked segment;
- Differentiation between depositors according to behavioral pattern;

**Limitations on the exposure to liquidity risks.** The limitations determined by the Supervisor of Banks prescribe that the total liquidity resources should not fall below possible liquidity requirements (under an extreme scenario). During 2006, the Bank complied with the limitations on exposure to liquidity risks.

As part of the preparations with respect to the possibility of an exceptional situation, the Bank formulated an alternative plan, which defines the strategy for the management of a liquidity crisis, the management team responsible for handling such a crisis, and the procedures and actions to be implemented by the Bank in handling the crisis.

It should be noted that in accordance with the Supervisor's directive, the Bank is required to determine a limitation on the liquidity margin according to repayment periods. The Bank has not yet determined a limitation on the liquidity margin for a period of one to seven days and is presently in the process of determining the limitation. Notwithstanding, until the determination of such limitations, the Bank utilizes several additional indicators, inter alia, that are being used to indicate an extensive increase in liquidity risks.

### (7) THE MAIN CHANGES OCCURRING IN 2006 IN THE BANK'S RISK MANAGEMENT POLICY AND ITS PROCEDURES:

- Determination of the maximum economic loss in an extreme scenario (in the Bank as a whole);
- Updating certain parameters in the internal model for the liquidity risk;
- Extending restrictions on commercial activity: limitations on foreign currency positions, limitations on interest risk, limitations on financial instruments and limitations on activity in foreign currency/shekel options.

## MEANS OF CONTROL AND APPLICATION OF THE POLICY

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

The Board of Directors appointed a Risk Management Committee and, in accordance with the directives of the Supervisor of Banks, the Board's Audit Committee is also involved in the aspects of risk management.

During the year, the board of directors, the risk management committee of the Board and the audit committee of the Board discussed various issues regarding market risk.

A report on the exposure to market and liquidity risks is included in the reporting document submitted quarterly to the Bank's Board of Directors. This document addresses exposure to market and liquidity risks as well as other risks, of the principal subsidiaries.

### (2) BANK MECHANISM RELATING TO MARKET AND LIQUIDITY RISKS MANAGEMENT ISSUES

Authority and responsibility in respect of risk management is designated to specific Bank entities. The highest forum for risk management in the Bank is the Asset and Liability Management Committee, which meets once a month, and is headed by the Bank's President and CEO. Market and liquidity risk management policy is discussed, reported and controlled within the framework of this Committee, subject to limitations and guidelines determined by the Board. The Committee determines a monthly plan regarding risk management.

A financial forum headed by the Head of the Financial Division is responsible for the current risk management. The Bank's exposure to market risk is reviewed and discussed at the weekly forum's meetings. The forum implements decisions regarding the risk to which the Bank may be exposed in the short term, subject to guidelines determined by the Asset and Liability Management Committee.

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

The Bank operates control mechanisms for the prevention of deviation from the market and liquidity risks management policy. The Bank's procedures requires those who accept the risk and the control factors to report to the Head of the Financial Division in respect of any exceptional events, e.g. loss exceeding the predetermined limit.

The risk evaluation department in the Financial Division reports weekly to the Risk Manager and to the various forums for market and liquidity risk management, regarding the Bank's exposure to market risk and its compliance with limitations.

The Middle Office unit of the Finance Division performs a general control over the trading 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 Market and Liquidity Risk Manager.

The Risk Manager and the Internal Auditor monitor independently the risk management process in order to identify and draw attention to any failures in risk management and deviations from the determined policy.

In 2006, no significant deviations were ascertained in implementation of the predetermined policy, if any.

#### (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, 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 person managing the portfolio and periodic control of compliance with the limitations and of the profitability by an independent controller.

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 daily 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) THE VALUE AT RISK (VAR)

**General.** As detailed above, the Bank implements various measures to manage exposure to market risks, in addition to the probability model – the VAR model. This model is compatible with directives for risk management issued by the Supervisor of Banks. The Bank is required to manage the exposure to market risk by means of an information system based on an internal model, which enables a current measurement of the Bank's overall exposure to market risk by assessing the VAR. The VAR assesses the maximum damage that might be caused to the Bank as a result of market risks being materialized in a given time period and at a defined statistical security level. This damage reflects erosion in the value of the Bank (in fair value terms).

The VAR serves as a central instrument for measuring the extent of exposure of the Bank to market risk. The VAR computation (at the Bank's level) is made, on a weekly basis, by the Iris/Riskpro system. This system assembles the financial data required for risk management and which relates to the variety of financial instruments transacted by the Bank, including embedded options as well as to market data (such as indices, exchange rates and interest rates), their extent of volatility and the statistical correlation between them.

The VAR is computed according to a parametric model based on the historical behavior of various market risk factors in the period preceding the computation (one year), assuming normal distribution of the changes in the parameters.

The Board of Directors of the Bank determined a limitation according to which the VAR of the Bank's portfolio (for a range of ten days and at a precision level of 99%) should not exceed 3% of the Bank's equity.

	2006			2005				
	At year	Yearly		At year	Yearly			
	end	average	Maximum	Minimum	end (1)	average	Maximum	Minimum
Estimate of VAR amount (in NIS millions)	44	66	89	34	61	46	79	28

Footnote:

(1) Starting with the computation as of June 30, 2006, the VAR data does not include a certain asset provided as security for a certain loan and which is not under the Bank's financial management. Elimination of the said asset from the VAR computation reduced the results for December 31, 2006, by an amount of NIS 17 million.

The results of the VAR measurements indicate that most of the exposure to market risks derive from the interest rate risk in linked and non-linked shekel segments. The value at risk comprised 0.6% of the Bank's equity, compared with 0.9% as of the end of the previous year.

In addition to the weekly parametric measurement, the VAR is also assessed monthly by the historic simulation method, and the two methods of measurement are compared. The historic simulation enables measurement of the risk without reliance on a specific probability structure.

The VAR relating to the option portfolio is tested both by the parametric model and by the VAR computed by the "Monte Carlo" simulation (in order to reflect the non-linear risk components). The resulting difference between the two methods is immaterial.

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

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

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

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

## (2) LOSS ANALYSIS IN EXTREME SCENARIOS (STRESS TESTS)

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

Stress tests enable the examination of the possible implications of such extreme events.

The Bank has established a stress test forum that examines extreme scenarios, at least once every quarter. The Bank's Market and Liquidity Risk Manager chairs the forum, while its members include the Chief Economist and

representatives of the ALM, the risk evaluation and the dealing room departments. In the forum meetings, the results of defined scenarios are reviewed and their effect on the portfolio of the Bank are examined. The forum also sets additional extreme scenarios which ought to be examined..

In addition to the above detailed limitations regarding base, interest and VAR exposure, the Board of Directors also determined in 2006 a limitation on the maximum economic loss in the event of an extreme scenario. The limitation determines that the decrease in the economic value of the equity should not exceed 12.5% of the Bank's equity. During 2006, the bank complied with this limitation.

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

In addition to protecting the economic value of its equity, the Bank examines the impact of changes in interest rates on interest income. This examination is implemented through dynamic simulation of the net interest income for the coming year, in order to test the impact of various strategies for asset and liability management on the Bank's future interest income.

The EAR index measures the sensitivity of interest income to changes in market yield.

### (4) 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 Bank's goodwill and rating, size 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.

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

Premature redemptions of savings deposits model. In evaluating the exposure to interest rate and liquidity risks, the Bank addresses the possibility of premature withdrawal of funds from savings deposits ("breaking of a deposit"). The Bank's assessment is based upon historical data at its disposal. For the purpose of the model, savings deposits at the Bank were classified into several groups having similar patterns of behavior, and a forecast model was established by using a moderating factor that grants a higher weight to the "decay factor". The rates of premature withdrawal are computed as from the end of the first two years of the period of the deposit and at each "exit point" until the end of the deposit period.

**Background assumptions on which the model is based:**

- A relationship exists between the age of the savings deposit and the rate of early withdrawals;
- The rate of early withdrawals may be estimated by examining withdrawals in recent years;
- The Bank utilizes a compensating mechanism in cases of early withdrawals not at predetermined "exit points" ("breaking of a savings deposit").

The average maturity of total liabilities, taking into account the above assumptions, is 4.21 years, lower than the average maturity according to the initial cash flow from savings deposits, which is 4.39 years.

The internal rate of return margin, taking into account the above mentioned assumptions, is 0.73 %, compared with an internal rate of return margin of 0.62 % according to the initial cash flow.

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

	December 31, 2006			December 31, 2005		
	Non-linked	CPI linked	Foreign currency <sup>(1)</sup>	Non-linked	Foreign currency <sup>(1)</sup>	CPI linked
<b>Internal rate of return</b>						
Assets	5.06	5.11	5.09	5.20	5.35	3.96
Liabilities	2.10	4.49	3.48	2.11	4.40	2.34
<b>Average maturity</b>						
Assets	0.68	3.82	0.28	0.70	3.67	0.24
Liabilities	0.28	4.39	0.23	0.32	4.00	0.26

(1) including foreign currency - linked shekels.

**Creditory current accounts spread model.** Schedule "D" presents current account balances according to Bank of Israel directives as deposits on demand and up to one month. However, for purposes of assessing the exposure to liquidity risks, the Bank assumes that a significant part of current account balances is not expected to be withdrawn immediately and is distributed over periods of one to seven years, in accordance with behavioral assumptions that are updated from time to time.

In accordance with these assumptions, the average maturity of liabilities in the non-linked segment is higher and reaches 0.65 years, compared with 0.28 years for the initial cash flow. The internal rate of return margin is 4.2 % compared with the internal rate of return margin of 3.0 % according to the initial cash flow.

## 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 minimize 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 the decision making process and make it 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 2007, the Bank rated some 93.6% 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 rating 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 2006, 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

The Bank controls and monitors on periodic basis developments in the various economic sectors that are typified by a relatively high sensitivity to the impacts of an economic slowdown in the domestic and in the global markets. Control procedures are being implemented despite the continued improvement in borrower repayment ability in most economic sectors.

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 high-tech field, the Bank has increased control over this sector, and, where possible, the increased collateral required and has also tightened demands where new financing applications are concerned. A consistent and continuous improvement was noticed as from the second half of 2003 in the local and global communications market, reflecting an increase in the volume of operations in this sector and an improvement in the repayment ability of most of the borrowers. As a result of the above, a substantial decrease in the weight of this sector in the provision for doubtful debts was recorded in 2006, in comparison to the corresponding period last year.

**The hotel and related services sector:** Due to the security situation in the country, a sharp deterioration has taken place since the last quarter of 2000, in the number of tourists and in the volume of hotel occupancy, and a number of hotels have even closed. The crisis in this sector adversely affected the operations of companies engaged in the sector and in related areas. The Bank has adopted measures to increase supervision, control and the monitoring of operations of companies belonging to this sector. A consistent and continuous improvement in the position of this industry was noticed as from the second half of 2003. Among other things, the improvement was reflected in the low weight of this industry in the provision for doubtful debts in 2005 and in 2006.

**The industrial sector:** As from the second half of 2003, there was an improvement in the volume of activity of companies belonging to the industrial sector, which was reflected in increased production, sales and imported inputs, and in an improved repayment ability of borrowers in this sector. During 2006, the weight of this sector in the provision for doubtful debts increased, mostly due to a one off provision in respect of two certain borrowers.

**The construction and real estate sector:** In view of the continuous slowdown in activity in this sector, which is reflected, inter-alia, in reduced demand on the one hand and in a drop in prices on the other especially in peripheral areas, the Bank strengthened control over its customers, increased the collateral where possible and tightened the demands when examining new applications for finance. Despite the continued slowdown, this sector's share in the provision for doubtful debts was significantly reduced in 2006, compared with the corresponding period last year.

**The commercial sector:** The trend of growth in the volume of demand and the improvement in profitability of

various commercial sectors and in particular the food and electrical appliances marketing chains, continued in 2006. In consequence thereof, the volume of the provision for doubtful debts decreased in 2006, in comparison to the corresponding period last year.

**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

The updated version of the Basel II guidelines was published by the BIS in June 2006, among its targets were: 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 I - minimum capital requirements – the aim is to expand and improve the existing framework of measurement determined in 1988.
- Tier II - expanding the examination process of bank supervisors, including capital adequacy of the financial institution, its management processes and risk assessment.
- Tier III - fair disclosure – by expanding public information as to the risks to which a bank is exposed.

During the past two years the Supervisor of Banks issued draft guidelines to the banks with respect to several matters (among which were: credit rating for companies, banks and states, and the management of operational risks) formed within the framework of the preparations made by the Supervisor of Banks for the application of the Basel II principles. The Supervisor of Banks clarified recently that it is his intension to adopt the guidelines of Basel II as a Proper Banking Management Directive and that banks in Israel would be required to implement them in 2009.

**Preparations of the Bank for the implementation of the requirements of Basel II.** The committee of risk managers at the Bank is in charge of the Bank's preparations. The Bank utilizes outside consulting services to advance its preparations. In the course of 2006 the Bank has completed the first stage, which included the formation of an appropriate risk management strategy, a comprehensive gap analysis and the preparation of a project program.

The second stage of the preparations commenced at the end of 2006, focusing on the definition of risk governance issues, including the definition of the appropriate organizational structure for enterprise risk management (ERM), risk management charter, determination of a framework for policy documentation, regarding risk management. Other activity implemented at this stage in the credit field includes the planning of computer projects required for compliance with the requirements of Basel II, and the development of internal models for credit rating, which correspond to the Basel principles development of new rating questionnaires and updating of procedures.

According to the Bank's assessment, the preparation taken as a whole would require the investment of considerable resources. Changes and adjustments will be required, inter alia in work procedures and infrastructure systems, and in completion and collection of data, establishment of data bases, development of various models and internalization of new systems for the implementation of capital requirements.

For further details see "Draft guidelines regarding management of operational risks", hereunder.

## OPERATIONAL RISKS

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

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 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.

**Operational risk management policy.** During 2004, the Bank set the "Operational risk management policy", which was approved by the Bank's Management and Board of Directors. Within this framework, the Bank endeavors to reach a stage of extensive reporting that would include also failure events that did not result in a financial loss. This with the view of creating an extensive data base that would enable the future use of advanced models for risk assessments.

During 2006 the Bank continued the preparation for the implementation of the policy, including:

- Updating and absorption of risk management procedures;
- A computerized process for the reporting of events representing the realization of operational risks;
- The establishment of an information system for the management of operational risks as a derivative of business activities and processes;
- Expansion of the references to operational risks in the procedures of the Bank.

**The operational risks forum**, headed by the operational risks manager and with the participation of divisional risk controllers met regularly during the year, discusses events representing the realization of operational risks and deals with furthering and coordination of operations for the absorption of the policy in practice.

**The mapping and hedging of risks.** During the first half of 2005, the Bank completed the detailed mapping of operational risks based on the comprehensive review performed in prior years. In the third quarter of 2005, the divisions of the Bank prepared plans for the treatment and reduction of material identified risks. These plans have gradually been executed throughout 2006. A revised assessment of the risk map at the Bank was conducted in the second half of 2006. In 2007, following three years since the carrying out of a risk mapping review, the Bank plans to carry out, with the assistance of an outside expert in this field, a new extensive mapping of operational risks based upon business processes. The products of this mapping are to be updated to a new information system for the management of operational risks, which is to be implemented at the Bank during the year.

## DRAFT GUIDELINES REGARDING THE MANAGEMENT OF OPERATIONAL RISKS

On August 28, 2006, the Supervisor of Banks issued draft guidelines for the management of operational risks. The

draft is intended to outline guidelines for the management of operational risks in the banking industry, the implementation of which would establish a proper infrastructure for the management of these risks while complying with international standards. The draft is based mostly on the Basel Commission documents, and in regards to certain matters, on the document of the U.S. regulation authorities. The draft constitutes an additional layer in a line of draft guidelines and instructions that have already been passed to the banking corporations, and which deals with the various aspects of managing the internal control environment at banking corporations. The Supervisor of Banks is currently conducting discussions with the banking corporations regarding the said draft guidelines.

### 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 credit risk that exposes the Bank to a situation of legal risk);
- Disappearance of the base asset.

The Bank is taking steps towards collecting and assembling information regarding legal risks. The Bank collects the findings regarding these risks and the handling thereof, the formation of processes, design of procedures and the creation of routine reporting.

### REGULATION RISKS

The Bank and its subsidiaries are exposed to frequent changes in legislation and in various regulatory directives, under which limitations are imposed on the areas of activity and sources of income, at times even retroactively (as in the "Gal Law" and in the legislation concerning local authorities). In addition, these directives may impose various obligations, the implementation of which involves significant costs.

### COMPLIANCE RISKS

The activity of the Bank and of its subsidiaries is subject to legislative and regulatory directives both in the field of banking and in other areas, as detailed in the section "Legislation and supervision" hereunder. Frequent changes in legislation and the many regulatory directives that apply to the Bank and to its subsidiaries, require changes in their mode and fields of operation and expose the Bank and its subsidiaries to risks involved in the frequent changes in work procedures, to costs involved in the preparations for the implementation of the new directives and to the exposure stemming from the possibility of non-compliance with the provisions of the law and the various regulatory authorities.

Within the framework of the legislation passed in recent years, and in particular the new legislation passed in the

wake of the Bachar Committee (see Note 33 to the financial statements), the various regulatory authorities were granted extensive powers to order instructions and guidelines to the entities regulated by them and even impose monetary sanctions on them in case of violation. This state of affairs exposes the Bank and its subsidiaries also to the risk of monetary sanctions in material amounts.

**Procedures and supporting systems.** The Bank operates according to a detailed system of procedures, intended to bring about the enforcement of compliance with the various legal and regulatory demands. The procedures are updated from time to time according to the legislative and regulatory directives. Concurrently, the systems supporting the operations are also updated and the employees are trained accordingly.

**Control and supervision.** Compliance with the provisions of the law and the procedures is enforced on a regular basis by means of various control and supervision systems. Some other control factors also exist, such as the internal audit, the compliance officer and the officer in charge in accordance with the Prohibition of Money Laundering Law.

The internal audit constantly and continuously examines all areas of operation of the Bank. For details of the activities of the internal audit, see the section "The internal audit in the Group" below.

The compliance officer is appointed according to Proper Banking Management Directive No. 308 with the object of assisting the board of directors and management in managing the responsibility for compliance with the instructions of the law and regulations in the consumer area. A compliance officer who reports directly to the President and CEO operates at the Bank under the Chief Legal Advisor. The compliance officer monitors the Bank's preparations for compliance with the law and regulations in the area of bank-customer relations ("consumer instructions"), including consumer instructions relating to the new activities of the Bank, as well as follows the correction of various deficiencies in the matter of compliance to consumer instructions. For the purpose of her work, the compliance officer is assisted by the coordination committee that meets once in every quarter. The compliance officer serves also as compliance officer of several subsidiaries of the Bank. The compliance officer submits periodic reports to the President and CEO, as well as an annual report to the board of directors. The banking subsidiaries in Israel have also appointed compliance officers in accordance with the said instruction.

The officer in charge of money laundering prohibition was appointed in accordance with the Prohibition of Money Laundering Law and related regulations, and coordinates the activity of the Bank in this respect and in respect of the prohibition of the financing of terror. The relevant subsidiaries in Israel have also appointed officers in charge of this issue as required by law. See "Prohibition of Money Laundering Law and Prohibition of the Financing of Terror Law" in the section "Legislation and supervision" below.

## RISK FACTOR TABLE

As from the Annual Report for 2006, banking corporations in Israel are required to include in their report a table indicating risk factors, classified as follows, according to their impact on the business of the banking corporation: high impact, medium or low impact. Considerable difficulties exist in evaluating the risks and their impact. Evaluation of the effect of a risk requires assumptions regarding the intensity of the future event and the probability that such an event will in fact occur. Reliable implementation of such evaluation requires utilization of advanced mathematical models, which are usually not available at this stage. Evaluation of risks and their impact, as presented in the following table, constitutes a subjective process implemented by the Bank's

Management. In view with the above, care should be taken in examination of risk factors and evaluation of their impact, and in comparison between banks.

This table relates to the risks at the level of the Bank (on a stand alone basis).

### RISK FACTORS TABLE

The risk	Risk factor Impact	Risk description
1. Overall impact of credit risk	Medium	A risk of the impairment in the value of the Bank and its profitability as a result of a decline in the ability of borrowers to honor their obligations. The Bank reduces the risk by determining a credit policy and exposure limitations relating, among other things, to the type of borrowers, market sectors, segments of operation, collateral, credit control, etc.
1.1. Quality of borrowers and collateral risk	Medium	A risk of the impairment in the value of the Bank and its profitability as a result of the quality of borrowers being in effect poorer than previously estimated and/or the collateral provided by the borrowers having a lower value than previously assessed. Work procedures and means of control have been improved and the present level of the provision for doubtful debts is similar to that of the banking industry in general.
1.2. Industry concentration risk	Low	A risk of the impairment in the value of the Bank and its profitability as a result of a decline in the business activity of a particular sector of the economy. The highest rate of credit at the Bank according to industry segment, is 16.55 %, lower than the limit of the "industry credit concentration" determined by the Bank of Israel and the Board of Directors. Ongoing control is maintained over compliance with these limits.
1.3. Borrower/groups of borrowers concentration risk	Low	A risk of the impairment in the value of the Bank and its profitability as a result of a decline in the business activity of a borrower/large group of borrowers. Directives of Bank of Israel determine limits for the concentration of indebtedness of borrowers and groups of borrowers. The Bank has not deviated from these limits and maintains ongoing control in this regard.
2. Overall impact of market risks	Low	A risk of the impairment in the value of the Bank and its profitability as a result of changes in various economic parameters that affect the value of the Bank's assets or its liabilities. The overall exposure to market risks, as assessed by the VAR model and various stress tests, is low in relation to the equity of the Bank, does not deviate from the exposure limits determined by the Board of Directors and is being controlled on

**RISK FACTOR TABLE (CONTINUED)**

The risk	Risk factor Impact	Risk description
		a current basis.
2.1. Interest rate risk	Low	A risk of the impairment in the value of the Bank and its profitability as a result of future changes in interest rates and their possible impact on the present value of assets and liabilities of the Bank. The exposure to interest risk, which is assessed by means of accepted tools, is relatively low, does not deviate from the exposure limits and is controlled on a current basis.
2.2. Inflation rate risk	Low	A risk of the impairment in the value of the Bank and its profitability as a result of changes in inflation rates due to the difference between assets and liabilities, including the impact of future transactions. The Bank's exposure to inflation risk is not material in relation to its volume of operations and its shareholders' equity, does not deviate from the limits and is controlled on a current basis.
2.3 Exchange rate risk	Low	A risk of the impairment in the value of the Bank and its profitability as a result of exchange changes due to the difference between assets and liabilities, including the effect of future transactions. The Bank's exposure to exchange rate risk is not material in relation to its volume of operations and its shareholders' equity, does not deviate from the limits and is controlled on a current basis.
2.4. Share price risk	Low	A risk of the impairment in the Bank's value of the Bank and its profitability as a result of changes in the market price of securities held by the Bank. The Bank owns a considerable amount of securities held as an investment and not for trading. However, a decline in the value of such securities might impair the value of the Bank's equity.
3. Liquidity risk	Low	A risk of the income and equity of the Bank resulting from the inability to provide for its liquidity requirements. This risk derives from the uncertainty existing as to the availability financial resources, as to the possible need to raise funds unexpectedly and in a short time, as well as the difficulty that might arise in a situation where a significant realization of assets is required at a given date and a reasonable price. The exposure, as measured by a model and additional indicators, is low, does not deviate from the limits and is controlled on a current basis.
4. Operating risk	Low	A risk of a loss deriving from deficient data processing systems,

**RISK FACTORS TABLE (CONTINUED)**

The risk	Risk factor Impact	Risk description
		human error and the absence of proper control and examination procedures. Past experience shows that the realization of operational risks exposed the Bank to low to medium losses. The Bank monitors on an ongoing basis both the exposure to operational risks and the events of realization of such risks, and is applying controls regarding the various procedures. At the same time the Bank acts to promote issues that would secure its business continuity. On the other hand, there are many risk factors that are included in this risk category, and it is not certain that the Bank has a complete mapping and measure of all operational risks.
5. Legal risk	Low	A risk of loss as a result of the inability to enforce compliance with an agreement by legal means. The Bank has not suffered material losses as a result of this risk and believes that the legal controls applied by it are appropriate.
6. Goodwill risk	Low	A risk for impairment in the business position of the Bank as a result of impairment in the Bank's image, resulting from various publications, whether correct or incorrect, in the eyes of customers, correspondent banks, investors, regulatory authorities and others.
<b>Additional risks relevant to the Bank:</b>		
7. Legislation risk	Low	Changes in legislation and regulatory developments which impose, among other things, restrictions on the activity of the Bank, which may affect its operating results, including the risk of retroactive legislation, e.g. the Gal Law and legislation relating to local authorities.
8. Compliance risks	Low	Risks deriving from the non-compliance with legislative provisions, including regulatory provisions binding on a banking institution. The Bank operates ongoing monitoring and control tools, which are believed to reduce this risk.
9. A political/security risks	Medium	A risk of the impairment in the value of the Bank and its profitability as a result of instability of the financial markets or impairment in the position of borrowers as a result of the political or security situations. The conservative policy of the Bank, the limits that have been determined and the ongoing control which it maintains, reduce this risk.

## 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.

In July 2005, the Supervisor of Banks published a "Questions and Answers" file in the matter of the disclosure of segment information. The issued circular clarified that the answers appearing in the said file were to be regarded as a Statement of Opinion (SOP) of the Supervisor of Banks' staff regarding guidelines for implementation so long as the Supervisor of Banks has not issued Directives in the matter.

In the said file the number of segments that would require disclosure in the relevant note to the financial statements were, among other things, reduced to the following: Households, Private Banking, Small Businesses, Middle Market Banking, Corporate Banking, Financial Management and Other (if relevant, on a specific basis in the reporting banking corporation). The segments relating to banking products (such as: credit cards, capital market activity and mortgage loans) are to be reflected in the relevant customer segments. Notwithstanding, it is required to include in the Directors' Report, in respect of each segment in a separate column, a disclosure as to the banking product.

In accordance with the above, beginning with the financial statements as of December 31, 2005, the product segments, which were reported in the past as separate segments (credit cards, capital market operations, construction and real-estate activity, and mortgage loans), are reflected now in the relevant customer segments, and in addition disclosure is given in their respect in the Section "Additional details regarding activity in certain

products" hereunder. Activity of the "Non financial companies" which had also been presented in the past as a separate segment is presented as a sub-segment of the "Financial management segment".

The said file clarified that the data for the international operations segment is to be presented similarly to the segment data presentation of the operations of the Discount group in Israel. In view of the fact that the subsidiary in New York was until recently not organized to provide the necessary details, the Supervisor of banks agreed that the Bank would continue to present the international operations in one column.

IDB New York completed its preparations for presenting the data according to the required segmentation, so that beginning with the financial statements as of December 31, 2006, the data for the international operations segment is presented in the form that the operations of the Group in Israel are presented. In addition a disclosure is included regarding the said operations in the item "International operations".

Whereas the data cannot be produced retroactively in the required form, the comparative figures for 2005 are presented in the form that was presented by the Bank in the past, with the approval of the Supervisor of Banks. The Bank is installing a management information system to manage profit centers according to customers, products and additional profiles (the cost and profit centers). Preparation of the segment data is based on the data supplied by the cost and profit centers system. 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 begun, though at this stage only partially. 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 addition, in view of the frequent changes in the definition of segments, as discussed above, together with the fact that the system is not able to provide retroactive data, a periodic series of data segmented according to operating segments has not yet been created, which are essential for basing the 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 be noted that in the said questions and answers file, the Supervisor of Banks requires banking corporations to consolidate the data of their subsidiaries according to quantitative characteristics determined by the parent company. Providing such data requires the maintenance of a double database for earnings and segments of subsidiaries. This involves great difficulties and at this stage the Bank is not prepared for its implementation. At this stage 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. Whereas, as stated, the system is in its development stage, and has not as yet been fully integrated at the Bank as a management control tool, certain changes are being made from time to time in the manner of determining assessments and in the way of allocating expenses, so that comparison between periods might be flawed.

## 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 four divisions: Retail Division, Corporate Banking Division, Finance Division, and Asset Management Division.

**The Retail Division** conducts business with households, VIP customers, small companies and businesses, foreign residents, private banking customers and customers of direct banking.

**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”. In addition, that division conducts business with middle market business customers and coordinates the operations of the business centers, foreign trade department, and the Tel-Aviv main branch.

**The Finance Division** is responsible for the Bank’s financial investments and for management of the Bank’s own account and liquidity and for the management of market and liquidity risks.

**The Asset Management Division** is responsible, itself and through subsidiaries, for the providing of a variety of capital market services to all segments of customers, including: securities and financial assets advisory services, securities purchase and sale services, portfolio management, services to portfolio managers who manage customer portfolios at the Bank, forward contracts activities, basket certificates and structured products. The division is also responsible for the management of the Bank’s non-financial investments.

For details regarding the change in the organizational structure, within the framework of which the Commercial Banking Division was merged into the Corporate Banking Division, see hereunder under “Miscellaneous”.

## RETAIL SEGMENT – GENERAL

The Bank presents two retail segments: the household segment and the small business segment. These segments include customers of the Bank’s retail division, excluding customers of the international private banking centers. This general section includes several subjects that relate jointly to the two said segments.

### THE BRANCHES AS THE CENTER OF RETAIL OPERATIONS

The branches are the central link in the relations between the Bank and the retail customer, the retail experience taking place at the meeting point of the retail customer with the Bank – in the branch.

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

The Retail 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.

### BANK BRANCHES

At the end of 2006, the Bank operated 125 branches across the country, organized within the framework of five areas. For details regarding the modification of the branch network, complementary services and the consultation layout, see “The household segment” hereunder.

**Opening of New Branches.** During 2006, an additional branch of the “Discount your way” series and an additional branch of the “Household Discount” series were opened. For further details of the adjustment of the branch layout, see “Household Segment” hereunder.

## TARGETS AND BUSINESS STRATEGY

In order to create for the Bank a relative advantage in retail banking, the Retail Division of the Bank has conducted since 2002 several moves, which included:

- Establishing customer focused departments at the Retail Division – private customers department, business customers department (small businesses), and affluent foreign residents department;
- Allocating the business management at the regional offices and at the branches according to segments – private (households) and commercial (small businesses);
- Adjustment of the branch layout – merger of branches and establishment of unique concept branches (see hereunder – “Adjustment of the branch layout” under “Household Segment”);
- Establishing indices and targets supporting the retail components – service and sales;
- Developing the consumer credit field as a growth engine in the operation of the segment;
- Recruiting new customers, by the “Circles” activity;
- Commercializing – Modifying the appearance of branches to retail banking;
- A project intended to remove operational work from the branches in order to provide more time for new initiatives and marketing (see a more extensive discussion in “The Bank portal project” hereunder).

## THE SEGMENT STRATEGY

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

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.

## CUSTOMER SEGMENTATION

**Private Sector.** Four principal segments of customers have been identified in the private sector: VIP customers; preferred private customers; private customers (households); the growing segment. The segments are defined in relations to parameters of the amount of salary and/or financial wealth, measured according to the assets held with the Bank. The growing segment is defined as a customer population having a potential growth: students, servicemen 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, different strategic emphasizes have been determined as regards the activity with respect of each segment in accordance with its characteristics, requirements and order of preference of the Bank.

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 five times the amount of their salary, respectively.

Modifying the credit facilities to the said population segments is achieved by initiating approach to the customer

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

**The business sector** includes three principal kinds of customers: business, business plus and extended business. The segments are defined in relation to parameters of volume of operations vis-à-vis the Bank, as measured mainly in the credit field.

### SERVICE CONCEPT

The service concept has been formed with the view of providing comprehensive services 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 shop – A comprehensive service to the customer at one service point;
- Team service – provides a response for a more comprehensive service at one address at the branch;
- Deployment according to spheres – teams that specialize in the customer sphere (rather than in the product sphere);
- Humane banking – familiarity and warm and humane relations on the part of the service providers;
- Service initiative – anticipating the customer's needs and customizing products or services to such needs;
- The allocation of resources based on the customer needs and the Bank's priorities.
- Expert banking – provision of various professional services in the credit and investment sectors, including customizing the product to customers' needs and requirements.

### CUSTOMER RELATIONS WITH THE SEGMENT AND SALES

Following the segmentation of branch customers and separating the service in their respect, the implementation of the segment strategy focuses on the manner of conducting operations in respect of each arena – specialization in the arena.

The service team is required to intensify its activity with its customers: to develop customer relations with the segment served by it and conduct initiated activity.

For this purpose the following is required:

- Familiarization with customer characteristics (banking activity, needs and preferences);
- Customization of the professional level and the required qualifications to the needs of the customer – for this purpose the Bank has devised courses, seminars and instruction classes on various subjects for the staff of the branches. Studies are conducted both by way of self study and at the Discount college. Among other things, the subjects studied are: consumer credit, advanced business credit, deposits, foreign currency, provident funds, sales, securities, etc.
- Customizing products focused on customer needs in the investments and credit fields;
- Broadening the personal acquaintance with customers;
- Customizing the manner of approach and sales to the various customers.

## INCORPORATING THE RETAIL CULTURE

Within the strategic framework of advancing retail banking, the Bank inaugurated, at the beginning of July 2005, a retail banking school, the first of its kind in the banking industry – a retail banking school.

The retail banking school will train managers and employees of the Bank's branches and will focus on attaining the following goals: to incorporate retailing culture into the Bank's branches, to provide management teams of the Bank's branches with tools for the implementation of the retail concept, and to train staff in a wide variety of courses.

The retail banking school operates within the framework of the Discount College and its lecturers are drawn from the field of retail activity in Israel and abroad.

## RETAIL BANKING SECTOR – HOUSEHOLD SEGMENT

### SEGMENT CUSTOMERS

This segment includes customers of the Bank's Retail Division who are private customers, who are defined as customers who are either salaried employees, possess the potential for growth, or may be viewed as VIP customers (the definition excludes customers of the private banking centers). The segment also includes the household segment customers of the Mercantile Discount Bank – private customers of Mercantile Discount Bank, whose activities are typical of those of households, including credit of a volume not exceeding NIS 200 thousand and deposits of a volume not exceeding NIS 500 thousand. As from 2006, the segment also includes the international operation data in the household segments.

### SERVICE

Customers of the household segment receive services through 125 branches of the Bank located throughout Israel, from Kiryat Shmoneh to Eilat, organized geographically under five regional managements. Mercantile Discount Bank's household segment customers receive service through 65 branches located throughout Israel.

The principal banking products available to customers of this segment include current account management, credit, deposits, capital market activity and credit card services, as well as loans for the purchase, lease, enlargement, renovation or construction of residential units, and the granting of loans for any purpose, secured by a mortgage on a residential unit.

### ADJUSTMENT OF BRANCH LAYOUT

Unique concept branches were established in recent years intended to provide an appropriate response to the various needs of retail customers. Such concept branches were integrated into the process that started at the end of 2006, to provide nationally deployed banking services at innovative business hours for the banking industry in Israel.

**"Discount Rapid"**. Discount Rapid is located at the front of the branch and provides rapid response to daily banking services. Rapid banking centers include several information desks, ATM machine, Telebank machine and Internet stations. Most importantly, Discount Rapid is manned by professional bank personnel and is open during special hours, from 8:00 - 20:00.

**"Discount Your Way"**. Three "Discount your way" branches were opened during 2005: at the "Avnat" shopping mall in Petach Tiqva. at the "Negev" Shopping Mall, Beer-Sheva, at the "Across the Park" shopping mall in Ra'anana

and at the "Giva'tayim shopping mall" in Giva'tayim. These branches, located in shopping malls, serve as service and sales points to customers of these malls, and are tailored to the retail environment of the malls. Opening hours are adapted to customers' needs and convenience: 10:00 – 22:00.

**"Household Discount"**. These branches are located in large neighborhoods in cities and serve private customers until late hours. Business hours are adapted to the needs of customers living in the vicinity. The personnel in these branches are specially trained in providing services and in professional banking matters.

**Program for 2007.** The plan is to open 20 "Discount Rapid" branches in the front of existing branches, one "Discount Your Way" branch and five "Household Discount" branches.

### 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.

**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.

### CONSULTING SERVICES LAYOUT

**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.

**Consulting services in Bank branches.** Intended to intensify branch investment consulting services in that began in 2006. Customers benefit from personal and innovative consulting services in a variety of capital market channels. The service is provided in the branches by authorized investment consultants designated only for the capital market. Receipt of this service requires liquid deposits in the range of NIS 250-750 thousand. This activity will be continued and extended to additional branches in 2007.

**Portfolio management.** Directing customers to outside and inhouse portfolio managers.

### NEW PRODUCTS AND SERVICES

**Extended business hours.** In accordance with directives of the Supervisor of Banks, business hours were extended as from February 21, 2006, to 18:30 on weekdays and to 14:00 on Fridays and holiday eves. As part of the preparations for the transition to the extended business hours, operational changes have been made, notices were sent to customers and new signs were prepared for branches of the Bank.

Following this change, Bank customers benefit from increased congruence between the calendar day and business hours, enabling customers to conduct business during afternoon hours without losing a value day and to conduct capital market transactions on the stock exchange during all trading hours.

**"Discount MAXGRADE" benefit card.** "Discount MAXGRADE" benefit card is the first and a one of its kind in

Israel. It is intended for customers aged 25-35 who deposit their monthly salary with the Bank as well as VIP customers depositing their salaries. The card was sent to these customers by direct marketing. This is a rechargeable electronic card, which includes a variety of high value off-banking benefits relating to vacation, culture and leisure fields in Israel.

**"Discount MAXGRADE"** card is innovative by granting significant value to the customer, with no underlying conditions and at full transparency. The card's benefits are offered for repeated use during the year and include: significant discounts of at least 50%, numerous gifts and a variety of surprises throughout the year.

A designated call center has been established, which operates twelve hours a day, five days a week as well as a designated web site, for benefit updates and additional data.

### MARKETING AND DISTRIBUTION

Marketing and distribution are conducted by way of advertising campaigns on the printed media, television, radio and billboards. In addition, this activity is conducted through the following channels:

- At the branches – frontal activity through plasma screens located in areas where customers await service, and through the telephone either by way of an initiated approach to the customer or in response to an approach by the customer;
- By Discount TeleBank - either by way of an initiated approach to the customer or in response to an approach by the customer;
- At the Discount website on the Internet, which provides marketing messages and marketing offers;
- Direct mailing to customers (to which is attached a statement of account) and through the automatic service machines (ATM and Information Desk).

### TARGETS AND BUSINESS STRATEGY

As from 2002, the Bank has been engaged in a marketing effort to attract private customers – "Circles campaigning". 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 300 thousand new customers, mainly from the household sector.

### POINTS OF EMPHASIS FOR THE COMING YEAR

- Continued realization of the Bank's vision – leadership in personal and professional service;
- Continued development and adaptation of unique products for customers;
- Continued country-wide distribution of "Discount Rapid" stations open to the public until 20:00 hours, in order to ensure the Bank's adaptation to customers' needs and requirements. Furthermore, efforts will be implemented to increase customer satisfaction by upgrading the experience of visiting the branch and benefiting from optimal service.

### 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 and Mizrachi-Tefahot 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 by way

of obtaining attractive products adapted to the needs of customers of this.

“Off banking” financial entities, e.g. credit card companies, have entered the competitive market in recent years with respect to consumer credit, investment and insurance companies – inter alia with respect to capital market transactions.

#### DEVELOPMENT IN MARKETS OF THE SEGMENT OR CHANGES IN CUSTOMER CHARACTERISTICS

No material changes occurred in 2006 in the characteristics of customers in this segment. Notwithstanding, a continuous trend exists in respect of direct banking activity (ATM, Telebank, Discount on the Internet).

#### TECHNOLOGICAL CHANGES THAT MAY AFFECT THE SEGMENT

The principal components of the Ofek system were launched in 2006 (for details see “Information and computer systems” hereunder).

The Bank’s Internet website was updated, including the addition of payment options to Government and Municipal agencies, and online access of copies of paid checks. The Bank’s securities’ website was also updated, enabling customers to receive information and to conduct banking transactions.

The telephone answering service for customers was improved, enabling referral of part of the calls to “Discount Telebank”.

#### CRITICAL SUCCESS FACTORS IN THE SEGMENT

- Distribution of service stations and adaptation of business hours to the region and to the characteristics of the local population;
- Expansion of exposure and access to direct technological channels;
- Development of customer adapted products in various banking activities;
- Timely response to customers’ needs and requirements;
- Flexibility and sensitivity to market changes, including regulatory requirements.

#### PRINCIPAL SEGMENT ENTRY AND EXIT BARRIERS

- Investment in branches layout all over the country;
- Investment in the establishment of advanced technological means, and in their maintenance and upgrading;
- Training of skilled service personnel engaged in providing a variety of banking products and activity;
- Reputation of level of service, leadership, professionalism and reliability established over many years.

#### SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

**Net income** of the segment in 2006 amounted to NIS 251 million, of which NIS 250 million domestic operations, compared with NIS 197 million in 2005, an increase of 26.9%. Disregarding certain components (see hereunder), net income from domestic operations would have amounted to NIS 148 million in 2006, compared with NIS 240 million in 2005, a decrease of 38.3%.

**The return on equity**, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 24.1% in 2006, compared with 19.9% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 14.3% in 2006, compared with 24.2% in 2005.

**Provision for doubtful debts** in this segment amounted in 2006 to NIS 109 million, compared with NIS 85 million

in 2005, an increase of 28.2 %.

Following are the principal data relating to the operations of the household segment (in NIS millions):

	Banking and financing		Credit cards		Capital market		Mortgage		Total Domestic Operations		International Operations	Total
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2006
Income (loss) from financing activities before provision for doubtful debts												
From externals -	217	(1,157)	108	111	1	2	159	219	485	(825)		486
Inter-segmental -	613	1,947	(5)	(36)	3	-	(43)	(80)	568	1,831		569
Total income from financing activities	830	790	103	75	4	2	116	130	1,053	1,006	2	1,055
Operating and other income	370	457	629	555	392	369	48	55	1,439	1,436	1	1,440
Total income	1,200	1,247	732	630	396	371	164	194	2,492	2,442	3	2,495
Provision for doubtful debts	60	39	31	14	-	-	18	32	109	85	-	109
Income from ordinary operations before taxes	1,356	1,121	481	427	264	201	86	81	2,187	1,830	2	2,189
Provision for taxes on ordinary activities	(216)	87	220	189	132	170	60	81	196	527	1	197
Net income (loss)	(138)	25	78	55	288	82	22	35	250	197	1	251
Net income (loss) disregarding certain components <sup>(1)</sup>	(45)	62	82	56	87	87	24	35	148	240	1	149
Return on equity (rate)	(38.9)	8.0	36.7	31.8		446.0	5.1	7.2	24.1	19.9	2.7	24.1
Return on equity disregarding certain components <sup>(1)</sup> (rate)	(12.0)	20.0	38.1	32.6	-	471.2	5.3	7.2	14.3	24.2	2.7	14.3
Average balance of assets	5,511	4,842	2,387	1,846	8	10	9,704	9,365	17,610	16,063	59	17,669
Average balance of liabilities	50,085	45,888	1,373	613	-	-	2,418	2,293	53,876	48,794	70	53,956
Average balance of risk assets	5,911	5,158	3,573	2,872	289	306	7,525	8,174	17,298	16,510	59	17,357
Average balance of provident funds and mutual funds assets <sup>(2)</sup>	-	-	-	-	25,381	29,384	-	-	25,381	29,384	-	25,381
Average balance of securities <sup>(2)</sup>	-	-	-	-	22,593	12,624	-	-	22,543	12,624	-	22,543
Average balance of other assets under management	-	-	-	-	1,283	964	2,269	2,282	3,552	3,246	-	3,552
Components of income from financing activities:												
Margin on credit	255	215	103	78	-	-	74	139	432	432	1	433
Margin on deposits	540	544	-	(3)	-	-	1	-	541	541	1	542
Other	35	31	-	-	4	2	41	-	80	33	-	80
Total income from financing activities	830	790	103	75	4	2	116	139	1,053	1,006	2	1,055

(1) The following components have been disregarded: the privatization bonus, expenses regarding early retirement incentive and the profit on the sale of Ilanot Discount.

(2) Until the exclusion of Ilanot Discount from consolidation, securities of mutual funds managed by Ilanot Discount were included in the average balance assets of provident funds and mutual funds, and following that in the average balance of securities.

## HUMAN CAPITAL

In 2006, the average number of positions in the segment amounted to 4,304 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, compared with 3,925 positions in 2005, an increase of 9.6%.

## LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SEGMENT

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

**A directive concerning the treatment of credit facilities in current accounts.** On February 8, 2005, the Supervisor of Banks issued a directive with regards to credit facilities granted within the framework of creditory and debitory current accounts. The directive was amended on August 17, 2005. 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, inter alia, 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 facility would be established in a written agreement specifying both parties' obligations – the customer and the Bank – to transact business within the limits of the credit facility, only, without any deviation therefrom;
- The bank may grant to a customer having an approved credit facility (that has been determined in a written agreement with him) or to a group of such customers, an additional unilateral credit line, for a limited time, 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 in this case, 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). (This item will come into effect on July 1, 2006);

- A credit facility agreement may be signed at a branch of the bank, at the customer's home or via the Internet. The new directive became effective on January 1, 2006; however, the Bank is entitled to grant a customer a unilateral credit facility, even without a written agreement, at an interest rate charged by the Bank to similar customers, until July 1, 2007. Until July 1, 2006, the Bank was permitted to allow an overdraft on current accounts and to charge exceptional interest in respect thereto. In respect of current account credit facilities in foreign currency the directive came into effect on January 1, 2007. An amendment of December 2006 enables banks not to apply the directive with respect to short-term overdrafts not exceeding NIS 1,000.

It should be noted that prior to the issue of the directive the Bank had already taken steps regarding conversion of overdrafts to loans and regulating credit facilities in order to reduce the level of overdrawn client accounts.

Following publication of the directive, the Bank is preparing and has taken intensive action for its implementation., among other things, by converting the overdrafts into loans, adjusting the credit facilities to the needs of the customer and its activity, offering loans at attractive prices, the establishing of unilateral credit facilities in accordance with the directive, conducting seminars for customers on the subject of managing the family budget, etc. As part of the above, already in September 2005, the bank sent a letter to its customers concerning the directive of the Bank of Israel. The letter explained the principles of the directive, and its meaning and implications on managing the customer's account. Customers were requested to stop in at the Bank's branches in order to adjust their credit facilities to their activities and needs as well as to receive from branch officers advice and solutions as to compliance with the approved credit facilities (loans, "The family as a business" seminar).

It should be noted that since December 2005, the volume of current accounts exceeding their approved credit limit decreased from a rate of 13.0% at the end of 2005 to a rate of 4.59% at the end of December 2006.

**Commissions.** During the years 2004-2005, various issues relating to commissions charged by the banks were put on the public's agenda. Following prolonged discussions in the matter by the Economic Committee of the Knesset, with a view of reaching some sort of a "package deal" between the banks and the various regulatory bodies. The Supervisor of Banks and the banks reached an arrangement in July 2005, with respect to commissions charged to household customers. On July 14, 2005, the Supervisor of Bank issued to the banking corporations a letter detailing the principles for the implementation of the "package deal" in the matter of commissions pertaining to current accounts of private customers.

As from October 1, 2005, the Bank offers its customers three tracks:

- A basic track – NIS 10 basket (the Bank of Israel basket);
- An extended track – NIS 18 Basket (the Knesset Economics Committee basket);
- "Discount Fix" track – a basket which costs NIS 30.

During September 2005, the Bank sent to its private customers letters describing:

- The Bank's decision as to the implementation of the package deal;
- The three tracks offered by the Bank, details of commissions included therein and the cost of each track;
- Dates for transition from one track to another based on the customer's notice and the date of the automatic transition to the basic track in the event of no response from the customer.

A form to be completed by the customer was appended to the letter, in which the choice between the tracks was given to the customer. Customers not responding to the letter had been automatically transferred to the basic track starting on December 1, 2005.

At the beginning of November 2005, the Bank sent additional letters to customers reminding them that they must decide upon the track according to which their account would be managed and to inform the Bank accordingly, as well as informing them that no response to the letter would mean consent to the transition to the basic track. The application of the "commission baskets" adversely affected the Bank's income from service fees charged to private customers, at an amount of NIS 38 million (per year).

The application of "commission baskets" also impaired Mercantile Discount Bank's income from ledger fees, which declined in the first nine months of 2006 by NIS 5 million.

The Bank updated on June 21, 2006, its fees price list, while taking care not to increase basic charges and prevalent ledger fees, including basket charges.

Towards the end of November 2006, the Bank announced the updating of several commission rates on its price list, while continuing the observance not to increase the rate of basic and prevalent commissions relating to ledger fees of private customers, including the commission basket. This update came into effect during the months of December 2006 and January 2007. Among other things, a commission on the purchase and sale of mutual fund units has been determined at a minimum rate of 0.1%.

During 2006, the matter of banking commissions was discussed from time to time, and a parliamentary commission of inquiry was appointed recently to examine all aspects thereof.

At the beginning of 2007, the Bank of Israel announced its formulation of a proposal for the regulation of prices for banking services. The proposal included, inter alia, legal authorization of the Supervisor of Banks to supervise prices of banking services, subject to certain conditions to be defined.

According to this proposal, the Supervisor of Banks would be authorized to determine the structure of the full price tariffs of banks, the services to be included therein, and the description, kind and method of calculation of the charges payable in respect of these services.

The Bank believes that if the proposed legislation is enacted, income from operating commissions will be affected adversely; however, at this stage the Bank is unable to assess the scope or extent of such effect.

**Removal of obstacles with respect to the transfer of accounts between banks.** Another issue examined by the Economics Committee of the Knesset to the easing of procedures for the transfer of accounts between banks.

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.

The Supervisor of Banks issued, on July 14, 2005, a Proper Banking Management Directive that regularizes this issue, effective as from December 1, 2005. The Directive is intended to facilitate the transition process for customers wishing to close their accounts with one bank and transfer their business to another bank. According to the Directive, banks are required to do everything necessary in order to enable the customer to close his account or to transfer his business, while taking all possible measures to avoid unnecessary inconvenience to the customer. The banks are required to provide the customer with full information regarding his assets and liabilities at the bank so as to enable him to examine the possibilities and weigh the advisability of transferring his business from the account or closing the account, and to receive from the customer distinct instructions as to the steps to be taken regarding the assets and liabilities pertaining to his account. The Directive also includes technical relief to facilitate the transfer from one bank to another. Alongside this, the Supervisor also included in his said

letter regarding the “package deal” instructions as to commissions, which, in his opinion, constitute obstruction or impediment with regards to the transfer from one bank to another, and therefore has directed the banks to reduce such commissions or change the manner of their collection. The Bank is preparing to implement the said Directive and the contents of the Supervisor’s letter.

For additional details in these matters, see “Legislation proposals and arrangements regarding banking commissions” under “Legislation and Supervision” hereunder.

For details as to the consequences of the capital market Reform, see “Capital market activity” hereunder in the Section “Additional details regarding activity in additional products” and Note 33 to the financial statements.

### THE RETAIL SEGMENT AT THE MERCANTILE DISCOUNT BANK

Most of the customers of Mercantile Discount Bank (some 59%) belonging to the household segment of this bank, receive banking services by means of the Mercantile Discount Bank branches organizationally belonging to the Acco and Nazareth regions (24 branches). Such branches are located in areas where the population has an absolute “non-Jewish” majority. Mercantile Discount Bank management believes that most of the customers belonging to such populations receive services from Bank Leumi and Bank Hapoalim, while the balance of the activity is divided among the remaining banks.

### RETAIL BANKING SECTOR – SMALL BUSINESSES SEGMENT

#### SEGMENT CUSTOMERS

This segment includes customers of the Bank’s Retail Division which are defined as small companies and small businesses with borrowings of up to NIS 4 million. The segment also includes the customers of Mercantile Discount Bank in that bank’s small business and commercial banking segments – that bank’s small business segment customers (individuals and corporations) whose granted volume of credit does not generally exceed NIS 1 million.

#### SCALE OF OPERATIONS AND NET INCOME OF SEGMENT

**Net income** of the segment in 2006 amounted to NIS 52 million, all from domestic operations, compared with 17 million in 2005, an increase of 205.9%. Disregarding certain components (see hereunder), net income would have amounted to NIS 78 million in 2006, compared with NIS 38 million in 2005, an increase of 105.3 %.

**The return on equity** in 2006, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 9.1%, compared with 3.4% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 13.4% in 2006, compared with 7.2% in 2005.

**Provision for doubtful debts** in this segment amounted in 2006 to NIS 183 million, compared with NIS 182 million in 2005, an increase of 0.5%.

Following are the principal data relating to the operations of the small business segment (in NIS millions):

	Banking and financing		Credit cards		and Capital market		Construction and real estate		Mortgage		Total	
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005
Income from financing activities before provision for doubtful debts												
From externals -	622	393	7	-	16	1	77	143	25	37	747	574
Inter-segmental -	(167)	91	1	4	-	-	(27)	(97)	(6)	(16)	200	(18)
Total income from financing activities	455	484	7	4	16	1	50	46	19	21	547	556
Operating and other income	252	242	11	14	47	112	19	12	2	3	331	383
Total income	707	726	18	18	63	113	69	58	21	24	878	939
Provision for doubtful debts	158	157	-	-	-	-	25	18	-	7	183	182
Operating and other expenses	573	562	10	11	28	100	11	15	12	9	634	697
Income (loss) from ordinary operations before taxes	(24)	7	8	7	35	13	33	25	9	8	61	60
Provision for taxes on ordinary activities	(4)	15	3	3	14	8	14	12	4	2	31	40
Net income (loss)	(20)	(8)	5	4	45	4	19	14	3	3	52	17
Net income disregarding certain components <sup>(1)</sup>	25	9	5	4	24	7	21	15	3	3	78	38
Return on equity (rate)	(4.6)	(2.3)	-	123.1	140.5	22.7	11.3	4.7	3.9	9.1	3.4	
Return on equity disregarding certain components <sup>(1)</sup> (rate)	6.0	2.9	-	136.9		23.8	11.7	4.7	3.9	13.4	7.2	
Average balance of assets	8,501	7,982	-	60	4	3	2,320	2,244	1,182	1,288	12,007	11,577
Average balance of liabilities	6,767	7,404	-	-	-	-	519	494	276	291	7,562	8,189
Average balance of risk assets	7,118	5,343	-	52	4	50	1,480	2,083	1,185	1,306	9,787	8,834
Average balance of provident funds and mutual funds assets <sup>(2)</sup>	-	-	-	-	3,499	5,060	-	-	-	-	3,499	5,060
Average balance of securities <sup>(2)</sup>	-	-	-	-	4,347	3,315	-	-	-	-	4,347	3,315
Average balance of other assets under management	-	-	-	-	283	244	-	-	-	-	283	244
Components of income from financing activities:												
Margin on credit	335	325	6	4	-	-	36	36	12	21	389	386
Margin on deposits	83	82	1	-	-	-	6	7	-	-	96	89
Other	31	77	-	-	16	1	8	3	7	-	62	81
Total income from financing activities	455	484	7	4	16	1	50	46	19	21	547	556

(1) The following components have been disregarded: the privatization bonus, expenses regarding early retirement incentive and the profit on the sale of Ilanot Discount.

(2) Until the exclusion of Ilanot Discount from consolidation, securities of mutual funds managed by Ilanot Discount were included in the average balance assets of provident funds and mutual funds, and following that in the average balance of securities.

## HUMAN CAPITAL

In 2006, the average number of positions in the segment amounted to 1,252 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, compared with 1,495 positions in 2005, a decrease of 16.3%.

## SERVICE TO SEGMENT CUSTOMERS

The small business segment provides a variety of services to small and medium size business customers. Customers entitled to a credit facility of up to NIS 500 thousand receive these services through personnel in branches specializing in the needs of this segment, and through direct banking channels (Internet and Discount Telebank). Customers entitled to a credit facility exceeding NIS 500 million receive services through regional credit centers. 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. Activities of business clubs are also provided to customers of this segment. (For further information, see below, 'Corporate Banking Segment').

## CREDIT CENTERS

As part of the innovative and breakthrough concept of the Retail Banking Division for dealing with small business customers, the handling of the business activity of customers having a credit facility exceeding NIS 500 thousand, has been transferred to the area credit centers.

The handling of these customers at the credit centers, which are manned by teams which specialize in the credit field, enables the providing of a focused response suitable to the characteristic need of this sector that constitute a central target arena for the Retail Division at the Bank.

The professional service provided and the operational efficiency contributes to the improvement of service and supports the leading values of retail business and humanity engraved on the flag of the Bank.

The following credit centers were opened in 2006: Tel-Aviv (in April), Haifa and the North, including a northern extension in Upper Nazareth (in May) and the Plains (in October). These centers join the Sharon credit center that was opened in 2005.

An additional credit center in Jerusalem, with a southern extension in Beer Sheva is expected to be opened in 2007. The credit centers serve as professional service bureaus, while the account of the customer and its current activity remain in the related branch office.

## MARKETING AND DISTRIBUTION

Marketing and distribution are conducted by way of advertising campaigns on the printed media, television, radio and billboards. In addition, this activity is conducted through the following channels:

- At the branches – frontal activity through plasma screens located in areas where customers await service, and through the telephone either by way of an initiated approach to the customer or in response to an approach by the customer;
- By Discount TeleBank - either by way of an initiated approach to the customer or in response to an approach by the customer;

- At the Discount website on the Internet, which provides marketing messages and marketing offers;
- Direct mailing to customers (to which is attached a statement of account) and through the automatic service machines (ATM and Information Desk).

### THE SMALL BUSINESS SEGMENT AT THE MERCANTILE DISCOUNT BANK

The small business segment at the Mercantile Discount Bank is one of the outstanding segments of this bank and accordingly is a central target in its business development.

One half of the customers of Mercantile Discount Bank who belong to this segment live in areas where the population has an absolute "non-Jewish" majority and receive banking services by means of 24 branches of this bank belonging organizationally to the Acco and Nazareth regions. Mercantile Discount Bank management believes that most of the customers belonging to such populations receive their services from Bank Leumi and Bank Hapoalim, while the balance of the activity is divided among the remaining banks.

### CORPORATE BANKING SEGMENT

#### SEGMENT CUSTOMERS

This 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 – corporations whose annual business turnover generally exceeds NIS 100 million and public companies handled by the corporate division of Mercantile Discount Bank. As from 2006, the segment also includes the international operations data in the corporate banking segment.

#### REVIEW OF DEVELOPMENTS IN THE BUSINESS SECTOR IN 2006

The increase in the volume activity in the business sector continued in 2006. The business product increased by 6.3%, compared to 6.6% in 2005. Growth was recorded in all sectors of the economy, including a moderate increase in the housing construction segment.

The growth was reflected in the expansion of the volume of activity of domestic companies as a result of the increase in private consumption and in the levels of domestic demand. In addition, investments in fixed assets also increased by 6.1%.

Compared to 2005, the growth rate of export-oriented sectors moderated in 2006. Exports of goods and services increased by 5.1%, compared to an increase of 5.6% in 2005. The increase in exports was balanced and was reflected in the increased contribution of traditional sectors to overall growth.

The increase in the volume of domestic activity contributed to improved profitability, cash flows and the debt repayment capability of most of the Bank's customers in the business sector.

The growth rate of the business product, levels of demand in the Israeli and foreign economies, volume of investments in the various economic sectors including the construction industry, all impacted materially on the development, volume of operations and business results in the Bank's corporate segment.

#### THREATS AND OPPORTUNITIES IN THE CORPORATE BANKING SEGMENT

##### Threats:

- Strengthening of alternative sources of banking 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 the creation of restrictions on the financing of the country's large companies.

#### **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 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 (as described in the next paragraph hereunder) may adversely affect the realization of these forecasts.

#### **DEVELOPMENTS IN THE SEGMENT'S MARKETS**

The significant increase in the scope of activity of the business sector in 2006, positively affected the expansion of activity by customers of the business segment of the Bank.

The said growth occurred despite repayments of credit in material amounts by large borrowers, mostly as a result of the acceleration in the raising of credit substitutes on the off-banking market.

A growth in the credit granted to the business sector at the Bank is anticipated for 2007, mainly on the background of forecasts for the continued growth in the business product, the growth in private consumption, in the export of goods and services and the investments in the physical capital inventory of the various sectors of the economy.

Notwithstanding, a slight moderation in the growth rate as compared with 2006 is expected in certain indicators. The above information constitutes forward-looking information. This information might not materialize if a decline occurs in the level of domestic demand due to a deterioration of the political-security situation, moderation in the growth rate in the domestic and global markets, including the American market, a significant increase in the interest rates both in Israel and overseas and other developments in the macro-economic conditions, which are out of the Bank's control.

#### **LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SEGMENT**

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

**Limitations on indebtedness of a single borrower, a group of borrowers and all the six large borrower groups.**

The Proper Bank Management directives contain restrictions with respect to the extent of the indebtedness allowed to any single borrower or group of borrowers, and the extent of the total indebtedness allowed to the bank's six largest borrower groups 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.

The directive provides that the total exposure to a group of borrower should not exceed 30% of the capital of the Bank, while the total exposure to the six largest borrower groups should not exceed 135% of the Bank's capital. The Bank determined an internal policy according to which the total debt of the borrower group will not exceed 25% of the Bank's equity. Deviation from this internal limit exists in the case of one borrower group, which was approved by the Bank's Board of Directors.

**The limitation on "related parties"**. The permit granted by the Governor of Bank of Israel to the Bronfman-Schron Group determined that the members of the Bronfman Group and Mr. Schron are to reduce their indebtedness to the Bank, in order to comply with the provisions of Proper Banking Management Directive No. 312, regarding the business of a banking corporation with related parties. During January 2006, proximately prior to the receipt of the permit, the members of the Bronfman-Schron Group reduced their indebtedness. As of December 31, 2006, there were no deviations from the said limitations.

**Ratio of capital to risk assets restriction.** 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 (until 2003), this directive affected the Bank's activities and led to the introduction of a restrained credit policy.

As from 2004, the capital adequacy ratio continues to improve, enabling the Bank to increase its credit portfolio and to finance new transactions.

**Basel II.** 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 2006 amounted to NIS 228 million, of which NIS 198 million from domestic operations, compared with NIS 55 million in 2005, an increase of 260%. Disregarding certain components (see hereunder), net income would have amounted to NIS 286 million in 2006, of which NIS 236 million from domestic operations, compared with NIS 80 million in 2005, an increase of 195 %

**The return on equity**, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 9.3% in 2006 (from domestic operations - 10.1%), compared with 3% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 11.6% in 2006 (from domestic operations - 12.0%), compared with 4.3% in 2005.

**Provision for doubtful debts** in this segment amounted in 2006 to NIS 159 million (from domestic operations - NIS 148 million), compared with NIS 303 million in 2005, a decrease of 51.2%.

Following are the principal data relating to the operations of the corporate banking segment (in NIS million):

	Banking and financing		Capital market		Construction and real estate		Total Domestic Operations		International Operations	Total
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2006
Income from financing activities before provision for doubtful debts										
From externals -	736	984	3	1	512	561	1,251	1,546	106	1,357
Inter-segmental -	(27)	(489)	-	-	(183)	(295)	(455)	(784)	165	(290)
Total income from financing activities	464	495	3	1	329	266	796	762	271	1,067
Operating and other income	118	67	18	20	15	16	151	103	30	181
Total income	582	562	21	21	344	282	947	865	301	1,248
Provision for doubtful debts	97	138	-	-	51	165	148	303	11	159
Operating and other expenses	383	389	11	17	72	53	466	459	235	701
Income from ordinary operations before taxes	102	35	10	4	221	64	333	103	55	388
Provision for taxes	42	23	4	2	91	31	137	56	25	162
Net income	60	12	8	2	130	41	198	55	30	228
Net income disregarding certain components <sup>(1)</sup>	92	36	5	2	139	42	236	80	50	286
Return on equity (rate)	4.6	1.1	488.6	225.2	18.8	5.9	10.1	3.0	6.2	9.3
Return on equity disregarding certain components <sup>(1)</sup> (rate)	7.4	3.1	369.9	238.4	19.5	6.0	12.0	4.3	10.1	11.6
Average balance of assets	21,542	17,749	29	11	10,752	11,263	32,323	29,023	9,527	41,850
Average balance of liabilities	9,208	11,068	3	3	1,359	1,299	10,570	12,370	5,975	16,545
Average balance of risk assets	20,835	19,549	21	18	12,794	11,822	33,650	31,389	7,236	40,886
Average balance of provident funds and mutual funds assets <sup>(2)</sup>	-	-	207	432	3	3	210	435	-	210
Average balance of securities <sup>(2)</sup>	-	36	25,427	20,504	34	-	25,461	20,540	-	25,461
Average balance of other assets under management	-	-	130	101	-	-	130	101	-	130
Components of income from financing activities:										
Margin on credit	358	375	1	-	204	226	563	601	166	729
Margin on deposits	42	88	-	-	5	14	47	102	103	150
Other	64	32	2	1	120	26	186	59	2	188
Total income from financing activities	464	495	3	1	329	266	796	762	271	1,067

(1) The following components have been disregarded: the privatization bonus, expenses regarding early retirement incentive, payments to the US regulatory authorities and the costs of improvements and examinations at IDB New York and the profit on the sale of Ilanot Discount.

(2) Until the exclusion of Ilanot Discount from consolidation, securities of mutual funds managed by Ilanot Discount were included in the average balance assets of provident funds and mutual funds, and following that in the average balance of securities.

## HUMAN CAPITAL

In 2006, the average number of positions in the segment amounted to 1,247, of which 834 in domestic operations, 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, compared with 916 positions in 2005, a decrease of 9.0%. A relatively high percentage of this segment's personnel has an academic education. Currently, within the Bank framework, these personnel undergo professional training in various banking sectors and in management services. The personnel are required to analyze complex credit requests and to provide high level service.

## ORGANIZATIONAL CHANGES

A decision was taken in October 2006 regarding the reorganization of the business layout at the Bank. In this context, the Commercial Banking Division was merged into the Corporate Banking Division, under a member of Management, the head of the Corporate Division.

The merger of these two divisions will enable focus and deployment in the risk management area, enabling the system and decision making process more effective, and a renewed deployment of the Bank's business formation layout.

The Bank's Corporate Banking Division is responsible for the activity with the large and medium size corporations and for the service provided to specific customer sectors, such as: the diamond industry, construction companies and "approved enterprises". As part of the renewed deployment the division will also include the activity with middle market customers and the operations of the business centers, the foreign trade department and the Tel-Aviv Main Branch.

This decision is intended to achieve several principal goals:

- A "one stop shop" business service system – The new deployment will enable business customers of the Bank to receive an all inclusive service, while setting professional standards, which will provide full response to their needs, both in the active and passive fields
- Risk management – The new deployment will enable centralized risk management while adopting the Basel II guidelines, from the stage of determining the credit policy, namely: deciding which sectors and industries would be granted credit, the process of approving credit and the ongoing monitoring of its utilization, while following the credit portfolio over time.
- Efficiency – The new deployment will enable the unification of the two divisions creating one unit and accordingly, more efficient procedures.

## SERVICE TO SEGMENT CUSTOMERS

The business segment enjoys professional banking services provided by the Corporate Division. In 2006, the division intensified its expertise in the comprehensive financial guidance (One Stop Shop), 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 various banking services are provided through the branch layout.

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

**The Bank's Project Financing Department** works with those customers entitled to benefits from the State by providing finance for the acquisition or construction of equipment and buildings, and for the establishment or expansion of tourist and industrial projects, by virtue of the provisions of the Law for the Encouragement of Capital Investments.

**The foreign trade department** serves customers engaged in international trade (for further information, see below).

**Discount Leasing Ltd.**, a company wholly owned by the Discount Bank, implements financing transactions for customers, in a variety of areas.

Some of the segment's customers utilize the services of the Bank's trading desk (see below, 'Finance management segment') and the overseas offices of the Bank (see below, 'International operations segment').

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 five 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, private customers attending to prime private customers and a business unit attending to the medium-large corporations.

The support units for the Commercial Banking unit in the Corporate Banking Division include the division's headquarter units, and banking business managers for the asset and liability sides.

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.

Segment customers, who are interested in broadening their knowledge of the capital market, are invited to participate in the capital market business club, which includes a theoretical study of a wide range of subjects in the capital market field as well as practical experience in the framework of investment simulations.

Deepening the current communication with segment customers is carried out by providing them with "Discount Business" magazine several times a year, which includes up-to-date banking information as well as an attractive offers, tailored to the needs of business people and companies in the framework of the said magazine cooperation "Business to Business" is being offered – business customers offering their services to the business sector. An additional communication channel for customers is available through the new business website inaugurated in 2006.

## FOREIGN TRADE OPERATIONS

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

**Scale of operations.** 2006 was characterized by the continued acceleration of the import and export activities in the market, in continuation to the growth recorded in 2005. According to the data published by the Central Statistical Bureau.

Imports increased by 9.4% while exports increased by 14.1% as compared with 2005.

Import transactions at Discount Bank increased by 12.1% as compared with 2005 (an increase of 8.6% in the activity of the business segment, an increase of 11.1% in the commercial banking segment and an increase of 28.1% in the small business segment). The Bank's share in the total activity of the banking industry reached 11.1% in 2006, compared with 10.8% in 2005 and 10.5% in 2004.

An increase of 14.7% was recorded in export transaction at the Bank in 2006 compared with 2005 (an increase of 15.5% in the activity of the business segment, an increase of 13% in the commercial banking segment and an increase of 10% in the small business segment). According to the Bank of Israel data, the Bank's share in the total activity of the banking industry stood at 8.6% in 2006, compared with 7.8% in 2005 and 2004.

The business activity of the foreign trade department coordinates in each department all the services in the foreign trade field that the customer requires (import, export, finance, future financial instruments, etc.). The personal and direct relations with the customer are particularly emphasized alongside the current communication of the customer with his business manager at the Bank, with the view of intensifying the activity with customers. The foreign trade department, which is responsible for the management operation of the product, provides foreign trade services by means of about 32 independent branches (including the Haifa and Jerusalem main branches).

The business development activity expanded in 2006, and according to the formed plan, an initiated activity for the identification of potential customers was carried out. Concurrently, activity with existing customers was intensified, while providing customers with a professional and personal service.

**Improvement of service.** Within the framework of the continued effort for improving customer service, the operating hours of the Division were extended on Mondays and Thursdays until 18:30 hours.

These operating hours are in addition to the "green route" introduced in 2005, whereby quick service is provided also beyond regular operating hours at the branches at times of heavy work load.

In 2006 the Bank began to concentrate the foreign trade operations at the three centers- Tel Aviv, Haifa and Jerusalem and to reduce the number of branches dealing independently with foreign trade operations. Out of the 50 branches providing foreign trade services, the activities of 18 branches were moved to the centers, and this process is to continue until the end of 2008.

## TECHNOLOGICAL CHANGES THAT MAY HAVE A MATERIAL IMPACT ON THE SEGMENT

The corporate banking segment is engaged currently in updating and upgrading its information systems that are utilized to analyze and to measure various risks (mainly credit risks) and to monitor and to control customer activity in "real time".

The segment focuses on improving the systems for measuring customer profitability and for reliable assessment of the customer's contribution to the Bank's profitability.

### CRITICAL SUCCESS FACTORS IN THE SEGMENT

The critical success factors in this segment include committed and long-term customer relationships, quality service, prompt response to credit requests and to the overall related services (foreign trade operations, security investment, derivative financial instruments, banking services to corporate executives and owners, etc.).

Additional success factors are: efficient management of the credit portfolio from the aspects of measurement, costing and sophisticated risk management "in real time", focusing on credit risks, professional training of staff and improvement of the technological capabilities of the information systems.

Furthermore, participation in the syndication transactions being led by the large banks. (For details regarding the Commissioner of Restrictive Trade Practices' instruction in this issue, see "Principles of conduct" under "Legislation and supervision").

### PRINCIPLE ENTRY AND EXIT BARRIERS OF THE SEGMENT

Customers of the segment transact business concurrently with several other banks, so that the relative advantage of the segment is based on the long-term relationship with the customers, including continued satisfaction with the quality of service and providing prompt and suitable solutions to complex financing needs.

A large number of large corporations have adopted a balanced leverage policy, reflected in the use of bank financing sources together with use of off-banking means of finance, on the background of the improvement in opportunities of raising finance on the capital market and the reduction in financing costs.

Entry and exit barriers may arise as a result of the need for the appropriate allocation of capital and compliance with regulatory limitations of the Bank of Israel, which impact the manner and volume of activity vis-à-vis borrowers and groups of borrowers.

Expanding financing operations and related services to Israeli corporations operating abroad, and/or to Israeli-owned foreign corporations, requires expansion of infrastructure through establishment of foreign extensions and/or branches.

### SUBSTITUTES FOR PRODUCTS AND SERVICES OF THE SEGMENT AND CHANGES THEREIN

As a substitute for bank credit to customers of the business segment, alternative financing products offered by off-banking financial institutions in general and institutional entities in particular have been developed.

These bank credit substitutes include the raising of finance by way of the issue of shares, bonds and other securities on the capital markets in Israel and abroad, including direct credit offered by such entities.

The off-banking finance constitutes an alternative financing source, mainly for long and medium term credit products, which contributes to the reduction in volume of such credit in the credit portfolio reflecting the activity of the segment.

### COMPETITION IN THE SEGMENT AND CHANGES THEREIN

The business segment is exposed to ever-increasing competition from the other four large banking groups as well as from foreign banks (HSBC, Citigroup) that intensify their activity in the local market.

The level of competition on the part of institutional bodies also increased in recent years, mainly insurance companies and pension funds, which established off-banking credit departments.

The increased competition among the banks is derived mostly from improvement in capital adequacy ratios and

the increase in the supply of sources on the part of the off-banking system.

The accelerated competition has contributed, as from the second half of 2004, to a continuous process of reduction in financial margins and in operating commissions that typify this segment. During the second half of 2006, the process of diminishing credit margins was curbed as a result of increasing awareness among the various players in the market of the necessity to maintain a risk adjusted policy.

### MARKETING AND DISTRIBUTION

Activity of the corporate banking segment in marketing credit and related services to existing and new customers is implemented principally by business managers engaged in the identification and analysis of comprehensive banking needs of customers and in appropriate adaptation of the Bank's products of the Bank to these customers' needs and requirements, as well as in the "real-time" provision of such services.

The bank's products are also marketed and distributed relative to owners, executives and employees of the corporations.

### DEALING WITH COMPETITION

The high level of competition in the segment is reflected in the quality of service, prompt reaction and the cost of credit and commissions

The principal means of the segment for dealing with competition include providing personal, professional and quality service and the establishment of a comprehensive system of communication with the customer, moving to an overall view of the customer's financial needs.

### PRODUCTS AND SERVICES

The services offered include current financing according to customer needs, including among other things, foreign trade activity and the trading desk, financing of investments for maintaining and expanding activity, financing acquisitions of controlling interests in corporations, granting credit to capital market operators, participating in credit and/or risk offered by the large local banks or foreign financial institutions extending credit to Israeli corporations operating abroad.

In addition, these include related services such as deposit accepting and investment activities, derivative financial instrument activities, granting financial guarantees, advances, execution and so forth.

The year 2006 saw an increase in applications for credit to finance the acquisition of controlling interests in corporations, on the background of the many transactions in the market involving mergers and acquisitions.

### TARGETS AND BUSINESS STRATEGY

- Recruitment of new customers and intensifying activity with existing customers.
- Improving the quality of the Bank's credit portfolio, and increasing debt and collection activity.
- Improving the quality of service, while moving to an overall view of customer need and providing overall solutions.
- Preparation for the implementation of the "Basel II" provisions.
- Continued improvement of the technological infrastructure supporting the identification, measurement, analysis and control of various risks, focusing on credit and operational risks.

## MIDDLE MARKET BANKING SEGMENT

### SEGMENT 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. The segment also includes Mercantile Discount Banks commercial banking customers – business customers (individuals and corporations) having a medium level of activity, whose granted volume of credit exceeds NIS 1 million and who do not belong to the corporate banking segment of Mercantile Discount bank. As from 2006 the segment also includes the international operators data in the middle market banking segment.

### SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

**Net loss** of the segment in 2006 amounted to NIS 18 million, of which NIS 35 million from domestic operations, compared with net income NIS 22 million in 2005. Disregarding certain components (see hereunder), net income would have amounted to NIS 30 million in 2006, all from international operations, compared with NIS 36 million in 2005.

**The return on equity** in 2006, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was (1.9%) in 2006, of which (5.7%) from domestic operations, compared with 3.2% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 3.2% in 2006, of which (0.2%) from domestic operations, compared with 5.4% in 2005.

**Provision for doubtful debts** in this segment amounted in 2006 to NIS 117 million, compared with NIS 83 million in 2005, an increase of 41.0%.

Following are the principal data relating to the operations of the middle market banking segment (in NIS millions):

	Banking and financing		Credit cards		Capital market		Construction and real estate		Mortgage		Total Domestic Operations		International Operations	Total
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2006
Income (loss) from financing activities before provision for doubtful debts														
From externals -	931	(298)	1	4	2	-	77	520	23	44	1,034	270	67	1,101
Inter-segmental -	(642)	654	-	-	-	-	(43)	(487)	(15)	(38)	(700)	129	110	(590)
Total income from financing activities	289	356	1	4	2	-	34	33	8	6	334	399	177	511
Operating and other income	120	117	1	-	27	35	7	6	-	1	155	159	20	175
Total income	409	473	2	4	29	35	41	39	8	7	489	558	197	686
Provision for doubtful debts	91	60	-	-	-	-	18	10	1	13	110	83	7	117
Operating and other expenses	410	401	1	-	18	21	6	9	1	1	436	432	157	593
Income (loss) from ordinary operations before taxes	(92)	12	1	4	11	14	17	20	6	(7)	(57)	43	33	(24)
Provision for taxes from ordinary operations	(34)	9	-	1	4	6	7	9	3	(4)	(20)	21	16	(4)
Net income (loss)	(58)	3	1	3	9	8	10	11	3	(3)	(35)	22	17	(18)
Net income (loss) disregarding certain components <sup>(1)</sup>	(23)	16	-	4	8	8	11	11	4	(3)	-	22	30	30
Return on equity (rate)	(10.9)	0.5	9.9	599.7		312.6	13.3	15.4	99	(9.6)	(5.7)	83.3	5.9	(1.9)
Return on equity disregarding certain components <sup>(1)</sup> (rate)	(4.3)	2.9	-	602.7		381.6	19.7	15.8	9.9	(9.6)	0.2	5.4	10.0	3.2
Average balance of assets	9,544	8,100	16	11	1	-	2,639	1,198	629	535	12,829	9,844	4,829	17,658
Average balance of liabilities	7,940	5,797	-	-	-	-	300	265	-	-	8,240	6,062	2,082	10,322
Average balance of risk assets	9,064	9,196	16	10	1	36	1,795	1,153	642	534	11,518	10,929	4,268	15,786
Average balance of provident funds and mutual funds assets <sup>(2)</sup>	-	-	-	-	1,525	2,335	-	-	-	-	1,525	2,335	-	1,525
Average balance of securities	-	-	-	-	11,000	11,250	-	-	-	-	11,000	11,250	-	11,000
Average balance of other assets under management	1,030	1,000	-	-	554	507	-	-	-	-	1,584	1,507	-	1,584
Components of income from financing activities:														
Margin on credit	216	243	1	4	-	-	26	27	6	6	249	280	107	356
Margin on deposits	45	92	-	-	-	-	2	2	-	-	47	94	69	116
Other	28	21	-	-	2	-	6	4	2	-	38	25	1	39
Total income from financing activities	289	356	1	4	2	-	34	33	8	6	334	399	177	511

(1) The following components have been disregarded: the privatization bonus, expenses regarding early retirement incentive, payments to the US regulatory authorities and the costs of improvements and examinations at IDB New York and the profit on the sale of Ilanot Discount.

(2) Until the exclusion of Ilanot Discount from consolidation, securities of mutual funds managed by Ilanot Discount were included in the average balance assets of provident funds and mutual funds, and following that in the average balance of securities.

## HUMAN CAPITAL

In 2006, the average number of positions in the segment amounted to 1,182, 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, of which 920 in domestic operations, compared with 1,049 positions in 2005, a decrease of 12.3%.

## SERVICE TO SEGMENT CUSTOMERS

The commercial banking segment enjoys professional banking services provided through the Commercial Banking unit of the Corporate Banking Division. Customers are provided with personal, professional and quality service that relates to all their financial needs by offering customized various banking products in credit, exchange-rate hedging, international trade, settlement through the use of credit cards, financing, specialist capital market investments, etc. Concurrently, solutions are also provided for meeting the financial needs of the owners of companies, and their executives and staff, who thus benefit from arrangements that afford them the status of preferred customers.

Customer service is provided at **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 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 above, 'Corporate Market Banking Segment.'

## ACCUMULATING INVESTMENTS AND SAVINGS AT BUSINESS CENTERS

In 2006, the liabilities side of the medium corporation segment at the business centers increased by 20%. This growth is reflected in all investment channels having a widespread selection of customers, both corporations and executives of customer corporations. These fine results, derive, among other things, from the positioning of investment consultants at the business centers.

## COMPETITION

2005 was characterized by the decline in the business risk in the market, the continued improvement in the condition of corporations, the increase in trade and foreign trade turnovers and the growth in business activity. As a result of these changes, a continued erosion in financial margins and increased competition on the part of the two largest banks in the market was witnessed.

## PRIVATE BANKING SEGMENT

### SEGMENT CUSTOMERS

This segment includes customers of the Bank's Retails Division (individuals and corporations), who maintain their accounts at private banking centers. The segment includes the relating activities of these customers in certain

products: credit cards, capital market operations and mortgages.

As from 2006, the segment also includes the international operation data in the private banking segments.

### STRUCTURE OF SEGMENT

The International Private Banking Division was set up at the beginning of 1999, and has since grown in the extent of its assets. At the end of 2001, the Bank embarked on a program intensifying its efforts to recruit and retain private customers. This program extended also to the domestic private banking segment, responsibility for which had been assigned to the division.

The International Private Banking Division provides services to customers foreign residents and Israeli citizens permanently residing abroad and to Israelis of considerable financial means.

In addition the Division's Global Center supports operations of the Bank's overseas extensions, working in full cooperation with them. These activities include assistance in attracting new customers, providing information regarding the overseas extensions and enhancing the awareness of branches and Head Office employees to the services of the Group.

In 2006 the Private Banking in Discount continued to strengthen its position as a leading factor in this field and as an appropriate service layout for customers of the segment at the Bank's branches.

### STRATEGIC EMPHASES

As mentioned above, as part of the reorganization of the retail division towards the implementation of the Bank's segment strategy, various strategic emphases have been determined. 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 2006 amounted to NIS 31 million, of which NIS 19 million from domestic operations, compared with NIS 35 million 2005, a decrease of 45.7%. Disregarding certain components (see hereunder), net income would have amounted to NIS 56 million in 2006, of which NIS 27 million from domestic operations, compared with NIS 43 million in 2005, a decrease of 37.2 %.

**The return on equity** in 2006, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was 21.1% in 2006, of which 71.3% from domestic operations, compared with 125.5% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 38.8% in 2006, of which 97.6% from domestic operations, compared with 152.6% in 2005.

Following are the principal data relating to the operations of the private banking segment (in NIS millions):

	Banking and financing		Credit cards		Capital market		Total Domestic Operations		International Operations	Total
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2006
Income(loss) from financing activities										
before provision for doubtful debts										
from externals -	(59)	(722)	-	-	1	-	(58)	(722)	872	814
Inter-segmental -	146	843	-	-	-	-	146	843	(658)	(512)
Total income from financing activities	87	121	-	-	1	-	88	121	214	302
Operating and other income	28	31	-	1	48	43	76	75	54	130
Total income	115	152	-	1	49	43	164	196	268	432
Provision for doubtful debts	-	-	-	-	-	-	-	-	2	2
Operating and other expenses	104	100	1	-	33	29	138	129	237	375
Income from ordinary operations										
before taxes	11	52	(1)	1	16	14	26	67	29	55
Provision for taxes	6	24	-	-	9	8	15	32	17	32
Net income (loss)	5	28	(1)	1	15	6	19	35	12	31
Net income disregarding										
certain components <sup>(1)</sup>	18	35	-	1	9	6	27	43	29	56
Return on equity (rate)	15.8	103.6		61.7		1,217.8	71.3	125.5	9.4	21.1
Return on equity disregarding										
certain components <sup>(1)</sup> (rate)	63.7	130.4		61.7		1,312.2	97.6	152.6	25.1	38.8
Average balance of assets	1,221	1,067	1	21	7	6	1,228	1,094	2,304	3,533
Average balance of liabilities	17,814	16,575	-	-	-	-	17,814	16,575	19,664	37,478
Average balance of risk assets	630	444	1	18	7	9	638	471	1,759	2,397
Average balance of provident funds										
and mutual funds assets	-	-	-	-	1,262	1,069	1,262	1,069	-	1,262
Average balance of securities	-	-	-	-	7,489	7,713	7,489	7,713	9,901	17,390
Average balance of other assets										
under management	-	-	-	-	499	502	499	502	127	626
Components of income from										
financing activities:										
Margin on credit	16	15	-	-	-	-	16	15	51	67
Other	68	106	-	-	-	-	68	106	163	231
Total income from financing activities	87	121	-	-	1	-	88	121	214	302

(1) The following components have been disregarded: the privatization bonus, expenses regarding early retirement incentive, payments to the US regulatory authorities and the costs of improvements and examinations at IDB New York and the profit on the sale of Ilanot Discount.

(2) Until the exclusion of Ilanot Discount from consolidation, securities of mutual funds managed by Ilanot Discount were included in the average balance assets of provident funds and mutual funds, and following that in the average balance of securities.

## HUMAN CAPITAL

In 2006, the average number of positions in the segment amounted to 475, including positions of employees directly related to the segment and positions of staff members whose salaries are attributed to the segment. of which 338 in domestic operations, compared with 281 positions in 2005, an increase of 20.2%. Personnel in the private banking segment undergo training, including professional and administrative courses and studies for the position of investment consultant, leading to receipt of a consultant's license from the Securities Authority.

## SERVICE TO CUSTOMERS

Segment customers enjoy the highest level of banking services in four private banking centers, while focusing on comprehensive service adapted to customer needs. Professional bankers with extensive experience in financial investments in Israel and abroad, most of whom have a command of those foreign languages spoken by the customer, provide service to these customers. In addition, customers benefit from direct access to dealing rooms, direct banking via the Internet, and customized trustee and investment banking services.

**The private banking center**, located 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, while focusing on investment products as well as credit and finance facilities.

**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. These centers provide both investment and service.

In 2006, the activity of providing loans for the purchase of real estate in Israel continued to increase, concurrently with the increase of investments in this field by foreign investors.

**The Business Promotion Department** operates "Global Centers", that enable private customers and corporations to enjoy the maximum benefit from the international network of the Bank. The segment also supports the business development of the Bank's branches, especially relative to foreign residents, and reinforces the Bank's head office activity with respect to this unique customer segment.

## DEVELOPMENT IN THE SEGMENT'S MARKETS AND COMPETITION

Customers of the private banking segment are exposed to a variety of financial investment products, focusing more and more on global financial instruments.

The year 2006 was characterized by the continued gradual increase in the activity of Israeli customers in foreign markets, following the equalization of taxes on domestic and foreign investments by Israeli residents. In addition, a significant increase was recorded in activity of Israel and foreign customers in real (non-financial) investments. In both sectors, consistent penetration into emerging markets was evident, especially in Eastern Europe and in Asia. Extensive competition exists in the private banking segment, reflected in the tendency of customers to maintain accounts at several banks, in Israel and abroad. Most Israeli banks have expanded service and marketing efforts in respect of private banking customers, in accordance with the composition of this segment at each bank. Competition exists also with respect to branches and local representative offices of foreign banks, including Israeli banks operating overseas, and with respect to insurance companies and investment houses, which offer services to the same target group.

## 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 management of market and liquidity risks and dealing room operations, including those involving derivatives. This segment also includes the Bank's share in the income of the First International Bank and its share in the income of its affiliated companies which operate in a supporting capacity.

The segment also includes the non-financial corporations sub-segment, which includes the Discount Group activity in non-financial investments. This sub-segment's main activity is the Bank's investment in Harel (most of which was sold during 2006) and investments made by the subsidiary Israel Discount Capital Markets and Investments ("DCMI") and by the Bank directly.

### SCALE OF OPERATIONS AND NET INCOME OF THE SEGMENT

**Net loss** of the segment, excluding operations in the non financial companies sub-segment, in 2006 amounted to NIS 137 million, of which NIS 198 million from domestic operations, compared with a loss of NIS 140 million in 2005. Disregarding certain components (see hereunder), net income would have amounted to NIS 16 million in 2006, of which NIS 65 million from domestic operations, compared with a loss of 82 million in 2005.

Total revenues amounted in 2006 to NIS 415 million, of which NIS 233 million from domestic operations, compared with NIS 45 million in 2005, and they include two major components:

1. Earnings from operations in the "Nostro" portfolio in the amount of NIS 331 million, of which NIS 52 million from gains on sale of securities and from adjustments to fair value of trading securities, compared with NIS 39 million "Nostro" earnings in 2005, of which NIS 32 million from gains on sale of securities and from adjustments to the fair value of trading securities.
2. Net loss from the management of positions taken and from currency and financial derivatives brokerage in the amount of NIS 98 million in 2006, compared with net earnings of NIS 6 million in 2005.

**The return on equity** in 2006, calculated on the capital allocated to the sector on the basis of the average balance of segment risk assets, was a rate of 8.4% in 2006, compared with a negative rate of 16.7% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 1% in 2006, compared with a negative rate of 9.7% in 2005.

Following are the principal data relating to the operations of the financial management segment (in NIS millions):

	Domestic Operations		International Operations	Total
	2006	2005	2006	2006
Loss from financing activities	164	(80)	162	326
Operating and other income	69	125	20	89
Total income	233	45	182	415
Operating and other expenses	368	410	156	524
Income (loss) from ordinary operations before taxes	(135)	(365)	26	(109)
Income (loss)	198	(140)	(61)	137
Income (loss) disregarding certain components(1)	63	(82)	(47)	16
Return on equity (rate)	19.9	(16.7)	(9.2)	8.4
Return on equity disregarding certain components <sup>(1)</sup> (rate)	6.3	(9.7)	(7.1)	1.0
Average balance of liabilities	8,366	9,195	12,489	20,855
Average balance of assets	35,793	35,800	25,517	61,310
Average balance of risk assets	8,599	8,761	10,972	19,571

(1) The following components have been disregarded: the privatization bonus, expenses regarding early retirement incentive, the impact of canceling the provision in respect of the investment in the First International Bank and the profit on the sale of shares of Harel Insurance Investments.

## HUMAN CAPITAL

In 2006, the average number of positions in the segment amounted to 702, 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, of which 614 position in domestic operations, compared with 386 positions as aforementioned in 2005.

## TRADING DESK

**General.** The expanded dealing room is engaged in three principal areas of activity: trade in foreign currency and interest rates, trade in foreign securities and management of liquidity in Israeli currency and in foreign currency. The dealing room is available to customers and to the Bank's branches and provides personal and professional service in the global money and capital markets with respect to financial instruments and implementation of special transactions in foreign exchange, interest rates and the capital market.

Dealing room customers include local and foreign banks, corporations, investors and institutional entities.

Advanced technology and a computer system, which is one of the most advanced systems utilized by dealing rooms in Israel, enable the dealing room to provide customers with timely professional service.

**Trading in foreign currency and in interest rates.** The dealing room is a principal focus for customers engaged in financial instruments, whether for investment or hedging purposes. The principal transactions provided by the dealing room include foreign currency, interest rate and index future contracts and options (including exotic options)., swap transactions and fixed and variable interest rate swap transactions.

**Market maker in shekel interest rate trading.** A reform was implemented in the Government bond/debenture

market in September 2006, converting this market into the largest and most liquid financial market in Israel. Discount Bank is one of the principal market makers out of 19 domestic and foreign institutions. As a market maker, the Bank is entitled to participate in the principal bond tenders issued by the Treasury, and to engage in lending bonds out of the central lending pool operated by the stock exchange. The duties of the Bank as a market maker are to provide the market with purchase and sale margin quotations. Since the market reform, the Bank leads the market maker activity and off-market transactions activity.

**Trading in foreign securities.** The foreign securities desk is active in a large variety of financial markets worldwide, utilizing complex financial instruments and offering a wide range of instruments: trading in shares on foreign markets, trading in options, in Government bonds and in corporate bonds and debentures, mutual funds and hedge funds, and in arbitration activity.

The dealing room develops and “constructs” the various transactions in accordance with customer needs and, inter alia, develops structured products based on currencies, interest rates and share quotations.

#### COMPETITION

The financial management segment includes, as stated, the customer activity of the dealing room. Activity of dealing rooms in Israel and worldwide is highly competitive. The principal competitors in Israel are the four large local banking groups. Involvement of foreign banks and other financial corporations in the foreign currency and interest rate markets has recently increased significantly.

#### BUSINESS STRATEGY

The strategic plan of the financial division for the coming years includes the establishment of a Global Treasury network to coordinate activity in assets and liabilities and activity of dealing rooms of the comprehensive Group in Israel, New York and Switzerland.

The above forward-looking statement is based on the Bank's plans as of publication of the financial report. The plan may not materialize, inter alia, as a result of implementation, technological and regulatory difficulties.

## NON-FINANCIAL COMPANIES SUB-SEGMENT

### SUB-SEGMENT DEFINITION

This sub-segment includes the Group's operations with respect to non-financial investments. The greater part of the sub-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. Until the sale of the holdings in Harel Insurance Investments, the investment therein constituted an important component in the activity of the sub-segment (for details regarding the sale of the holdings in Harel, see below and Note 6 H to the financial statements).

### LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE SUB SEGMENT

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

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

- (1) Up to fifteen per cent of its capital – in any non-financial corporation;
- (2) Up to a further five per cent of its capital – provided that it does not hold in corporation more than five per cent of a certain class of means of control and it is not entitled to appoint a director;
- (3) Up to a further five per cent of its capital – in non-financial corporations which are foreign corporations that do not conduct any material and continuing business operations in Israel.

As of December 31, 2005, the amount of the Bank's investment in non-financial corporations was considerably less than the amount of the above restriction.

The legislation passed in the wake of the Bachar Committee recommendations included limitations on the holdings of controlling interests in non-financial corporations being an insurer or a corporation controlling an insurer or whoever holds over 25% of the equity of an insurer. For additional details, including details regarding the necessity for the Bank to reduce its holdings in Harel Insurance Investments Ltd., in view of the decision taken by the Bank to engage in pension consultation, see Note 33 to the financial statements.

### SCALE OF OPERATIONS AND NET INCOME OF THE SUB SEGMENT

**Net income** of the sub segment in 2006 amounted to NIS 155 million, compared with NIS 45 million in 2005, a decrease of 244.4%. Disregarding certain components (see hereunder), net income would have amounted to NIS 51 million in 2006, compared with NIS 45 million in 2005, an increase of 13.3 %.

**The return on equity** in 2006, calculated on the capital allocated to the sector on the basis of the average balance of sub segment risk assets, was 431.2% in 2006, compared with 127.9% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 143.3% in 2006, compared with 127.9% in 2005.

Following are the principal data relating to the operations of the non-financial company segment (in NIS millions):

	2006	2005
Loss from financing activities	(18)	(15)
Operating and other income	13	1
Total income	(5)	(14)
Operating and other expenses	4	4
Income (loss) from ordinary operations before taxes	(9)	(18)
Bank's equity in income of affiliated companies	56	54
Extraordinary income on the sale of investments	104	-
Net income	155	45
Net income disregarding certain components*	51	45
Return on equity	431.2	127.9
Return on equity disregarding certain components*	143.3	127.9
Average balance of liabilities	24	26
Average balance of assets	307	616
Average balance of risk assets	601	583

\* The following components have been disregarded: the profit on the sale of shares of Harel Insurance Investments.

## HUMAN CAPITAL

In 2006, the average number of positions in the sub segment amounted to 7, 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, compared with 7 positions as aforementioned in 2005.

## PRINCIPAL AREAS OF OPERATION IN SEGMENT

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

- **Investments in venture capital funds.** Investments in this field are made through the subsidiary DCMI, through the subsidiary of Mercantile Discount Bank, and directly by the Bank itself.
- **Investments in companies.** The principal investment in this sector was, until recently, the investment in Harel Insurance Investments (for details regarding the sale of the holdings in Harel, see below and Note 6 H to the financial statements).

## REVIEW OF THE ISRAELI VENTURE CAPITAL MARKET IN THE YEAR 2006\*

During 2006, 402 Israeli hi-tech companies raised funds in a total amount of US\$1.62 billion, compared with 378 companies, which raised US\$1.34 billion in 2005, an increase of 21% in the amount raised (and an increase of 14% in the average amount per company). The share of Israeli venture capital funds amounted to US\$651 million (US\$655 million in 2005). The relative part of the funds in the total investments in hi-tech companies reached 40% in 2006, compared to 49% in 2005.

107 companies in the communications sector raised US\$393 million (about 24% of total investments) in 2006 to, compared to 112 companies, which raised US\$469 million (about 35% of total investments) in 2005.

The volume of funds raised by companies in the biotechnology sector increased significantly in 2006. 86 such companies raised US\$369 million (about 23% of total investments) in 2006, compared to 88 companies, which raised US\$284 million (about 21% of total investments) in 2005, an increase of 30% in total investments.

An analysis of the fundraisings according to the development stage of the companies evidences that in 2006 the volume of funds raised by medium-stage companies (with income up to US\$10 million), as well as their relative part in the total investments, decreased from 52% of total investments (US\$702 million) to 42%.

Both the number of "seed" stage companies and the amounts they raised increased in 2006. However, no significant change was evident in their relative part in total investments – 8% in 2006 (US\$110 million raised by 52 companies; average of US\$2.1 million per company) compared to 8.5% in 2005 (US\$138 million raised by 68 companies; average of US\$2 million per company).

During 2006, 76 exits related to the venture capital sector were implemented through mergers and acquisitions (M&A) or through initial public offerings (IPO), and cumulative exits exceeded US\$10.5 billion. The most outstanding exits in 2006 included the acquisition of Mercury Interactive Ltd. by the HP conglomerate in consideration for US\$4.5 billion and the acquisition of M-Systems by SanDisk in consideration for US\$1.55 billion.

#### INVESTMENTS OF THE GROUP IN CAPITAL FUNDS

In the field of venture capital fund management, DCMI (directly and through a consolidated company) 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, 2006. The fund has concluded its investment program and realized holdings in some of its investments.

**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, 2006, 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, 2006, DCMI had invested US\$12.7 million.

**Vertex Israel III Fund** This fund's size is US\$150 million, and DCMI's share will reach US\$13.5 million. As of December 31, 2006, DCMI had invested an amount of US\$2.8 million.

**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, 2006, DCMI had invested an amount of US\$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\$1.7 million had already been invested by the end of 2006. The Golden Gate Bridge Fund is jointly managed with the Plenus Technologies Fund since 2002.

**Plenus Venture Lending II Fund.** The Fund, which amounts to US\$55 million, engages in the granting of bridging loans and credit facilities to technology companies. DCMI has undertaken to invest up to US\$5 million in the fund. As of December 31, 2006, DCMI had invested an amount of US\$2.2 million.

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 primary volume of the fund was US\$30 million. Following the increase in the fund in 2006, the fund's volume reached US\$40 million. DCMI's share is due to reach US\$15 million, of which US\$10.1 million had been invested by the end of 2006.

**Alon Fund.** DCMI has invested in a venture capital fund, of the Gaon Financial 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.** The size of the fund stands at US\$78 million. DCMI has undertaken to invest US\$5 million in the fund, of which US\$2.3 million had been invested by the end of 2006.

**Edmond de Rothschild Europorties.** This fund is a member of the Rothschild Group. During 2006, DCMI committed to invest Euro 11.3 million in this fund. As of December 31, 2006, Euro 3 million was invested. The size of the fund is Euro 100 million.

DCMI has invested in **"Menif" – Financial Services Ltd.** "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\$8.7 million. Subsequent to balance sheet date, the project guarantee facility was increased to US\$17.3 million. The balance of the guarantees granted by Discount Israel Capital Markets & Investments Ltd., amounted to NIS 20 million as of December 31, 2006.

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). During July 2006, DCMI sold all its holdings in the company in consideration for US\$0.7 million.

**Additional investment in funds.** In addition to the investment in funds through DCMI, the Bank has made a direct investment in additional funds.

**FIMI Opportunity Fund I.** The size of this fund is US\$114 million. The Bank's share in the fund is due to reach US\$23 million, of which US\$17.9 million had been invested by December 31, 2006.

**FIMI Opportunity II Fund.** The Fund reaches a total of approximately US\$293 million. The Bank's share in the Fund will reach US\$50 million, of which an amount of US\$7.1 million has been invested up to December 31, 2006.

**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, 2006, the Bank had invested US\$2.5 million in the fund.

Furthermore, Mercantile Discount Bank is committed to investments in five venture capital funds. As of December 31, 2006, the investment of Mercantile Discount Bank in these funds amounted to NIS 10.9 million. As of December 31, 2006, the maximum commitment for the future investments in these funds amended to NIS 3.8 million.

## DEVELOPMENTS IN THE SUB-SEGMENT

**The sale of holdings in Harel.** On November 1, 2006, the transaction for the sale of 10.1% of the share capital of Harel and for an option to sell all the remaining shares that the Bank holds in Harel, comprising 5.79% of the share capital of Harel, came into effect. The net gain from the sale of shares amounted to approximately NIS 104 million.

**Investment in a real estate corporation.** The Bank, by means of Israel Discount Capital Markets and Investments Ltd., is looking into the possibility of investing Euro 30 million in the acquisition of 20% of the means of control in a corporation engaged in commercial property and the housing property business in Eastern Europe. The investment is subject to a due diligence review and to the signing of an investment agreement.

## FURTHER DETAILS AS TO ACTIVITY IN CERTAIN PRODUCTS

### CREDIT CARD OPERATIONS

#### GENERAL INFORMATION ON THE CREDIT CARD FIELD

The activity of the Bank in the credit card field is being conducted both through Israel Credit Cards Ltd. (hereinafter – “ICC”), a credit card company owned at a rate of 65% by the Bank, and by the issue as co-issuers of ICC credit cards to customers of the Bank, as part of the services and products basket offered by the Bank.

The income of the Bank from the credit card operations includes, primarily, various commissions related to the credit card activity of ICC (both as an issuer of credit cards and as a clearing agent for credit cards), as well as the financing income from credit granted to transactions effected through off-banking credit cards. In addition, the bank derives income from payments transferred to it in respect of credit cards issued to its customers by ICC, at the initiative of the Bank.

In recent years, the credit card serves as one of the principal means of payment in the market. The credit card is issued to the customer by the credit card company and the customer uses it for payment, as an alternative for cash or checks. The credit card company issues credit cards of two types: most of the cards are being issued to customers of banks, for the customers of such banks (hereinafter – “banks included in the arrangement”). The remaining cards are being issued directly by the credit card companies to customers, not by way of banks (hereinafter – “off-banking credit cards”).

Credit cards have constituted an instrument of payment in Israel since the 1970s.

Israel is considered an advanced country in the credit card field. ICC estimates that approximately 75% of the adult population in Israel uses credit cards as an instrument of payment, the Israeli consumer holding on an average of 1.3 credit cards. ICC also estimates that as of December 31, 2006, approximately 4.5 million credit cards were issued in Israel (of which, according to ICC’s data, 89% were active cards).

#### STRUCTURE OF THE FIELD OF OPERATION

The use of a credit card as an instrument of payment is enabled, subject to the existence of several cumulative factors: an issuer, a clearing agent, a trader and a customer (the credit card holder), all of which are bound by separate and independent agreements (direct or indirect agreements, by virtue of the issuer and the clearing agent being members of an international organization that provides the franchise in respect of the credit card brand name). These contractual engagements provide the infrastructure for communicating the relevant data for settling

the payments relating to transactions paid by credit cards.

There is a social and a consumer need of the existence of the above mentioned agreements, in order to facilitate transactions, thereby increasing market efficiency and improving the economy. Accordingly, customers can conduct transactions with a large number of traders and traders can sell their goods or services to a large number of customers.

As stated, the credit card system is composed of four factors: **Issuer** – the entity issuing credit cards to its customers; **Customer** – the holder of a credit card; **Trader** - the entity accepting a credit card; **Clearing agent**– the financial institution through which the trader receives payment.

The trader enters into an agreement with the clearing agent. In this framework, the clearing agent, in consideration for a commission, undertakes to credit the trader related to it, in a manner secured in advance, with the consideration due to the trader for the transactions made with him by the customers holding the credit card of the brand that is being cleared. The commission collected by the clearing agent in respect of clearing services to the trader is the “**Trader commission**”. The clearing agent, on his part, pays the issuer an issuance commission called “**Cross commission**”. This commission is embedded in the trader commission collected by the clearing agent. Namely, the trader commission is composed of the clearing commission and the issuer commission.

## THE OPERATIONS OF ICC

ICC operates in two sectors of activity in the credit card market, constituting together the core activity of a credit card company: (a) issuance of credit cards; and (b) clearing of credit card transactions.

ICC is engaged in the issuance and operation of credit cards and the clearing of credit card transactions under the international brand name “VISA”. It also markets and operates, exclusively in Israel, the “Diners” credit card and, in a very limited scope, also “MasterCard” credit cards.

As part of the credit cards issuance operation, ICC offers credit to customers holding credit cards issued directly by ICC. In addition, ICC provides clearing services for transactions made on the Internet for various traders in Israel and abroad.

In the issuance field, ICC issues (directly and through Diners, a company under its control) credit cards under two routes: (a) issuance of cards to customers of banks in the arrangement with which ICC has agreements for co-issuance or distribution agreements (above and hereunder – “co-issuance”); (b) issuance of cards directly by ICC, mostly through clubs and unique organizations (hereinafter – “off banking cards”). In addition, ICC provides credit to customers holding off-banking cards. Such customers are offered various credit channels with respect to transactions made by them through their credit cards. ICC is entitled to the interest income and to the commissions related to the credit so granted, this differently from the credit offered to holders of cards Issued by ICC as a co-issuer, the granting of which is generally made by the relevant bank and the bank is the one that in this case is entitled to a payment from the customer in respect of the credit extended to him.

Within the framework of the clearing channel ICC conducts the clearing of credit cards in Israel. An additional activity conducted in the clearing field is the granting of credit to traders with whom ICC has clearing agreements, by way of discounting credit card slips, advancing payments in respect of transactions made and the granting of loans on account of future payments.

## SCALE OF OPERATIONS AND NET INCOME

**General.** The volume of credit card transactions increases annually. The increase in the use of credit card derives both from an increase in the volume of transactions (as a result of population growth and the existence of a younger population that is accustomed to using credit cards as part of its consumer culture) and from an increase relative to transactions paid for through other means.

ICC estimates that approximately 65,000 traders and marketing chains in Israel (comprising approximately 73.5 thousand points of sale) enable purchases through credit cards. ICC estimates that the annual volume of business transacted in Israel by way of credit cards was NIS 124 billion in 2006, compared to NIS 113.1 billion in 2005, an increase of 10.4%.

**Net income** from the operations in 2006 amounted to NIS 83 million, compared with NIS 63 million in 2005, an increase of 31.7%. Disregarding certain components (see hereunder), net income would have amounted to NIS 87 million in 2006, compared with NIS 65 million in 2005, an increase of 33.8%.

**The return on equity** was 38.4% in 2006, calculated on the capital allocated to the operations on the basis of the average balance of the operations risk assets, compared with 35.6% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 40.2% in 2006, compared with 36.6% in 2005.

**Provision for doubtful debts** amounted in 2006 to NIS 31 million, compared with NIS 14 in 2005, an increase of 121.4%.

Following are the principal data relating to the credit cards operations:

	Households		Small businesses		Middle market banking		Private banking		Total	
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005
Income from financing activities before provision for doubtful debts										
From externals -	108	111	7	-	1	-	-	-	116	111
Inter-segmental -	(5)	(36)	-	4	-	4	-	-	(5)	(28)
Total income from financing activities	103	75	7	4	1	4	-	-	111	83
Operating and other income	629	555	11	14	1	-	-	1	641	570
Total income	732	630	18	18	2	4	-	1	752	653
Provision for doubtful debts	31	14	-	-	-	-	-	-	31	14
Operating and other expenses	481	427	10	11	1	-	1	-	493	438
Income from ordinary operations before taxes	220	189	8	7	1	4	(1)	1	228	201
Provision for taxes on ordinary activities	79	81	3	3	-	-	-	-	82	85
Net income (loss)	78	55	5	4	1	3	(1)	1	83	63
Net income disregarding certain components <sup>(1)</sup>	82	56	5	4	-	4	-	1	87	65
Return on equity (rate)	36.7	31.8	-	123.1	9.9	599.7	-	61.7	38.4	35.6
Return on equity disregarding certain components <sup>(1)</sup>	38.1	32.6	-	136.9	-	602.7	-	61.7	40.2	36.6
Average balance of assets	2,387	1,846	-	60	16	11	1	21	2,404	1,938
Average balance of liabilities	1,373	613	-	-	-	-	-	-	1,373	613
Average balance of risk assets	3,573	2,872	-	52	16	10	1	18	3,590	2,952
Components of income from financing activities:										
Margin on credit	103	78	6	4	1	4	-	-	110	86
Margin on deposits	-	(3)	1	-	-	-	-	-	1	(3)
Other	-	-	-	-	-	-	-	-	-	-
Total income from financing activities before provision for doubtful debts	103	75	7	4	1	4	-	-	111	83

(1) The following components have been disregarded: the privatization bonus and the expenses regarding early retirement incentive.

## REGULATIONS, LEGISLATION AND ARRANGEMENTS

**General.** The activities of ICC are regularized under the Credit Card Law, 1986 and various rules under the general law also apply to it. In addition, due to the fact that ICC is a subsidiary of a banking corporation, it is defined also as an "auxiliary corporation" under the banking Law (Licensing), 1981, and as such, a set of Laws, Regulations and Orders under the banking laws also apply to it.

**Commissioner of Restrictive Trade Practices.** The Commissioner of Restrictive Trade Practices is involved

extensively in the field of credit card activity. For details as to the arrangements between the credit card companies and the three way agreement for cross clearing, which was submitted for approval of the Antitrust Court, see hereunder.

**Prohibition of money laundering and the financing of terror.** In October 2006, the Constitution and Legislation Committee of the Knesset approved an amendment to the Prohibition of Money laundering Order (Obligation for identification, reporting and maintenance of records by banking corporations for the prevention of money laundering and the financing of terror). The amendment also applies to credit card companies' obligations for identification, maintenance of records and reporting to the Prohibition of Money Laundering Authority in all matters concerning with credit card holders and traders with whom the companies have clearing agreements, this subject to certain terms and while granting certain relief to credit card companies as compared with banking corporations. The amended Order has not yet been published in the official gazette, and will become effective six months after being published. ICC is preparing to act in accordance with the requirements of the amended Order.

**Proper Banking Management.** ICC is deemed as an "auxiliary company" according to relevant banking (licensing) regulations and, as such, is subject to a legislation, directives and regulations, including the Banking Law (Licensing); Bank of Israel Law, 1954; the Banking Ordinance 1941; the Banking Law (Customer Service), 1981, and regulations promulgated thereunder; Supervision of Financial Services (Consulting and Marketing of Pension Schemes) Law, 2005 (hereinafter – "the Pension Consulting and Marketing Law"); the Arrangement of Investment Consulting, Investment Marketing and Investment Portfolio Management Business Law, 1995 (hereinafter – "the Arrangement of Investment Consulting Business Law"); and to directives and instructions issued by the Supervisor of Banks. In 2005 the Supervisor of Banks issued Proper Banking Management Directive No. 470, the purpose of which is regulating the charge card operations of credit card companies both in the field of risk management and in various consumer fields. In the risk management field, the Supervisor applied to the credit card companies additional Proper Banking Management Directives, such as "the board of directors", "risk management", "fraud and embezzlement by employees", "banking insurance" and so forth. In the consumer field the instruction relates to several principal issues, including: rules for the issue of credit cards, their delivery, their renewal and cancellation, the information provided as part of the monthly statement, rules regarding point/stars drives, rules regarding the conversion of transaction in foreign currency into Shekels, and so forth.

**Reporting to the public by credit card companies.** Further to the initiative of the Supervisor of Banks regarding disclosure of activity of credit card companies, and based on a reporting framework formulated by a team appointed for this purpose including representatives of the Supervisor of Banks, the Israel Securities Authority, banking corporations controlling credit card companies, credit card companies and their auditors, the Supervisor of Banks published a public reporting format for credit card companies. Accordingly, in mid-March 2007, credit card companies published their financial statements for the first time to the public.

**A commission of examination with respect to market failures in the credit card field.** In February 2007, the report of the inter-ministerial commission, headed by the Accountant General at the Ministry of Finance, which dealt with the examination of market failures in the credit card field in Israel, was published. The commission recommended that the clearing market should be regularized by way of the Banking Law (Licensing). According to the recommendations of the commission, engaging in clearing would require a license from the Governor of Bank of Israel (existing clearing agents shall be entitled to a license); The Supervisor of Banks shall be entitled

to require mutual clearing between the three existing credit card companies and between them and any new company in this field, and to require a large issuer to allow any clearing agent to clear its cards; the Supervisor of Banks shall be authorized to supervise clearing agents and to issue directives as to their operation, including the recommendation to the price commission, established under the Supervision of Commodities and Services Law, as to the maximum cross commissions, and to determine instructions requiring a clearing agent to enter into agreements with discount companies and not to discriminate between them.

**Additional legislation and arrangement initiatives.** Various State agencies have recently voiced opinions according to which the credit card companies should be separated from the banks. These positions brought about private bills tabled by members of the Knesset. To the best knowledge of ICC and the bank, the Government has not yet formed its position with regards to such initiatives.

### TECHNOLOGICAL CHANGES

**Use of the "smart card".** As part of the effort to reduce misuse and forgery of credit cards, the international VISA organization and the international MasterCard organization are adopting various measures to improve the security of credit cards carrying their brand names. These organizations have directed their members to introduce the use of a credit card with special features that complicate its use and/or forgery by unauthorized factors (hereinafter: "the smart card"). In accordance with these directives, the Company commenced preparations for introduction of the smart card, mainly upgrading of the technology acquired by the Company in the past and its adaptation for issuance of smart cards, and upgrading and/or acquisition and/or development of sophisticated POS instruments and their installation in various businesses with which ICC has clearing agreements. Smart cards are expected to be issued to ICC customers during a period of two and a half years beginning in the second half of 2007.

### CRITICAL SUCCESS FACTORS

- An operating network including technological information systems, teleprocessing and advanced infrastructures;
- Authorization to issue brand name credit cards under a franchise granted by the international organizations;
- Cooperation with banking corporations;
- Ability to recruit customers and their maintenance through an extensive marketing layout;
- Consummation of agreements for the establishment of consumer clubs;
- Ability to offer customers attractive credit products;
- A developed and effective risk management system;
- The ability to borrow funds from financial institutions at attractive terms.

### OBSTACLES TO MARKET ENTRY

Principal entry barriers into the issuance field:

- Activity as an issuer requires the existence of an extensive, complex, costly operating system, with sophisticated information and communications systems, including information security systems, customer service, etc;
- A massive and ongoing investment is required for country-wide marketing, distribution and sales channels in order to compete in the issuance field, especially through a distribution chain for credit cards is required in

- accordance with agreements with banks and/or customer clubs;
- High financial stability is required for purposes of issuing sources for financial activity, i.e. ability to borrow extensive funds at more preferable conditions compared to conditions offered to “regular” customers;
  - Maintenance of control of the issuer by banking corporations is required for purposes of recognition and membership in international organizations that manage leading international brand names;
  - The existence of a recognized and efficient system for rating credit risks;

Principal entry barriers into the clearing field:

- Entry into the credit card clearing field involves, primarily, obtaining a license from the international organization to which the clearing activity is related. Receipt of such a license requires that the applicant have a banking connection and compliance with business and financial standards that will secure its activity, in addition to payment of membership fees to the international organization.
- An entity requesting entry into the clearing field should establish a communications network enabling on-line clearing of credit card transactions (or should acquire the services of Electronic Banking Services, which maintains such a system in Israel)
- The existence of a solid, credible information system for billing management;

### ALTERNATIVE PRODUCTS

In addition to the classic alternatives to a credit card, e.g. checks, cash and bank transfers, additional instruments and services exist, constituting an advanced technology and which, in contrast to the above stated instruments and similarly to credit cards, are characterized by availability and convenience:

- Payment service through cellular phone;
- Internet transactions for transfer of funds without disclosing the credit card details of the customer/details of the customer’s bank account;
- Alternative instruments to credit instruments are the many credit instruments offered on the market – whether by the banks or by other factors (private companies that offer off-banking credit, including the “grey market”).
- A very wide range of credit products having various characteristics, exist in the market, all of which serve as alternatives for one another. Notwithstanding, most of the customers purchase a credit product provided by the entity known to them (namely, their bank), therefore every customer sees various alternatives to products offered by ICC.
- An alternative product in the clearing channel is the check discounting service.
- Alternative products in the clearing field on the Internet are being developed all the time in view of the fact that the trade on the Internet is an activity being continuously developed.

### NEW PRODUCTS

**The issuance field.** ICC attributes great importance to the maintenance of a wide range of products with unique features offered to its credit card customers and therefore invests efforts to develop a line of products and services designed especially for these customers. Most of the products constitute instruments of payment and credit products offered to holders of ICC credit cards.

- As from 2005, ICC offers its customers revolving credit under the brand name “Active”.
- As from 2006, ICC began to offer customers a virtual VISA credit card (“a credit card without a card”), developed

in cooperation with the VISA international organization. In this framework, the customer receives a card number and a code, with which he can effect transactions in the account (in an amount up to a predetermined ceiling) without the existence of a plastic card.

- The "Wish-U-Card" was launched in the first quarter of 2006. This product is a gift card which can be loaded with predetermined amounts to be used for purchases at the selected leading chain stores.
- In June 2006, the "YOU" Club card was launched jointly with the Dor-Alon Group. The card is an off-bank card issued within the limits of a customer club, which would grant the holders thereof benefits at the chains of the Dor-Alon Group.

**The clearing field.** During the fourth quarter of 2006, ICC launched the World Wide Wallet Card website (WWWcard) whereby holders of credit cards of other companies may acquire a virtual credit card. This product comprises a pre-paid card, which awards the customer the fully secured benefits of the e-commerce world. The card was launched in the U.K.

## CUSTOMERS

**The issuance field.** The majority of ICC customers in the credit card issuance field are customers holding credit cards issued in conjunction with the banks included in the arrangement (including the Bank and Mercantile Discount Bank). ICC is investing special effort to increase the part of off-banking credit cards and to issue off-banking credit cards through consumer clubs or special cards.

**The clearing field.** ICC customers in the clearing field are those traders that accept VISA or Diners credit cards.

## MARKETING AND DISTRIBUTION

**The issuance field.** The banks that are a party to the arrangement constitute ICC's "base recruiting level" for customers ordering credit cards through their banks. Consumer clubs serve as an additional "base recruiting level", through which ICC recruits off-banking customers through direct distribution. The marketing of credit products offered by ICC to holders of off-banking credit cards is made through the advertising of credit products by way of the media.

**The clearing field.** The marketing operations in this field are directed towards the traders, with special emphasis on traders that have several points of sale (marketing chains generally utilize one clearing agent for all their branches). Sales representatives market clearing services to the traders. These sales representatives remain the contact persons for the traders also after the clearing agreements have been signed.

## COMPETITION

**The structure of competition.** Competition in the field of credit card issuance is derived from the competition between the banks over customers. In addition, the competition is over the heart and pocket of the customer with the aim of convincing the customer to pay for the major part of his current consumption by means of the cards issued by ICC, and at the same time increasing the number of credit cards issued by it. In providing credit in the issuance channel, ICC competes with bank credit as well as with other entities providing off-banking credit. In the clearing field, competition is over traders to whom clearing services and complementing services are being provided.

**The issuance field.** Three credit card companies operate in Israel, all of which are owned or controlled by banks:

- **ICC** issues and clears VISA credit cards and Diners credit cards (through Diners, exclusively). ICC also issues a limited number of MasterCard credit cards.
- **IsraCard**, a group of private companies all of which are controlled by Bank Hapoalim Ltd., issues and clears Isracard (exclusively), American Express (exclusively) and MasterCard, credit cards. IsraCard is a brand name owned by IsraCard, which issues credit cards under this brand name for use within Israel only. To the best of ICC's knowledge, as of date of this report, the activity of IsraCard in the issuance field of VISA credit cards is negligible; however, its activity in the issuance field of MasterCard credit cards comprises most of the activity under this brand name in Israel. American Express is issued by an affiliated company of IsraCard (exclusively).
- **LeumiCard**, a private company which is wholly owned by Bank Leumi, issues and clears VISA credit cards, and issues MasterCard credit cards.

Competition in the issuance field focuses today on off-banking issuance in order to recruit new customers and to increase the number of customers to whom ICC can offer credit products.

**The clearing field.** The players in the field of credit card clearing includes:

- **ICC**, which clears VISA credit cards and Diners credit cards (through Diners, exclusively);
- **IsraCard**, which clears IsraCard (exclusively), "American Express" (exclusively) and MasterCard (exclusively);
- **LeumiCard**, which clears VISA credit cards.

In accordance with an agreement of October 30, 2006 between ICC, LeumiCard, IsraCard and the banking corporations controlling these companies, regarding the opening of the clearing market for VISA and MasterCard credit card by the three companies, the clearance of MasterCard credit cards is expected to open for competition in June 2007. As a consequence, the operational ability of ICC (and of LeumiCard) in respect of clearing MasterCard credit cards in Israel has increased. ICC intends to clear MasterCard credit cards in Israel after activating the joint interface.

Following the signing of the new agreement, Isracard joined the local agreement for cross clearing between ICC and LeumiCard with respect to the VISA brand name, after which the competition in the credit card clearing field is expected to increase (for further details see below).

#### DEVELOPMENTS IN THE SEGMENT

**A joint issuance agreement between ICC and the First International Bank.** Among other distribution agreements signed by ICC (including Diners) with several banks, are also agreements signed with The First International Bank with ICC for the joint issue of VISA and Diners credit cards to customers of the First International Bank for a period of six years as from August 1, 2000, at the end of which the agreement would be renewed for an additional period of three years. However, as from February 2006, each of the parties is entitled to terminate the engagement at any time giving prior notice of six months.

The First International Bank announced on August 17, 2006, the cancellation of the said agreements in their present format, at the end of six months from the date of the announcement. At the same time, the First International Bank informed ICC of its wish to conduct, as early as possible, a fast negotiation for the renewal of the engagement between them, based on existing agreements and their annexes, without granting preference to credit cards issued by ICC, and including additional changes that might arise through the negotiation.

On February 14, 2007, ICC and the First International Bank signed an agreement for the extension of the existing joint issue agreement until March 31, 2007. ICC and the First International Bank are at present negotiating the extension of the joint issue agreement for the coming years.

**Arrangements between the First International Bank and the IsraCard Group.** In the reports of the First International Bank regarding the agreement signed in January 2006 with Bank Hapoalim for the purchase of means of control in Otsar Ha-Hayal Bank Ltd., it is stated, among other things that the parties to the agreement determined “arrangements as to the continued engagement between Otsar Ha-Hayal and the IsraCard Group and for cooperation between the bank and the IsraCard Group”.

The approval for the merger, granted by the Antitrust Authority, to the First International Bank and to Otsar Ha’Hayal Bank, stipulated that the said banks would not be party to exclusivity arrangements, unless prior approval is granted by the Commissioner. The said banks and Bank Hapoalim were ordered to annul any exclusivity arrangement to which they are a party, so that no restrictions shall apply to the said banks as regards the marketing of credit cards that are not credit cards issued by Bank Hapoalim or a corporation under its control.

An exclusivity arrangement is any arrangement according to which any of the said banks have undertaken to market credit cards of Bank Hapoalim or corporations under its control, including any undertaking with regards to the number of Bank Hapoalim Group credit cards to be marketed by the said banks, or with regards to a percentage of Bank Hapoalim Group credit card to be marketed out of the total number of credit cards marketed by the said banks.

**The holdings in Diners.** On August 22, 2006, the Supervisor of banks approved the move by which ICC purchased from its shareholders the remaining balance of shares in Diners, in accordance with the agreement of January 2005. Following this acquisition, ICC holds 100% of the equity and voting rights in Diners.

**The establishment of a new customer club and the sale of the means of control in Diners.** On November 29, 2005, ICC entered into an agreement with Dor-Alon Energy in Israel (1988) Ltd. and Blue Square Israel Ltd. (hereinafter together – “the Purchasers”) according to which ICC has committed to sell to the Purchasers 49% of the issued and paid share capital of Diners Club Israel Ltd. (hereinafter – “Diners”) in consideration of NIS 21.3 million. Concurrently, Diners entered into an agreement with the Purchasers for the establishment of a customer club. The transaction was consummated on November 18, 2006, following fulfillment of all relevant conditions. The consideration for the shares has been financed by a loan granted to the Purchasers by ICC. The shares sold are to serve as collateral for the loan, which is to be repaid at different dates over eight years, during which the Purchasers are entitled to decide on returning the shares to ICC instead of repayment of the loan, and ICC on its part is entitled to demand the return of the shares, all in accordance with the terms stated in the agreement for the sale of the shares.

This agreement provides, among other things, the formation of a joint enterprise of the company and of the purchasers for a joint activity under the brand name “YOU”. In terms of the agreement, the entities of the Dor-Alon group are to establish a consumer club, which shall award its customers with various benefits at the Blue Square supermarket chain, at the Dor-Alon petrol stations and at additional stores owned by the Dor-Alon group. As part of joining the club, customers would be offered a club credit card to be issued by Diners as an off-banking credit card.

It should be noted that to the Bank’s best knowledge, the purchasers in accordance with this agreement include certain controlling shareholders which, at the time of entering into and consummation of the transaction, constituted part of the purchasers in accordance with the agreement for the purchase of the control core of the Bank, or were related thereto (see “Control of the Bank” hereunder).

**Arrangements between credit card companies.** At the beginning of September 2001, ICC, The First International Bank, Israel Discount Bank, Bank Leumi Le'Israel B.M. and Leumi Card (hereinafter together – “the appellants”) filed motions with the Antitrust Court (hereinafter – “the court”) for the approval of a binding arrangement between them, concerning the cross clearing of VISA cards, as well as motions for temporary permits, allowing them to operate in accordance with this arrangement. In the motions, the Court was requested to approve the issuer commission rates, according to a mechanism, which among other things, would bring about a gradual reduction in the higher categories of the issuer’s commission.

Within the framework of the Court proceedings, the appellants presented a methodology for the determination of the Cross Clearing Commission rate. The Commissioner of the Antitrust Authority opposed the methodology proposed by the appellants and offered a different one.

On August 31, 2006, the Antitrust Court handed down a ruling regarding the methodology for the determination of the Cross Clearing Commission, while adopting the principal points of the Commissioner’s position on the matter. ICC, the Bank and the First International Bank appealed the Court’s decision.

Concurrently with the procedures in court, negotiations have been conducted between the Commissioner and the credit card companies – ICC, LeumiCard and Isracard – regarding the agreement for the formation of a cross clearing system for VISA cards and MasterCard. In view of the said negotiations, the appellants requested the Commissioner to issue a provisional permit, enabling them to complete the negotiations prior to the expiration of the provisional arrangement between them.

On September 6, 2006, the Commissioner of Restrictive Trade Practices granted the request, extending the exemption granted to the existing arrangement between the parties until October 31, 2006.

**A tri-party Cross Clearing agreement.** On October 30, 2006, the Commissioner, the credit card companies and the banks owning the credit card companies entered into an agreement for the Cross Clearing of Visa and MasterCard credit cards (hereinafter – “the Agreement”). The agreement came into effect upon the granting of a provisional permit by the Antitrust Court on October 31, 2006, and will both expire on July 1, 2013 (hereinafter: “the period of the agreement”) unless the Court rules otherwise at a prior date.

The Agreement specifies, among other things, the rates of the Cross Clearing commissions and the structure of the categories of the Cross Clearing commissions applying to the credit card companies during the effective period. The Agreement outlines a gradual decrease in the rates of the Cross Clearing commissions down to a rate of 0.875% starting on July 1, 2012, alongside the reduction in the number of categories over the effective period.

The Agreement specifies general guidelines that, among other things, prohibit the inter-dependence between various types of credit cards being cleared by a trader with each of the credit card companies. The guidelines also prohibit the deterioration in the terms of clearing following a reduction in the number of credit card types being cleared by a particular trader.

The Agreement specifies further rules that, among other things, do not permit banks that control credit card companies, to link between the services provided to the trader and the terms of engagement with the clearing entity. Further rules prohibit banks from discriminating between customers of a bank holding a credit card issued by that bank and other customers of that bank who do not hold credit cards issued by it.

Within the framework of the agreement, certain provisions were determined according to which, under certain circumstances, the Commissioner would withdraw the declaration of IsraCard as a monopoly with regards to the

clearing of IsraCard and MasterCard credit cards, forcing IsraCard to determine under certain circumstances identical commission rates for a trader that clears with it transactions with IsraCard and MasterCard, and an undertaking of the parties to apply to the Court for approval of a cross clearing commission for the period following the termination of the arrangement, in case they would request the continuation of the cross clearing. The Agreement further provides that until May 30, 2007, a joint interface would be established and operated to enable the three credit card companies to effect the clearing of VISA and MasterCard credit card transactions.

At this stage it is not possible to assess the implications of the Agreement as a whole. On the one hand, a gradual decline is expected as stated in the rate of the cross commission, though on the other hand, the Bank and ICC believe that the Agreement will drive the market to open competition and will reduce the uncertainty in this field. Among other things, due to the ability of ICC (as well as LeumiCard) to operate in the field of clearing MasterCard credit cards in Israel.

Following the signing of the new agreement, IsraCard joined the local agreement for cross clearing existing between the company and LeumiCard with respect to the VISA brand, and consequently, the competition in the field of VISA credit card clearing is also expected to grow in the future.

#### 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.

#### INTANGIBLE ASSETS IN THE CREDIT CARD FIELD

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

Furthermore, ICC owns many registered trade marks in Israel, including "ICC", "Cal" "Active" and "WWWCARD". ICC is also in the process of registering several additional trade marks.

**Licenses and franchise.** ICC is a principal member of the international VISA organization, which granted ICC a license to use the VISA trade marks and a franchise to issue and clear credit cards in Israel under this brand name. In March 1992, Diners International Organization granted ICC a franchise to use the "Diners" trade marks.

In July 2001, ICC entered into an agreement with Europay International S.A. (that later merged with the MasterCard international organization), which owns the exclusive right to grant licenses to use the trade marks of "MasterCard", "Cirrus", "EuroCard" and "Maestro", according to which ICC joined this organization as a principal member. In accordance with this agreement, ICC was granted a license to use the said trade marks and licenses to issue and clear credit cards in Israel under the said brand names.

**Data base.** ICC holds three data bases of registered customers holding VISA, Diners (through Diners) and MasterCard credit cards, as well as of traders accepting these cards.

#### GOALS AND STRATEGY

**The issuance field.** ICC aims at leading the market through utilization of the banking channel and providing customized solutions for customers, and marketing of cards through the off-banking channel in existing consumer

clubs and through cooperation with various entities for the establishment of additional consumer clubs. Converting ICC into a significant player in the consumer credit market, distribution of off-banking cards, principally rolling credit cards of the "Active" type, constitute an infrastructure for issuing customer credit. In addition, ICC will promote itself as an entity providing varied credit services (including through credit cards), without dependence on banks, and will develop additional products in this field.

**The clearing field.** ICC's strategy is intended to convert the Company to a clearing agent marketing a comprehensive basket of products to traders, while enlarging its market share in the clearing field. Accordingly, ICC is preparing for commencement of market competition as from June 2007, from both the technological and the business standpoints. Furthermore, ICC will endeavor to develop and market additional products to be offered to traders, in addition to discounts and the advancement of payments offered at the present time. The acquisition of the ERN shares, a company active in the check clearing field, is a constituent of the said strategy.

## OPERATIONS IN THE CAPITAL MARKET

The operations in the capital market 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 operations include the activity of the Bank's securities department, as well as the operations of specialized subsidiaries: Tachlit Investment House, Discount Management of Provident Fund and Kahal, and the operations in the capital market of Mercantile Discount Bank. Until June 30, 2006, the activities included those of the specialized subsidiary Ilanot Discount, that has been sold.

## OPERATIONAL STRUCTURE

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

- Securities department;
- Product development department;
- Tachlit Investment House (subsidiary);
- Discount Management of Provident Fund (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).
- Green Bull Capital Markets Ltd. (hereinafter: "Green Bull")

## TREND OF EVENTS AND DEVELOPMENTS IN THE MACRO-ECONOMIC ENVIRONMENT

**The mutual funds market.** The mutual funds market contracted during 2006 to the tune of 10.5%, from a level of market value of NIS 124.6 billion in December 2005 to a level of NIS 111.5 billion in December 2006. The weight of mutual funds investing in the foreign currency, equity and the convertibles channels increased in 2006, in contrast to the decrease in weight of funds investing in the non-linked channel.

**The provident funds market.** The provident fund market was marked by the continuous trend of diversion of funds towards provident funds managed by private entities.

**Change of ownership.** Soon after the publication of the regulations adopted following the recommendations of

the Bechar Commission, the banks started to sign agreements for the sale of the ownership or the operations of the mutual funds and/or the provident funds management companies, operating within the banking groups to which they belong. In most of the cases transactions were entered into between the banks and the major insurance groups operating in Israel. In the course of 2006 and at the beginning of 2007, a part of the transactions were consummated, while others are still in the process of being completed. In view of the intensity of the change in ownership, the short period of time since such change in ownership (in cases where the sale transaction has been consummated) and the fact that certain of the transactions have not as yet been completed and the activity of the banks as pension consultants has not yet begun, it is not possible to assess the impact of the said events upon the Israeli capital market operation.

**The basket certificate market.** The volume of operations in basket certificates has doubled itself. In 2006, 73 new basket certificates were issued and at the end of the year 4 local share indices basket certificates, 59 international share indices basket certificates, 13 commodities certificates and 3 local bonds basket certificates were traded on the Tel-Aviv Stock Exchange. This variety includes 15 "short" certificates and 6 cover options. In 2006 the trade in basket certificates comprised some 20% of the total trade on the Tel-Aviv stock market, double the average rate in 2005. The sharp increase in activity stemmed from both the issue of new series and the increase in trade turnover in existing series of local indices certificates, comprising about 70% of the total volume of trade in basket certificates.

#### LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE OPERATIONS IN THE CAPITAL MARKET

The main restrictions that are expected to affect the operations are those that will be applied to banks under the legislation enacted following the Bachar Committee recommendations. For details see "Reform in the structure of the capital market in Israel and in the activity of banks and other players in the capital market field" in the section "Legislation and regulation" hereunder, as well as Note 33 to the financial statements.

Among other things, the legislation regularized the following issues:

- The gradual detachment of provident funds and mutual funds from the banks;
- Separation of the activities of a consultant who is not connected to the entities generating the products, and the activities of a promoter who has an affinity to the entities generating the products he sells to customers;
- The gradual entry of the banks into the pension and life assurance product distribution market.

As for details regarding limitations on the deposit and withdrawal of funds with provident funds, in effect as from January 1, 2006, see "Amendment No. 3 to the Income Tax Regulations (Rules for the Approval and Management of Provident Funds)" in the Chapter "Legislation and Supervision" hereunder. For details as to the guidelines regarding information as to the needs and instructions of a customer seeking investment advice and draft regulations regarding the documentation of consulting see "Legislation and Supervision" hereunder.

#### SCALE OF OPERATIONS AND NET INCOME

**Net income** of the operations in 2006 amounted to NIS 365 million, compared with NIS 102 million in 2005, an increase of 257.8%.

Following are the principal data relating to the operations in the capital market (in NIS millions):

	Households		Small businesses		Corporate banking		Middle market banking		Private banking		Total	
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005
Income from financing activities before provision for doubtful debts	4	2	16	1	3	1	2	-	1	-	26	4
Operating and other income	392	369	47	112	18	20	27	35	48	43	532	579
Total income	396	371	63	113	21	21	29	35	49	43	558	583
Operating and other expenses	264	201	28	100	11	17	18	21	33	29	354	368
Income from ordinary operations before taxes	132	170	35	13	10	4	11	14	16	14	204	215
Provision for taxes on income from ordinary operations	58	77	14	8	4	2	4	6	9	8	89	101
Net income	288	82	45	4	8	2	9	8	15	6	365	102
Net income disregarding certain components <sup>(1)</sup>	87	87	24	7	5	2	8	8	9	6	133	110
Average balance of assets	8	10	4	3	29	11	1	-	7	6	49	30
Average balance of liabilities	-	-	-	-	3	3	-	-	-	-	3	3
Average balance of risk assets	289	306	4	50	21	18	1	36	7	9	322	419
Average balance of provident funds and mutual funds assets <sup>(2)</sup>	25,381	29,384	3,499	5,060	207	432	1,525	2,335	1,262	1,069	31,875	38,280
Average balance of securities <sup>(2)</sup>	22,543	12,624	4,347	3,115	25,427	20,504	11,000	11,250	7,489	7,713	70,806	55,206
Average balance of other assets under management	1,283	964	283	244	130	101	554	507	499	502	2,749	2,318

(1) The following components have been disregarded: the privatization bonus, expenses regarding early retirement incentive and the profit on the sale of Ilanot Discount.

(2) Until the exclusion of Ilanot Discount from consolidation, securities of mutual funds managed by Ilanot Discount were included in the average balance assets of provident funds and mutual funds, and following that in the average balance of securities.

#### DATA RELATING TO THE SCALE OF OPERATIONS IN DIFFERENT AREAS:

**Securities.** On December 31, 2006, the balance of securities held for customers amounted to NIS 82.1 billion, including NIS 9.8 billion of non-marketable securities, compared to NIS 70.2 billion as at December 31, 2005, including NIS 9.6 billion of non-marketable securities, an increase of 17%. The said balances include holdings by way of provident funds, branches, investment centers, portfolio managers, the business department of the capital market and the international private banking division. For details as to income from security activities, see Note 24.

**Investment portfolio management.** On December 31, 2006, Tachlit was managing 1,692 investment portfolios, which together were valued at approximately NIS 2,308 million, as compared to 1,757 portfolios valued in total at approximately NIS 1,996 million as at December 31, 2005. The above data point to a decrease of 3.7% in the number of portfolios managed and to an increase of approximately 15.6% in the monetary value of the managed portfolios.

For details as to restrictions imposed on investment portfolio management companies and on the ownership and control thereof by banking corporations in accordance with legislation enacted in the wake of the Bachar Committee recommendations, see Note 33 to the financial statements.

**Basket certificates.** Tachlit has expanded its activities in the basket certificates field, in which it operates in coordination with companies of the Michael Davis Group, and has issued additional such certificates. The total position held by Tachlit in basket certificates amounted, at the end of 2006, to NIS 3,815 million, compared with NIS 1,734 million at the end of 2005, an increase of 120%.

**Provident funds.** As of December 31, 2006, the total value of provident fund assets amounted to NIS 18.34 billion, as compared to NIS 17.3 billion as of December 31, 2005, an increase of approximately 4.05%.

The number of provident fund accounts as of December 31, 2006 was approximately 514.6 thousand as compared to 534.5 thousand as of the end of 2005, a decrease of approximately 3.73%.

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 2006 were as follows: “Tamar” – 7.75%, “Gefen” – 7.70%, “Shikma” – 7.90%, “general severance pay fund” – 7.75%, “Toar” – 7.73%.

“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 4.15% and 16.5%, With the exception of “Eshkolot Foreign Currency”, which recorded a negative return at the rate of 0.64%.

The Articles of “Tamar”, “Geffen” and “General Severance Pay Fund” provident funds state that the Bank has guaranteed each of its members that the provident fund would pay the member no less than the total amount of the deposits made by the member or on his behalf. Therefore, in the event that the total amount to be received by a member from the provident fund, according to his entitlement therein is lower than the total amount deposited by him or on his behalf with the provident fund, the Bank would pay the difference to that member. A similar arrangement also exists with the “Mercantile Central Severance Pay Fund” managed by Mercantile Discount Bank. As a general rule, the amounts accumulated in the said funds significantly exceed the amounts guaranteed by the Bank and Mercantile Discount Bank. In view of the above and based on past experience, the Bank believes that the amounts that the Bank and Mercantile Discount Bank might have to pay in respect of the said guarantees are negligible.

The Articles of Association of the provident funds “Tamar” and “Gefen” and the Articles of Association of “General Severance Pay Fund” have been changed recently, determining that the guarantee of the Bank shall not apply to

members joining the funds subsequent to June 30, 2006 and to accounts opened subsequent to this date.

**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, 2006, total fund assets amounted to approximately NIS 3.8 billion, as compared to approximately NIS 3.6 billion as of the end of 2005, an increase of 5.9%. The number of members was approximately 110 thousand NIS, a decrease of approximately 2.8% in comparison with the number of members as of December 31, 2005.

### DEVELOPMENTS IN THE OPERATIONS

**General.** Concurrently with the legislative process in the wake of the Bachar Committee recommendations, and even more intensely, following the completion of this process, the Bank commenced the examination of the reform in the capital market, the risks faced by the Bank, and the opportunities that it presents the Bank. The Bank began to apply several moves intended to enhance its preparations for capital market activities in the post Bachar Committee era, as detailed hereunder.

**Agreement in Principle for the sale of shares of Ilanot Discount Ltd. and the operations of Discount Management of Provident Fund.** On November 7, 2005, the Bank approached several parties with respect to the possible sale of the Bank's holdings, in whole or in part, in Ilanot Discount Ltd. and in Discount Management of Provident Fund Ltd. (hereinafter: "the Provident Funds"). The said approach included certain conditions precedent. The Bank advised that it does not undertake to accept the highest offer or any particular offer of the offers, and that the Bank reserves the right to change the terms of sale, the process of sale, the determined schedules or totally discontinued the sale process.

On November 9, 2005, an agreement in principle was signed between the Bank and Clal Insurance Enterprises Holdings Ltd., whether itself or by way of a company under its control (hereinafter – "the Purchaser") for the sale of all shares of Ilanot Discount Ltd. and for the sale of the operations of Discount Management of Provident Fund Ltd., as one package, in consideration for NIS 1,310 million, subject to adjustments.

The consideration for the sale of the shares of Ilanot Discount Ltd. was set in the Agreement in Principle to NIS 600 million, subject to adjustments, and the consideration for the sale of the operations of the Provident Funds was set in the Agreement in Principle to NIS 710 million, subject to adjustments.

The Agreement in Principle determined, among other things, that following the consummation of the transaction, the Bank shall provide Ilanot Discount and the Provident Funds with distribution services in consideration for a distribution fee equal to the rate of fees stated in the draft regulations regarding distribution commissions payable by mutual funds and provident funds, respectively, as well as operating services and additional services.

**The sale of the shares of Ilanot Discount.** On April 11, 2006, the Bank, Clal Finance Batucha Management and Investments Ltd. (hereinafter – "the Purchaser") and Clal Insurance Enterprises Holdings Ltd. (both of the IDB Group), signed an agreement for the sale by the Bank to the Purchaser of all the shares of Ilanot-Discount (hereinafter – "the Sales Agreement"). In addition, the Bank is to assign to the Purchaser the right to receive management fees from Ilanot Discount and will also sell to the Purchaser the goodwill it acquired in the field of mutual fund management. In consideration for the above, the Purchaser will pay the Bank NIS 580 million, subject to adjustments that may arise from the difference between the expenses of Ilanot Discount and the actual

payments made to the Bank in the period from January 1, 2006 until date of closing of the transaction, in comparison to the amount of expenses determined in the Sale Agreement.

The sale agreement came into effect on June 18, 2006, after the completion of all conditional terms for its execution. As part of the completion of the sale, the following agreements were signed between the Bank and Ilanot Discount: an operational agreement, according to which the mutual funds managed by Ilanot Discount would gradually be transferred for operation by the Bank, and a distribution agreement (replacing a previous agreement) according to which the Bank would distribute the mutual funds managed by Ilanot Discount.

The Sales Agreement includes, inter-alia, provisions as to additional services that the Bank may provide to Ilanot Discount. The Sales Agreement also stipulates indemnification arrangements between the Bank and the Purchaser under certain circumstances.

Correspondingly with the completion of the sale, the Bank paid IDB and DCMI a sum of NIS 12.5 million, as additional consideration for the 45% of Ilanot Discount shares that it acquired from them in September 2005.

As above mentioned, the profit derived from the sales transaction amounted to approximately NIS 256 million, net after tax, and has been recorded in the financial statements as of net gain from extraordinary items.

**The sale of the provident fund operations.** On January 29, 2007, the Bank and its subsidiary Discount Management of Provident Fund Ltd. (hereinafter: "Discount Provident") signed an agreement with Clal Insurance Company Ltd. (hereinafter: "Clal Insurance") according to which Clal Insurance will acquire from the Bank and from Discount Provident their provident fund management activity (hereinafter: "the sold provident funds") including and additionally, the goodwill acquired in respect of provident fund management, the rights to ownership of the trade names of the sold provident funds, as well as the information, data base, lists of members and actual portfolios; rights and liabilities with respect to the management of all the sold provident funds as well as the assets of the sold provident funds, including the right to receive management fees and other income related to the management of the sold provident funds and all remaining rights and liabilities of the management company with respect to the sold provident funds (hereinafter together: "the assigned rights and liabilities"). The consideration for the assigned rights and liabilities was fixed at NIS 621 million, subject to adjustments in the event of a positive difference between the income of Discount Provident from management fees in respect of the sold provident funds as from January 1, 2007 until the closing of the transaction, and the expenses of Discount Provident as fixed in the sale agreement in respect of the said period.

Concurrently, the parties formulated agreements regarding the terms of distribution, operating and member services to be signed by the parties at the closing of the transaction. Pursuant to these agreements, the Bank will distribute the sold provident funds for a period of ten years, and will also distribute other provident funds managed by subsidiaries of Clal Insurance, and will provide Clal Insurance with operating services with respect to the sold provident funds for a period of five years. In consideration for the distribution services, the Bank will receive a distribution commission according to the maximum tariff stated in relevant legislation. The annual consideration for operating services will be calculated at the rate of 0.1% of the assets of the sold provident funds. As part of the member services agreement, the Bank will provide services to members of the sold provident funds in the period from the closing of the transaction until the date of signing consulting agreements with the members, but not later than December 31, 2007 (hereinafter – "the transition period"), all as stated in the memorandum issued by the Commissioner of Capital Markets. The member services agreement includes adjustment

mechanisms in the event of changes in the provisions of the legislative arrangement with respect to the transition period.

The agreement includes provisions with respect to the transfer of the data base of the sold provident funds and with respect to limited utilization rights of the said data base for the Bank and for Discount Provident. Compensatory arrangements subject to fulfillment of certain conditions were also included in the agreement.

As from the date of closing of the transaction, the Bank will be released from its obligation and guarantee regarding certain payments to members of the sold provident funds relating to their deposit component in nominal terms (hereinafter – “the Bank’s guarantee”) and, insofar as required, Clal Insurance will accept an alternative obligation towards the members (subject to the approval of the Commissioner of Capital Markets).

Closing of the transaction is subject to receipt of relevant approvals required by law or agreement, including: approval by the Commissioner of Restrictive Trade Practices regarding corporate merger, a permit from the Commissioner of Capital Markets for transfer of management of the sold provident funds to Clal Insurance, all matters relating to replacement of the Bank’s guarantee, and any other approval or permit (insofar as required) under and according to any relevant legislation.

The sold provident funds are: Tama, Gefen, General Severance Pay Fund, Shikma, Eshkolot, Toar, Hadas Central Severance Pay Fund and Edmond de Rothschild Discount Overseas.

The Bank estimates that the net gain (after tax) from this transaction will amount to NIS 380 million, subject to adjustments as stated above. The gain will be recorded in the quarter in which the transaction is consummated.

**The sale of KAHAL.** On May 26, 2006, the Bank, Bank Leumu Le’Israel B.M., KAHAL – Employee Training Fund Ltd. (hereinafter – “KAHAL”) and KAHAL Training Fund Management (1996) Ltd. (hereinafter – “KAHAL Management”), entered into an agreement with Migdal Capital Markets Ltd. on behalf of a company controlled by it and Migdal Insurance Holding and Finance Ltd. on behalf of a company controlled by it (hereinafter – “the Purchaser”) for the sale of goodwill, management rights, additional rights and the means of control of the banks in KAHAL, and for the sale of goodwill, operations, assets and liabilities connected to the training funds managed by KAHAL Management, everything in consideration of an amount of NIS 260 million, adjusted for the volume of assets of the training funds sold at date of the closing of the transaction.

The Bank’s share of the consideration amount to approx. NIS 110.5 million (42.5%)

Among other things, it was agreed upon that the Bank would enter into a distribution agreement with KAHAL and with the Purchaser, according to which the Bank shall distribute the training funds in consideration for a distribution commission at the maximum rate specified in the regulations. The closure of the transaction is subject to regulatory approvals being obtained and to the fulfillment of certain conditions.

The Bank estimates that the pre-tax gain to be derived from this transaction may reach approximately NIS 110 million, subject to adjustments, and it would be recognized in the quarter of the closure of the transaction.

**Distribution of mutual funds.** In the first half of 2006, the Bank entered into distribution agreements with most of the companies managing mutual funds. In the second quarter of the year, the Bank commenced charging distribution fees in respect of mutual fund units held by its customers, in accordance with the applying regulations that came into effect on April 1, 2006. According to the said regulations, the Bank will enter into agreements with all mutual funds managers who wish to do so, for the distribution of mutual funds managed by them, in consideration for the payment of distribution fees for this service, at identical rates and payment terms.

**Preparations towards pension consulting.** In view of the changes anticipated in the provident and pension

market and within the framework of the possibilities offered by the recommendations of the Bachar Committee, the Bank is preparing for providing pension advisory services to its customers and has established a head office unit to manage pension consulting. As part of this move, the Bank has absorbed the executives and staff of "Logos Pension Models and Payroll Benefits Ltd.", a company specializing in pension consulting, who were integrated into the pension consulting layout and will lead it.

The process of establishing the layout includes, among other things, the training of a number of the Bank's investment consultants as pension consultants, recruitment of specialized pension consultants, integration of a decision supporting system for pension consultation and support for the distribution of provident and pension product, and the establishment of technical and human working interface.

As part of the Bank's preparation for the distribution in the near future of an array of pension products – such as: provident funds, pension funds and further education funds, and in the more distant future also insurance products – the bank develops of a flexible distribution system, the main duties of which are:

- Establishing an interface between the customer and the companies managing the products, both for the purpose of creating the initial engagement (setup) and for the purpose of current operations, such as: deposits, withdrawals, transfer between products, change of details, etc.;
- Getting feedback from the companies managing these products, aimed for providing up to date information to the customer regarding his products and the balances accumulated to his credit in each;
- Controlling the distribution fees to which the Bank is entitled in respect of the distribution of the products.

Concurrently, the Bank have started entering into agreements with leading entities in the market for the distribution of pension funds managed by them, and with entities distributing provident and further education products, and is conducting negotiations with many additional entities for the signing of distribution agreements of products managed by them.

The Bank will enter the pension advisory services field, after the completion of all pre-conditions determined in the Law, which includes, among other things, the consumation of the transaction for the sale of the provident funds of the Bank, following fulfillment of all conditions precedent determined for this purpose; the closing of the transaction for the sale of KAHAL Fund, following fulfillment of all conditions precedent determined for this purpose; the sale of control of the provident funds of Mercantile Discount Bank.

**Presentation of new services having a leading value in the capital market.** As part of the preparations made by the Bank as regard the capital market operations, the Bank is seeking complementary services having a high added value to customers. The Bank intends making use of its holdings in Green Bull. The Bank owns 20% of the equity in Green Bull, a company specializing in global investment portfolio management. Green Bull signed an agreement for the joint management of investments with CMA, a US corporation showing record yields of US and global investment portfolios.

Green Bull manages the investment portfolios using unique statistical models for choosing companies, business sectors and countries. Furthermore, Green Bull provides "Family office" services, which is a unique consulting service in Israel. This service includes assistance to the customer in forming an overall investment strategy as regards his total assets, a review of his existing investment position (including investments managed by various portfolio managers, various banks, deposits, provident and further training funds, real estate and so forth) and taking action modify existing investments to the desired strategy of the customer.

**An inspection by the Israel Securities Authority and a plan for improvement of the consulting layout.** During the months of January and February 2006, the Israel Securities Authority conducted an inspection at the Bank regarding the sale of structured products.

The audit related to various service systems, in the framework of which, the work of several investment consultants was examined. The audit discovered deficiencies in all matters relating to the observance of the consultation law and the procedures of the Bank, as well as in the control over the operation of the consultants. It has been agreed that the Bank would formulate a plan for improvements in the investment consulting service, for the enforcement of work procedures and for intensifying control in this area, in cooperation and discussions with the Israel Securities Authority.

Following the inspection the Bank has prepared a comprehensive plan for the upgrading of the consultation layout, enhancement of the controls over the consultants activities, the training of consultants and measures for integrating the law and procedures. The plan has been presented to the Securities Authority and is being gradually implemented in cooperation with the Authority.

#### MARKETING AND DISTRIBUTION

The distribution of products and services is undertaken by segment employees through the use of the Bank's existing distribution apparatus, the branch network, investment centers, private banking centers, staff units and the Bank's subsidiary companies. For additional details, see "Consulting services system" in the Section "The retail sector – General" in the Chapter "Activity of the Group according to principle segments of operation" above.

No dependence exists on marketing channels, though attention should be drawn in this respect to the changes described above, following the implementation of the Bachar Committee recommendations.

As stated above, following the new legislation for the implementation of the Bachar Committee recommendations, the Bank is to become a financial and pension consultant independent of the providers of the products, and will distribute a range of financial and pension products.

#### COMPETITION

In the capital market activity, the Bank competes both with other banks and with private brokers.

In the field of financial products competition exists against the consulting entities as well as against the marketing entities (the providers of the products) as regards the sale to customers of one or another financial product.

In the field of pension products the Bank plans to begin during the year pension consulting services activities. This activity requires a continued pension consulting agreement between the consultant or the marketer and the customer. Accordingly, fierce competition is expected regarding the preferences of the customer in an effort to create a long-term relationship, within its framework the Bank is committed to maintain a continuous connection with the customer.

In this respect, competition is expected against all the consulting entities on the one hand and the marketing entities as well as against the providers of the products (insurance companies, insurance brokers, pension funds, etc.) on the other hand.

For details as to the conditions required for entry into the pension-consulting field, see Note 33 to the financial statements.

## GOALS AND BUSINESS STRATEGY

- Completing the procedures required for obtaining a pension consultant license, as discussed above;
- Completing the preparations for pension consulting;
- Completing the preparations for operating as a “supermarket” for financial and pension products;
- Improvement in securities trading by means of the Internet, development of the activity of arbitrage player and capital market players;
- Cultivation and distinction of the status of the investment consultant;
- Providing operating services to provident funds and mutual funds.

## THE MERCANTILE DISCOUNT BANK PLAN FOR THE COMING YEAR REGARDING THE CAPITAL MARKET

**Global investment management.** On January 31, 2007 the Board of Directors of Mercantile Discount Bank approved a plan for the establishment of a subsidiary that will engage in global investment management for institutional, business and private customers interested to divert part of their investments to the international market, without transferring funds abroad.

According to the plan, the subsidiary will be established by Mercantile Discount Bank jointly with other partners. The share of Mercantile Discount Bank in the equity and voting rights of the new subsidiary is expected to be at least 51%.

**Preparation for pension advisory services.** Mercantile Discount Bank started preparations for entry into the pension advisory services market, and is preparing to train investment consultants for this activity. According to understandings reached with the Commissioner of the Capital Market, Insurance and Savings, Mercantile Discount Bank would be permitted to engage in pension advisory services in the interim period (until August 2011), on condition that it does not control a provident fund management company. Mercantile Discount Bank is considering various proposals and possibilities for the disposal of the provident funds under its control prior to the final date determined by Law, as a condition precedent to commencing operations as provider of pension advisory services. Until now, proposals submitted to the bank have not developed into binding agreements and the Mercantile Discount Bank has not as yet adopted a final decision regarding this issue.

The above comprises forward-looking information reflecting the plans of the Bank and plans of Mercantile Discount Bank at date of issue of the financial statements. Delays in fulfilling the conditions required for obtaining a pension consulting license, that might result from reasons not under the control of the Bank and delays in the development of systems supporting the achievement and plans described above, might cause at the end of the day, the non-materialization, in whole or in part, of the plans of the Bank and Mercantile Discount Bank described above. Furthermore, the plans of the Bank may change and their implementation may be delayed because of changes in the competitive environment, changes in preferences of customers and their needs or as a result of changes in regulatory arrangements applying to the Bank and to the other capital market players.

## CONSTRUCTION AND REAL ESTATE ACTIVITY

This activity includes customers of the Bank's various divisions whose industry classification is construction and real estate. This activity also includes customers of the construction and real estate segment of the Mercantile Discount Bank and the loans for the purchase or building of commercial property segment at Discount Mortgage Bank and the building project finance segment at Discount Mortgage Bank.

### MARKET DEVELOPMENTS

**Residential construction projects.** A moderate improvement was evident in 2006 in real estate and construction industries. The volume of investments in residential construction increased by 1.5%, following a continuous decrease during the last five years. Non-residential construction decreased by 5.9%.

The slowdown in activity of residential construction was evident mostly in peripheral areas, due to characteristics of low disposable income of households, relatively high unemployment rates and the decrease in grants to eligible individuals.

Several developments occurred in 2006, which may indicate a moderate and continued improvement in the residential real estate market in central Israel and in preferred areas in the periphery:

Acquisition of luxury apartments by foreign residents continued to increase, concurrently with a significant increase in prices.

Acquisition of land through cash and combination transactions continued to increase in preferred areas in central Israel, also concurrently with a significant increase in prices.

The demand for residential units in preferred areas in central Israel, mainly on the coastal plain, continued to increase, concurrently with a moderate increase in prices, following a long slowdown in this sector.

**Office and commercial income producing property.** Activity in this sector is divided into the office-space and commercial fields.

Demand for prestigious office space increased, particularly in the Tel Aviv and central areas, concurrently with an increase in rental prices following stabilization in the preceding year. The increased demand was sourced in foreign companies, Israeli entrepreneurs and institutional investors, on the background of preparations for entrance into the RIET market.

The commercial sector also evidenced increased demand for quality commercial property on the part of foreign companies and local investors, concurrently with an increase in prices. Many large companies relocated their operations in the residential, office and commercial construction market abroad, in order to benefit from relatively high profitability and rate of return, availability of relatively high levels of finance extended by the financing banks and attractive interest rates.

### LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE ACTIVITY

The limitations described above, with respect to the business segment as a whole, also apply to the construction and real estate activity. Furthermore, it should be noted that 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, 2005 was approximately 16.6%.

### CREDIT POLICY IN THE CONSTRUCTION REAL ESTATE ACTIVITY

The Bank's credit policy is based on the following principles:

- The greater part of the credit facilities made available to the real estate sector will be processed through 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.
- Financing of national infrastructure projects, in conjunction with banks and/or off-banking financing corporations.

**Discount Mortgage Bank** focuses on construction finance of housing projects of small and medium size in preferred areas. The granting of credit for the purchase of income bearing property is made under a strict examination of the quality of the transaction. As detailed in the Chapter "Mortgage and housing loan activity" below, Discount Mortgage Bank considers housing loans as its main line of business.

### SCALE OF OPERATIONS AND NET INCOME

In view of the slow recovery in this sector the Bank has increased its business activity with enterprising construction companies by way of approval of new credit facilities for the purpose of land acquisition and/or the building of residential projects in preferred areas both in central and peripheral regions.

In addition, the business activity has been extended by way of approval of new credit facilities to finance both current and investment operations, according to the Bank's policy.

A reasonable volume and rate of sales were reported in respect of projects in the process of construction.

The shortage in equity capital and cash on the part of some of the contractors contributed to the increased trend of acquiring land through "combination transactions" or by the "vacate and build" system, where the payment for the land is only made upon the completion of the project.

**Net income** from the operations in 2006 amounted to NIS 185 million, of which NIS 159 million domestic operations, compared with income of NIS 66 million in 2005, an increase of 140.9%. Disregarding certain components (see hereunder), net income would have amounted to NIS 202 million in 2006, of which NIS 171 million domestic operations, compared with NIS 68 million in 2005, an increase of 151.5%.

**The return on equity**, calculated on the capital allocated to the operations on the basis of the average balance of operations risk assets, was 14.6% in 2006, of which 19.2% domestic operations, compared with a rate of 7.5% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 15.6% in 2006, of which 20.0% return on domestic operations, compared with 7.7% in 2005.

**Provision for doubtful debts** amounted in 2006 to NIS 103 million, of which NIS 94 million domestic operations, compared with NIS 193 in 2005, a decrease of 51.1%.

Following are the principal data relating to the construction and real estate operations (in NIS millions):

	Small businesses		Corporate banking		Middle market banking		Domestic operations Total		Intenational operations	Total
	2006	2005	2006	2005	2006	2005	2006	2005	2006	2006
Income from financing activities before provision for doubtful debts										
From externals -	77	143	512	561	77	520	666	1,224	43	709
Inter-segmenta -	(27)	(97)	(183)	(295)	(43)	(487)	(253)	(879)	70	(183)
Total income from financing activities	50	46	329	266	34	33	413	345	113	526
Operating and other income	19	12	15	16	7	6	41	34	11	52
Total income	69	58	344	282	41	39	454	379	124	578
Provision for doubtful debts	25	18	51	165	18	10	94	193	9	103
Operating and other expenses	11	15	72	53	6	9	89	77	77	166
Income from ordinary operations before taxes	33	25	221	64	17	20	271	109	38	309
Provision for taxes on ordinary activities	14	12	91	31	7	9	112	53	12	124
Net income	19	14	130	41	10	11	159	66	26	185
Net income disregarding certain components <sup>(1)</sup>	21	15	139	42	11	11	171	68	31	202
Return on equity (rate)	22.7	11.3	18.8	5.9	13.3	15.4	19.2	7.5	5.8	14.6
Return on equity disregarding certain components <sup>(1)</sup> (rate)	23.8	11.7	19.5	6.0	19.7	15.8	20.0	7.7	7.1	15.6
Average balance of assets	2,320	2,244	10,752	11,263	2,639	1,198	15,711	14,705	2,816	18,527
Average balance of liabilities	519	494	1,359	1,299	300	265	2,178	2,058	336	2,514
Average balance of risk assets	1,480	2,083	12,794	11,822	1,795	1,153	16,069	15,058	-	16,069
Components of income from financing activities:										
Margin on credit	36	36	204	226	26	27	266	289	111	377
Margin on deposits	6	7	5	14	2	2	13	23	-	13
Other	8	3	120	26	6	4	134	33	2	136
Total income from financing activities	50	46	329	266	34	33	413	345	113	526

(1) The following components have been disregarded: the privatization bonus and the expenses regarding early retirement incentive.

### CRITICAL SUCCESS FACTORS OF THE OPERATIONS

The critical success factors of the segment include current communication with customers, qualitative service, continued customer satisfaction as regards the quality of service and the financing of projects that had been completed, providing prompt response to applications for credit and other related services. In addition – the offer of competitive terms as regards project financing, the volume of the equity capital required and the financing costs and commissions.

In addition, adequate understanding and mapping of the market is required in order to identify risks/opportunities in various sectors, e.g. standard housing construction, luxury housing construction, rental office and commercial property.

### THE MAIN ENTRY AND EXIT BARRIERS OF THE OPERATIONS

Operations customers conduct business with several banks at any given time, so that the relative advantage of the operations is based upon the long-term relationship of the Bank with its customers, including continued satisfaction as regards the quality of service and the financing of projects. In order to provide quality customer service, highly proficient personnel are required, with comprehensive familiarity with customers of this segment, nature of their activity and analysis of their needs and requirements, while adapting the Bank's products to such needs. In addition, systems are required to monitor and control exposure and risks relating to project financing. The said close-end system of project financing is, prima facie, supposed to allow the construction company to finance each project at another bank.

Nevertheless, considering the fact that surplus created in respect of projects financed by the Bank or current credit facilities allotted to promoters is being used in many cases as capital for leveraging other projects, a certain difficulty exists as regards the transfer from bank to bank, mostly with respect to the small and medium customers.

### ALTERNATIVES TO PRODUCTS AND SERVICES OF THE OPERATIONS AND CHANGES THEREIN

In 2006, large and medium-size real estate corporations continued to raise off-banking finance through share and bond issues, in domestic and foreign capital markets.

Off-banking financing constitutes an alternative financing source for segment customers as to long and medium-term credit used for the financing of investments and/or the purchase of income producing property, while in building projects, customers generally prefer the use of medium-short term bridging finance for the set up period.

### STRUCTURE OF THE COMPETITION PREVAILING IN THE OPERATIONS AND CHANGES THEREIN

Most of the competition prevailing in the operations lies within the banking industry. The off-banking finance comprises, primarily, an alternative long-term financing source required for the construction and/or acquisition of income producing property in Israel and abroad, or as equity capital for the leverage of residential construction projects.

Some institutional entities (insurance companies and pension funds) extend guarantees to apartment purchasers, in accordance with relevant provisions of the Sales Law (Apartments).

### COPING WITH COMPETITION

Providing professional service, timely response and establishment of a comprehensive and ongoing communication system with customers, while maintaining an overall view of their financial needs, constitute the principal means to confront competition successfully.

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.

### PRODUCTS AND SERVICES

**The Bank's project financing department** provides credit to real estate companies according to their particular needs, primarily in the following areas:

1. Financing of housing projects and/or projects involving income-producing property (mainly commercial property the majority thereof is marketed in advance);
2. Credit financing the purchase of income-producing property;
3. Credit for current financing and/or investments;
4. Providing guarantees under the Sales Act to purchasers of dwelling units and performance guarantees to the rights owners in land in the context of combination transactions or clearing and construction transactions.
5. Extending credit to infrastructure projects, mainly in the construction stage.

For further information relating to services provided to segment customers, see above, 'Corporate segment.'

**Discount Mortgage Bank** offers its services to customers through its four branches (in Tel Aviv, Jerusalem, Haifa and the Stock Exchange), as well as through 51 mortgage bank counters located in various branches of Israel Discount Bank Ltd.

**Mercantile Discount Bank.** The construction project financing department, providing services to customers Mercantile Discount Bank engaged in the construction field – construction companies in the real estate segment, including financing under the "closed construction finance" method, for the purpose of executing projects for the construction of buildings (especially housing projects).

### ORGANIZATIONAL CHANGES AT DISCOUNT MORTGAGE BANK

At the beginning of 2006, Discount Mortgage Bank implemented a conceptual organizational change, from the traditional structure of a two segment operation – retail and business, each including in its own sphere of activity: credit, marketing and sales, to a structure including a segment specializing in marketing and sales and another segment specializing in credit management, with two principal operating activities: business activity and sales and marketing activity.

### MORTGAGE AND HOUSING LOAN ACTIVITY

#### 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.

#### DEVELOPMENT IN THE MORTGAGE MARKET

The volume of credit extended by the mortgage banks in 2006, excluding credit from State funds, reached NIS 20,231 million, not including internal refinancing. The volume of credit extended by the mortgage banks in 2005, excluding credit from State funds, reached NIS 24,022 million, including internal refinancing. According to the Bank of Israel's data, the volume of internal refinancing amounted in 2005 to NIS 5,021 million.

Granting of credit from State funds decreased further in 2006 and amounted to NIS 2,110 million (including standing loans and conditional grants in the amount of NIS 0.3 billion), compared with NIS 2,340 million in 2005 (including standing loans and conditional grants in the amount of NIS 0.2 billion), a decrease of 9.9.%.

#### SECTORS OF OPERATION

**Loans for the purchase or building of housing units.** Loans for the purchase or building of housing units (by private individuals). The loans are generally granted to private individuals (households). These loans constitute most of the activity in the mortgage loan field.

**Multi purpose loans secured by a mortgage on a housing unit.** These loans are granted not in the course of purchasing or building of a housing unit but by using it as collateral. Discount Mortgage Bank offers house owners whose property is free of a mortgage or with a relatively low mortgage loan compared to the value of the property, to use the property as collateral for raising funds for use of the household, similarly to the conduct of business entities.

**Providing services to the State.** Discount Mortgage Bank provides entitled individuals, credit and grants out of State funds according to guidelines of the Ministry of Construction and Housing and the Accountant General at the Ministry of Finance. The volume of this operation is diminishing due to the policy of the Finance Ministry to reduce the scope and advantage of the loans to entitled individuals.

In recent years, the Accountant General reduces the commission paid to the banks for handling loans to entitled individuals. The said reduction in commission rates caused the commission income of the Group in respect of new loans from State funds to become immaterial. The agreement between Discount Mortgage Bank and the Ministry of Finance as regards loans to entitled individuals was supposed to expire on June 30, 2006. In May 2006, the Ministry of Finance informed in a letter of the extension of the agreement for an additional year, up to June 30, 2007. The Ministry of Finance has not yet announced whether it intends to publish a new public tender in the matter or renew the existing agreement.

The activity regarding the granting of rent subsidies from State funds to entitled borrowers, in accordance with directives of the Ministry of Construction and Housing and the Accountant General's department at the Ministry of Finance, which was implemented in previous years by the mortgage banks, including Discount Mortgage Bank, ceased on July 1, 2006, and was transferred to non-banking entities.

Discount Mortgage Bank estimates that the termination of its operation in providing the above services would reduce its operating income by an annual amount of NIS 3 million (about NIS 1.5 in 2006). This estimate is considered "forward-looking information". The above estimate is based on actual income data. This estimate may not materialize, among other things due to longer reaction times than expected and so forth.

**Mortgage related insurance.** As an additional security for credit granted by Discount Mortgage Bank, this bank

requires its customers to purchase property insurance and in some of the cases life assurance.

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 was anchored in legislation, 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.

For many years, Discount Mortgage Bank offered its customers to purchase insurance by means of that bank, serving as an insurance brokers for this purpose. The customer could choose using the services of that bank or of any other insurance agent. As from January 1, 2006, Discount Mortgage Bank no longer offers the sale of these insurance schemes as a broker.

Discount Mortgage Bank formed a subsidiary, **Discount Mortgage Home Insurance Agency (2005) Ltd.**, which acts as an insurance broker. This subsidiary operates independently and sells insurance through a telephone service separate from that bank's telephone service. Discount Mortgage Bank believes that this subsidiary will show operating losses in the first years of operation. In 2006, the insurance agency's losses amounted to NIS 802 thousand.

The transition of the sale of insurance from the Discount Mortgage Bank to an insurance broker owned by that bank, is expected to adversely affect the operating income in the mortgage field, though it is not possible to assess the volume of such effect. Discount Mortgage Bank continues to maintain the existing customer insurance portfolio.

According to the Supervisor of Banks' directives, as from 2007 property insurance of borrowers will not include third party liability. At this stage, Discount Mortgage Bank is unable to estimate the effect of this change.

Some of the information given in this section is "forward-looking information". As to the meaning of this term, see above in the Section "Forward-looking information".

### SCALE OF OPERATIONS AND NET INCOME

**Net income** from the operations in 2006 amounted to NIS 28 million, compared with NIS 33 million in 2005, a decrease of 15.2%. Disregarding certain components (see hereunder), net income would have amounted to NIS 31 million in 2006, compared with NIS 33 million in 2005, a decrease of 6.0%.

**The return on equity**, calculated on the capital allocated to the operations on the basis of the average balance of operations risk assets, was 5.4% in 2006, compared with 5.6% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 5.6% in 2006, compared with 5.6% in 2005.

**Provision for doubtful debts** in 2006 to NIS 19 million, compared with NIS 52 in 2005, a decrease of 63.5%.

**Provision for doubtful debts in accordance with the extent of delinquency.** On January 1, 2006, Bank of Israel published guidelines with respect to calculating the provision for doubtful debts of credit to the public. In practice, Discount Mortgage Bank had already applied most of the provisions of the new guidelines so that its effect on the doubtful debts provisions recorded by Discount Mortgage Bank in the financial statements for December 31, 2006, was minor, increasing the provision by only NIS 1 million.

Following are the principal data relating to the mortgage and housing loan operations (in NIS millions):

	Households		Small businesses		Middle market		Total	
	2006	2005	2006	2005	2006	2005	2006	2005
Income from financing activities before provision for doubtful debts from externals	159	219	25	37	23	44	207	300
Inter-segmental	(43)	(80)	(6)	(16)	(15)	(38)	(64)	(134)
Total income from financing activities	116	139	19	21	8	6	143	166
Operating and other income	48	55	2	3	-	1	50	59
Total income	164	194	21	24	8	7	193	225
Provision for doubtful debts	18	32	-	7	1	13	19	52
Operating and other expenses	86	81	12	9	1	1	99	91
Income from ordinary operations before taxes	60	81	9	8	6	(7)	75	82
Provision for taxes on ordinary activities	26	30	4	2	3	(4)	33	28
Net income (loss)	22	35	3	3	3	(3)	28	35
Net income (loss) disregarding certain components <sup>(1)</sup>	24	35	3	3	4	(3)	31	33
Return on equity (rate)	5.1	7.2	4.7	3.9	9.9	(9.6)	5.4	5.6
Return on equity disregarding certain components <sup>(1)</sup> (rate)	5.3	7.2	4.7	3.9	9.9	(9.6)	5.6	5.6
Average balance of assets	9,704	9,365	1,182	1,288	629	535	11,515	11,188
Average balance of liabilities	2,418	2,293	276	291	-	-	2,694	2,584
Average balance of risk assets	7,525	8,174	1,185	1,306	642	534	9,352	10,014
Average balance of other assets under management	2,269	2,282	-	-	-	-	2,269	2,282
Components of income from financing activities:								
Margin on credit	74	139	12	21	6	6	92	166
Margin on deposits	1	-	-	-	-	-	1	-
Other	41	-	7	-	2	-	50	-
Total income from financing activities	116	139	19	21	8	6	143	166

(1) The following components have been disregarded: the privatization bonus.

**Restriction on the credit concentration in a particular segment.** Proper banking Management Directives require an additional provision in respect of credit concentration as regards housing loans, in the event that the balance of housing loans in respect of which a provision based on the extent of default has been recorded, net of such a provision, exceeds 1.5% of the total balance of housing loans. As of December 31, 2006, the said rate at Discount Mortgage Bank amounted to 2.85%, and the provision required in this respect amounted to NIS 3.4 million.

## MARKETING OF MORTGAGE PRODUCTS

Discount Mortgage Bank serves its customers through three branches (in Tel Aviv, Haifa and the Stock Exchange branch) and through 51 counters located inside branches of Israel Discount Bank Ltd.

Discount Mortgage Bank engages in the marketing and advertising of its many and varied products, customizing them to the changing requirements of the public, to changing economic conditions and to market trends.

Discount Mortgage Bank continues to constantly examine new and original ways of customizing its products to public needs. In this respect, for instance, Discount Mortgage Bank launched in February 2006 a campaign for the product "Buy a house at the price of paying your rent". This integrated product offers the potential customer to turn from a tenant to a house owner both as regards the variety of mortgage channels suitable to his needs during the transition as well as the arrangements made by the bank with a line of leading building companies, who offer a variety of dwelling units for sale and participate in part of the cost of the mortgage.

Alongside this, the bank expands its activity with varied populations, such as: purchase groups, foreign residents, the Jewish Orthodox sector, students, VIP's and others.

Housing loans in Mercantile Discount Bank are currently granted through 13 specialized branches of this bank. Following a renewed study of this subject, performed during the reported period, the Management of Mercantile Discount Bank has decided to gradually increase the number of branches specializing in this field over a period of three years.

## INTERNATIONAL OPERATIONS

### GENERAL

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

### LEGISLATIVE RESTRICTIONS, REGULATIONS AND SPECIAL CONSTRAINTS APPLICABLE TO THE INTERNATIONAL OPERATIONS

The principal restrictions applicable to the international operations are briefly described below:

**Exposure restriction with regard to overseas extensions.** 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, 2006, the calculated rate of exposure of the Bank with respect to overseas extensions stood at 36.95%, as compared to a rate of 40.78% on December 31, 2005.

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.

For details of the investigation regarding matters relating to the prohibition of money laundering, conducted at IDB New York, see "Discount Bancorp Inc." under "Main investee companies" and Note 6 D to the financial statements hereunder.

#### SCALE OF OPERATIONS AND NET INCOME

**Loss** in 2006 amounted to NIS 1 million, compared with net income of NIS 227 million in 2005. Disregarding certain components (see hereunder), net income would have amounted to NIS 63 million in 2006, compared with NIS 294 million in 2005, a decrease of 76.1 %.

**The return on equity** in 2006, calculated on the capital allocated to the international operations on the basis of the average balance of segment risk assets, was 0.1% in 2006, compared with 16% in 2005. Disregarding certain components (see hereunder), the return on equity would have been 4.0% in 2006, compared with 22.2% in 2005.

**Provision for doubtful debts** amounted in 2006 to NIS 20 million, compared with NIS 38 in 2005, a decrease of 47.4%.

Following are the principal data relating to the international operations (in NIS millions):

	2006					Total	2005 Total
	Households	Corporate banking	Middle market banking	Private banking	Other		
Income from financing operations before provision for doubtful debts	2	271	177	214	162	826	948
Operating and other income	1	30	20	54	20	125	124
Total income	3	301	197	268	182	951	1,072
Provision for doubtful debts	-	11	7	2	-	20	38
Operating and other expenses	2	235	157	237	156	787	768
Income from ordinary operations before taxes	1	55	33	29	26	144	266
Provision for taxes on ordinary operations	-	25	16	17	87	145	39
Net income	1	30	17	12	(61)	(1)	227
Net income disregarding certain components <sup>(1)</sup>	1	50	30	29	(47)	63	294
Return on capital (rate)	2.7	6.2	5.9	9.4	(9.2)	(0.1)	16.0
Return on capital disregarding certain components <sup>(1)</sup> (rate)	2.7	10.1	10.0	25.1	(7.1)	4.0	22.2
Average balance of liabilities	70	5,975	2,082	19,664	12,489	40,280	40,209
Average balance of assets	60	9,527	4,829	2,304	25,517	42,236	45,277
Average balance of risk assets	59	7,236	4,268	1,759	10,972	24,294	23,577

(1) The following components have been disregarded: expenses regarding early retirement incentive, payments to the supervisory authorities in the U.S. and the cost of implementing the improvements and the examinations in IDB New York.

## 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.

## TARGETS AND BUSINESS STRATEGY

**Switzerland.** The Bank initiated an expansion of its operations in Switzerland, either directly and/or through Discount Bank (Switzerland), by way of acquiring a local corporation engaged in the banking field.

The due diligence review of a local corporation, as aforesaid, has been completed. The completion of the transaction is, among other things, subject to obtaining the necessary approvals and to the signing of an agreement. The Bank started negotiations towards the signing of an agreement for the acquisition of the shares.

**London.** The approval of the regulatory authorities in the U.K. has recently been received, according to which, the London branch would be permitted to expand its activity in the field of private banking, including investment advisory services for customers, investment portfolio management, etc.

**IDB New York.** The Board of Directors of IDB New York has recently approved several steps, as follows:

- The reorganization of IDBNY Realty Reit. This reorganization is intended to allow IDB New York to file consolidated income tax returns to the tax authorities of the State of New York and to the City of New York.
- IDB Capital Corp. This company is a wholly owned subsidiary of IDB New York, which operated as a broker/dealer in the capital market. A change in its organizational structure has been decided upon, according to which ownership of IDB Capital Corp. would be transferred to Bancorp. Concurrently, it has been decided to appoint Ms. Alexandra Lebenthal as President and CEO of the company. The company is to focus, inter alia, on the municipal capital market and on the providing of wealth management services.  
It should be noted that Ms. Lebenthal is a member of the Board of IDB New York.
- A reorganization of the representative offices in Latin America, which would be directly subordinate to Bancorp. The aim is to change the character of the representative offices from activity as customer management to customers who have an account in the U.S. to the activity of sales and marketing, as to all companies in the Discount Group.

The said steps are subject to the approval of the regulatory authorities abroad and in Israel and to the approval of the Bank's Board of Directors.

#### SERVICE TO SEGMENT CUSTOMERS

**Europe.** 2006 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, two branches in California and one branch in the Cayman Islands. IDB Bank has an Uruguayan banking subsidiary, Discount Bank (Latin America), and representative offices situated in various centers in South America.

#### SERVICES AND PRINCIPAL PRODUCTS OF IDB BANK

**Credit** – IDB Bank, and its leasing subsidiary, provides financing to a variety of US based corporations and also, at times, to the principals of these privately held companies. The leasing subsidiary provides equipment financing to IDB customers and 3rd party lessors as well as to lessees of vendor programs through Fleetwood.

**Middle Market** – 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 diamonds and jewelry, apparel and accessories, food, finance companies, retail, not-for-profit, sports and entertainment. The biggest increases have been in New York (upper middle market and

syndication loans), California (upper middle market and syndication loans) and Florida (25%) with the addition of two new branches in both Los Angeles and Boca Raton.

**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.

The distinction between asset-based loans and other secured loans resides in the amount of monitoring required to ensure the existence, value and integrity of the collateral. It is this constant collateral appraisal and field process that functionally differentiates asset based loans from other secured commercial loans.

**Factoring** – Since its inception just six years ago, IDB Bank 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. It should be noted that a well known factoring executive has joined IDB Bank in order to initiate asset based lending activity in Canada.

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

**Trade & Finance** – 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 Amending 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 International Private Banking customers. Officers of the International Private Banking Department are also licensed representatives of IDB Capital Corp.

**U.S. Private Banking** – 2006 was a year of moderate 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 have doubled. 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 that provided its U.S. and international clients with compelling opportunities for upside gain, without risk to principal. 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 2006, versus less than one-third at year-end 2003..

**Deposits** – The largest part of IDB New York's customer deposits, approximately 85%, are from residents of Latin America. These same depositors vary their investment patterns between deposit based products offered by IDB Bank and investing with IDB Bank's brokerage subsidiary; dependent upon interest rates and maturities vs. opportunities in the bond and equity markets.

**International Banking** – This department continued in 2006 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.

## 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, 2006, amounted to NIS 6.6 billion, compared with NIS 6.4 billion on December 31, 2005.

Following is the distribution of net income (loss) by main operating segments (in NIS millions):

	Contribution Disregarding		the effects of coverage	
	2006	2005	2006	2005
	Contribution to Group's results		of investment <sup>(*)</sup>	
	2006	2005	2006	2005
	In NIS millions			
<b>Banking Activity:</b>				
Commercial banks:				
In Israel - the Bank				
(including branches overseas)	95	(228)	(29)	(143)
- Mercantile Discount Bank	60	113	60	113
- First International Bank	133	122	133	122
Overseas - Bank offices	(138)	307	(14)	222
Discount Mortgage Bank	23	17	23	17
<b>Other Activities:</b>				
Israel Credit Cards	55	42	55	42
Other financial services	87	84	87	84
Total operating (gain) loss	315	458	315	458
Income (loss) from extraordinary operations	521	-	521	-
Net gain (loss)	836	458	836	458

(\*) 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 2006, the shekel was devalued in real terms as against the US dollar by 8.2%, compared with an appreciation of 6.8% in 2005. In 2006, the shekel was appreciated in real terms against the Swiss Franc by 0.8%, compared with a devaluation of 8.1% in 2005. The said devaluation resulted in a decrease in the Bank's net operating income after tax in Israel by NIS 123 million, compared with an increase of NIS 85 million in net operating income in 2005. 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 2006, 19% of all assets in the consolidated balance sheet were assets of consolidated companies in Israel, and 25.5% were assets of overseas consolidated companies and branches. The contribution to the net results by the consolidated companies in Israel totalled NIS 182 million in 2006 (in 2005 the contribution totalled NIS 205 million). The contribution to the net results by overseas consolidated companies totaled in a loss of NIS 138 million in 2006 (in 2005 the contribution totalled NIS 305 million), and the contribution to the net results by affiliated companies totalled NIS 178 million in 2006 (in 2005 the contribution totalled NIS 172 million).

The total contribution by both domestic and overseas investees companies to the net results of the Bank amounted to NIS 223 million in 2006, compared with NIS 684 million in 2005, a decrease of 67.4%.

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 2006, would have been NIS 346 million, compared with 799 million in 2005, a decrease of 42.2%.

**Sale of main investee companies.** As part of its preparations for capital market activity in the post- Bachar Committee era, in 2006 the Bank sold its holdings in two main investee companies:

- Ilanot Discount was a subsidiary of the Bank that engaged in mutual funds management. In June 2006, the transaction for the sale of all the shares in Ilanot Discount came into effect. For further details see "Capital market activity" under "Further details as to activity in certain products" above and Note 6 E to the financial statements.
- Harel constituted an associated company of the Bank, the investment in which was considered a strategic investment intended to diversify the Bank's income sources. In November 2006, the transaction for the sale of 10.1% of the share capital of Harel came into effect. The Bank was granted the option to sell the balance of its holdings in Harel (5.9%). For further details see "Non-financial companies sub-segment" under "Activity of the Group according to principal segments of operations" above and Note 6 H to the financial statements.

## DISCOUNT BANCORP, INC.

Discount Bancorp, Inc. (hereinafter: "Bancorp") is a holding company fully owned by the Bank. Bancorp fully owns and controls Israel Discount Bank of New York (IDB New York). IDB New York is the largest Israeli bank operating overseas.

Pursuant to Bancorp's Certificate of Incorporation and By-Laws, IDB New York may not be sold by Bancorp unless the Bank has given its prior written consent thereto. A legend to this effect appears on the share certificate of IDB New York.

**Total assets** at the end of 2006 amounted to US\$8,822 million, compared with US\$9,121 million at the end of 2005, a decrease of 3.3%.

**Total credit** at the end of 2006 was US\$3,120 million, compared with US\$2,775 million at the end of 2005, an increase of 12.4%.

**Total deposits** stood at US\$6,937 million as at the end of 2006, compared with US\$6,613 million at the end of 2005, an increase of 4.9%.

**Shareholder's equity** totalled US\$582 million at the end of 2006, compared with US\$554 million at the end of 2005, an increase of 5.1%.

**The ratio of capital to risk assets** was 11.88% as at December 31, 2006, compared with 11.85% at December 31, 2005.

**Net income** in 2006 totalled US\$28 million, compared with US\$46 million in the preceding year, a decrease of 39.1%.

The deterioration in the results derives, mainly, from an increase in payroll expenses following the retirement of members of management, and from a provision in respect of the encouragement of early retirement plan relating to some 120 employees as well as from the increase in the provision for unrealized losses on operations in derivatives and from the cost of carrying out improvements and examinations (see "An investigation regarding matters relating to the Prohibition of Money Laundering Laws" hereunder). On the other hand, the provision for payments to the supervisory authorities in the U.S. was decreased by US\$4.5 million, following the determination of the final amount to be paid in October 2006 (see hereunder).

**Return on equity** was 5.1% in 2006, compared with 8.6% in 2005.

**The contribution of the Bank's investment in Bancorp to the net results of the Bank** was a loss of NIS 140 million in 2006 (after deducting a provision for additional taxes of NIS 23 million that applies to the Bank in Israel), compared with NIS 310 million in 2005 (after deducting provision for additional taxes of NIS 58 million that applies to the Bank in Israel).

The said contribution is comprised of Bancorp's net income in 2006 (after deducting the provision for tax as aforesaid) of NIS 72 million disregarding exchange rate differentials on the investment of NIS 212 million, compared with net income of NIS 159 million (after deducting a provision for taxes as aforesaid) and disregarding exchange rate differentials on the investment of NIS 151 million in 2005.

Together with exchange rate differentials on the said investment, the Bank in Israel recorded financing expenses in 2006 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.

**An investigation regarding matters relating to the Prohibition of Money Laundering Laws.** The New York County District Attorney's Office conducted in 2005 an investigation with respect to several banks and financial institutions, regarding matters pertaining to the transfer of funds from a third country and in matters relating to duties imposed by anti money laundering laws and regulations, including the conduct of IDB New York in these matters.

Concurrently, a mutual examination performed by the New York State Banking Department ("NYSBD") and the FDIC discovered many deficiencies in the efficiency in the systems of control and reporting of matters regarding the prohibition of money laundering and prevention of financing of terror at IDB New York. Following these findings, the NYSBD and the FDIC, impose a Cease and Desist order on IDB New York. These orders require IDB New York to, among other things, refrain from operating with its deficient procedures, correct these deficiencies, reinforce control and supervision processes, establish an enforcement plan and correct the procedures related to these matters, all in the manner and dates determined by the said authorities.

On December 15, 2005, IDB New York consented to the entry of these orders. The Cease and Desist orders required, among other things, that the Board of Directors of IDB New York would appoint an independent entity that would examine the actions adopted by the senior management for the correction of the deficiencies found by prior inspections; that an overall plan be formed, adopted and implemented to assure compliance with the provisions

of law and the principles governing matters of prohibition of money laundering and the financing of terror, which would relate, inter-alia, to control systems, training programs, audit program and the appointment of an executive in charge of compliance with the said laws and principles; that a compliance committee be appointed of members of the Board of IDB New York, which would monitor the implementation of the requirements stated in the Cease and Desist orders. In addition, IDB New York is to be charged with the payment of an amount not exceeding US\$16.5 million, which is to be paid to the Superintendent of Banks of the State of New York, to the FDIC and to the FinCEN. In 2005, a provision was recorded in the full amount. In October 2006, the final amount that IDB New York will have to pay was determined at US\$12 million. Accordingly, the provision for payments to the supervisory authorities in the U.S. was decreased in 2006 by US\$4.5 million.

Discount Bank, as the parent company of IDB New York, has declared that it is aware of the said arrangements and that it has taken upon itself to act to the best of its ability to assure the fulfillment of the above commitments.

Concurrently and in addition, IDB New York reached an agreement on December 15, 2005, with the District Attorney of the County of New York for the termination of the inquiry by way of settlement. In the agreement IDB New York has undertaken to cooperate with the District Attorney of the County of New York. Furthermore, IDB New York has recognized the facts relating to certain accounts, and to the fact that the internal controls and the procedures of the bank as well as its treatment of the matters relating to the prohibition of money laundering contributed to the findings of the District Attorney of the County of New York. According to the terms of the agreement, IDB New York has undertaken to pay an amount of US\$8.5 million, as well as to report to the District Attorney of the County of New York within one year, as to all the actions taken to improve the procedures of the bank and to correct the deficiencies found both by the District Attorney of the County of New York and by the bank regulatory authorities, as detailed in the abovementioned Cease and Desist orders. In 2005, a provision was recorded in the full amount. The District Attorney of the County of New York has agreed not to sue IDB New York and its related companies with respect to the investigation.

The Management of IDB New York has begun implementing the requirements included in the Cease and Desist orders and in the cooperation agreement with the District Attorney of the County of New York, and these are being implemented in accordance with the schedule, as required. IDB New York was required to act in three dimensions: the first one – the preparation of a comprehensive enforcement plan for performing the Cease and Desist orders. For this purpose, IDB New York engaged the services of KPMG. The second one – examination of the activities of senior management with regard to the implementation of prior inspection findings. For this purpose, the services of Promontory were engaged. The third layer, examination of all transactions conducted by IDB New York during the years 2002-2005 (“look back”) in order to identify operations deemed to be suspicious, and as such requiring report.

On April 5, 2006, Promontory presented IDB New York with a report summarizing the findings of the Cease and Desist examination conducted by it.

The report describes the circumstances and the deficiencies that led, in the authors’ opinion, to the issuance of the Cease and Desist orders and to the examination by the District Attorney. In addition, the report includes a series of recommendations for improvements and changes, which in the opinion of the authors of the report are vital for the prevention of similar failures in the future. According to the report, the major part of the

recommendations had already been implemented by IDB New York. The failures and deficiencies indicated in the report are mostly reporting and supervisory failures, some of which derive from deficient internal organization communication and deficient communication with the regulatory authorities, some of which due to an organizational structure in need of change (which has already been carried out, and certain of which, as stated, due to weakness in the supervisory and control tools.

In consequence of this report, the Board of Directors of IDB New York decided to appoint a sub-committee to discuss the recommendation of the report concerning the performance of the Board of Directors. The committee of the Board of Directors has discussed the recommendations of the report in as far as they relate to the activities of the Board, and has prepared an analysis of the measures that had been and will be taken. Management of IDB New York was also required by the Board of Directors to present to the Board a detailed program for the implementation of the recommendations of the report.

On February 6, 2006, The Board of Directors of the Bank decided to recommend to the Board of Directors of IDB New York to appoint Mr. Reuven Spiegel as President and CEO of IDB New York in place of Mr. Arie Sheer. On February 23, 2006, the Board of Directors of IDB New York decided to terminate the office of Mr. Arie Sheer and to appoint Mr. Reuven Spiegel as President and CEO of IDB New York. (For details regarding a lawsuit filed by Mr. Sheer, see below "Further legal proceedings to which the Bank is a party" under "Legal proceedings").

IDB New York continues with its timely filing of quarterly AML/BSA progress reports to the Superintendent of Banks of the State of New York and to the FDIC. In October 2006, the Superintendent of Banks of the State of New York and the FDIC informed IDB New York that the Look Back Methodology Report appears reasonable.

The Internal Audit Department of IDB New York continues its role to oversee and monitor the status of all the corrective actions implemented following the Promontory Report. As on the date of the publication of the financial statements, 90% of the Report's items have been completed.

During the first months of 2006, IDB New York continued to reinforce the controls and procedures, as required by the Cease and Desist orders of the FDIC and of the NYSBD and by the cooperation agreement with the District Attorney of New York. The financial statements as of December 31, 2005, include a provision of NIS 120 million in respect of fines and consulting fees.

The cost of implementing the improvements and of the examinations during 2006 amounted to US\$16.1 million. It is estimated by IDB New York that the additional cost of improvements and examinations will amount to an amount of approximately US\$9 million in 2007. At the meeting of the Board of Directors of IDB New York convened in February 2007, the outside Counsel advising IDB New York on regulatory matters, drew the attention of the Directors to their responsibility to supervise the relations between the shareholders and their representatives on the Board of Directors of IDB New York in order to ensure that the progress made by the bank in the implementation of the Cease and Desist orders are not impaired.

**Examination report for the year 2005.** The Banking Department of the State of New York and the FDIC have completed their examinations at IDB New York for the year 2005. At a meeting held at the beginning of 2007, the following findings were reported: a significant improvement had been noted at the bank in all regulatory matters, though there was still room for improvement. The general mark awarded to the 2005 report was "requires improvement" (3). The written report is expected to be delivered at the end of March 2007.

**The examination at Discount Bank Latin America ("DBLA").** Following the above examination procedures,

performed by the Authorities at IDB New York, an examination was performed in December 2005 at DBLA by the Central Bank of Uruguay.

Following this examination, a fine of US\$41,000 was imposed on DBLA and recommendations for regularizing its operations were issued: namely, procedures for reporting suspicious transactions, installation of electronic systems for identification and the alert of suspicious transactions, improvement of the manner of documentation and keeping customer data and the closing down DBLA's representative offices in Peru, Brazil, Argentina and Mexico. Following the examination, DBLA hired the services of KPMG, which formed a plan for improving its preparations for the implementation of money laundering prohibition rules. Most of the recommendations have already been implemented. The process of closing down the representative offices and/or reorganizing them under Bancorp is not complete yet.

**Material deficiencies in the internal control.** As reported to the Bank, the Management of IDB New York reported to the audit committee in the meeting approving the financial statements of IDB New York as of December 31, 2005, that no material weaknesses had been identified in the internal control, except for controls regarding the compliance with the Bank Secrecy Act (BSA) and the Anti-Money Laundering Act (AML).

In order to properly relate to control issues regarding BSA and AML, IDB New York established a compliance committee (hereinafter – “the committee”), composed of three external directors and also appointed a new officer in charge of BSA/AML. The committee reports to the board of directors on a monthly basis and a set of rules was established for the compliance committee as well as definition of duties for the officer in charge of BSA/AML. The board of directors also approved on February 7, 2006, the compliance plan for BSA/AML and distributed it on February 23, 2006 to all employees of IDB New York. The new officer in charge of BSA/AML took office on January 16, 2006, and he also serves as a member of the compliance committee and reports to the board of directors, to the audit committee and to the president and CEO.

According to what has been stated at the meeting of the Audit Committee approving the financial statements of IDB New York as of December 31, 2006, Management of IDB New York reported that no material weaknesses in the internal control had been identified, and that all material weaknesses identified in 2005 had been corrected.

**Material weaknesses in the internal control over financial reporting.** Within the framework of the report of IDB New York in accordance with the rules of the Federal Insurance Corporation Improvement Act (FDICIA) (which IDB New York was granted an extension for its submission until June 30, 2006), the new Management of IDB New York, appointed following the change in control of the Bank, reported that it had identified material weaknesses in the internal control over the financial reporting as of December 31, 2005. The Bank has been informed that these weaknesses are on the background of and following the letters of instruction issued by the regulatory authorities in the United States in December 2005.

The independent auditors of IDB New York informed that the identified material weaknesses have no effect on their unqualified opinion on the financial statements as of December 31, 2005, which was issued on March 20, 2006, and that they had been taken into consideration in determining the scope of the audit of the financial statement for 2005.

The identified weaknesses, in respect of which the new Management of IDB New York has already undertaken corrective measures, relate to the following matters: proper controls as defined by COSO; insufficient expertise of the accounting staff in application of Accepted Accounting Principles in the United States; ineffective policies

and procedures for the preparation, review and analysis of accounts reconciliation; policies and procedures and manpower ensuring the due preparation of accurate and reliable financial statements.

### MERCANTILE DISCOUNT BANK LTD.

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

At the end of 2006, Mercantile Discount Bank operated through 65 branches, compared with 63 branches in 2005.

**Total assets** at the end of 2006 amounted to NIS 17,280 million, compared with NIS 16,813 million at the end of 2005, an increase of 2.8%.

**Total credit** granted to the public at the end of 2006 was NIS 12,646 million, compared with NIS 13,024 million at the end of 2005, a decrease of 2.9%.

**Total deposits** from the public at the end of 2006 amounted to NIS 14,484 million, compared with NIS 14,119 million at the end of 2005, an increase of 2.6%.

**Shareholder's equity** at the end of 2006 amounted to NIS 1,160 million, compared with NIS 1,055 million at the end of 2005, an increase of 10.0%.

**The ratio of capital to risk assets** was 12.7% as at December 31, 2006, compared with 12.2% as at December 31, 2005.

**Net income** was NIS 61 million in 2006, compared with NIS 111 million in 2005, a decrease of 46.9%.

The deterioration in the business results of Mercantile Discount Bank in the first nine months of 2006 resulted from the bonus granted by Mercantile Discount Bank to its employees and from the accounting treatment of the related part of the State's bonus to employees of Mercantile Discount Bank (see – "The accounting treatment of the Employee Agreement", in Note 32 to the financial statements) (hereinafter, together – "the privatization bonus"). Disregarding the effect of the privatization bonus, net earnings for 2006 would have reached NIS 94 million.

**Return on shareholders' equity** in 2006 was 5.8%, compared with 11.7% in 2005. Disregarding the effect of the privatization bonus, the return on equity would have reached an annualized rate of 8.9%.

**Issuance of deferred capital notes.** On August 23, 2005, Mercantile Hanpakot Ltd., a subsidiary of Mercantile Discount Bank, successfully completed issuing NIS 200 million of deferred capital notes (series A), out of a series of a total of NIS 300 million which were listed for trading on the Tel-Aviv Stock Exchange. Ma'alot rated the said capital notes as "AA-". Mercantile Discount Bank received the approval of the Supervisor of Banks to have the said capital notes included as Mercantile Discount Bank's second tier capital. (Accordingly, the said capital notes are considered second tier capital for the purpose of calculating the bank's capital ratio). Up to December 31, 2006, Mercantile Discount Bank raised additional secondary capital out of the same series of NIS 4 million.

**Investigation of suspected employee violations of the Prohibition of Money Laundering Law.** On March 7, 2006, police arrived at the Ramla Branch of Mercantile Discount Bank and detained the branch manager, his deputy and another employee, on suspicion of violations of the Prohibition of Money Laundering Law.

It should be mentioned that over a several month prior to the said date, an undercover investigation was conducted in this matter, with the knowledge of some of the members of the of Mercantile Discount Bank's management, who assisted the Israel Police investigation as required, and who signed a "non disclosure agreement" relating to this investigation so as to prevent disrupting its process.

Four of Mercantile Discount Bank's employees connected with the branch were detained for four days during the investigation, and several other employees were interrogated, including four members of Mercantile Discount Bank's management, among whom was the President and CEO. In addition, according to a Court order, the activity of several accounts of customers of the branch with an insignificant volume of credit was frozen.

To the best knowledge of the Bank and Mercantile Discount Bank, the investigation in this matter has been largely completed and the material has been passed to the State Prosecutor Office. However, to the best of the Bank's and Mercantile Discount Bank's knowledge, the suspicions involve a number of employees and not Mercantile Discount Bank itself. In view of the above, the managements of the Bank and Mercantile Discount Bank are of the opinion that the investigation will not have a material impact, if at all, on the future financial results of Mercantile Discount Bank and/or the Bank.

**Cooperation enhancement.** During the reported period, Mercantile Discount Bank, in conjunction with the Bank, launched a survey in the framework of which operational procedures at the two banks are being mapped. The aim of the survey is to examine the possibility of cooperation enhancement between the two banks regarding various operational and administrative procedures, with a view of improving the service level and the efficiency of work procedures. The implementation of joint processes has begun in areas found suitable for tightening the cooperation, or work plans for their future implementation have been prepared, and activity for locating additional areas for cooperation is continuing.

See Note 19 C to the financial statements, article 15.2 as regards a request for approval of an action as a class action suit against Mercantile Discount Bank in the matter of a share hiking affair. As regards a motion for the approval as a class action of an action filed against Mercantile Discount Bank and against the Bank, in the matter of the method of calculating excessive interest, see Note 19 C 15.4 to the financial statements.

### DISCOUNT MORTGAGE BANK LTD.

Discount Mortgage Bank is a subsidiary of the Bank. Discount Mortgage Bank is a public company listed for trading on the Tel Aviv Stock Exchange. As of December 31, 2006, the Bank held 65.1% of its equity and of its voting rights.

Discount Mortgage Bank operates through three main branches (Tel-Aviv, Jerusalem and Haifa), a branch in the Ramat-Gan stock exchange and through 51 counters located all over the country within branches of the Bank or adjacent to them (compared with 44 counters and branches at the end of 2005). Furthermore, Discount Mortgage Bank operates a telephone center that enables applicants to obtain an immediate approval in principle for a loan. Total assets at the end of 2006 amounted to NIS 10,464.2 million, compared with NIS 10,355.2 million at the end of 2005, an increase of 1.1%.

**Total credit granted to the public** amounted at the end of 2006 to NIS 9,854.1 million, compared with NIS 10,024.0 million at the end of 2005, a decrease of 1.7%.

**Shareholder's equity** amounted to NIS 844.5 million at the end of 2006, compared with NIS 809.2 million at the end of 2005, an increase of 4.4%.

**Net income** totalled NIS 35.3 million in 2006, compared with NIS 26.2 million in 2005, an increase of 35%.

**Return on shareholders' equity** in 2006 was 4.4%, compared with a negative rate of 3.3% in 2005.

**The ratio of capital to risk assets** was 12.2% as at December 31, 2006, compared with 11.3 % as at December

2005.

**The Contribution of the Bank's investment in Discount Mortgage Bank to the net results of the Bank** totalled NIS 23 million in 2006, compared with NIS 17 million in 2005, an increase of 35%.

**Issuance of deferred capital notes.** On November 23, 2005, Discount Mortgage Issues Ltd., a subsidiary of Discount Mortgage Bank, published a prospectus for issuing of NIS 125 million deferred capital notes (Series "A"), out of a total series of NIS 300 million which were listed for trading on the Tel Aviv Stock Exchange. Up to December 31, 2006, Discount Mortgage Bank raised additional secondary capital out of the same series of NIS 59 million. Discount Mortgage Bank received the approval of the Supervisor of Banks to have the said notes included as Discount Mortgage Bank's second tier capital (accordingly, the said capital notes are considered second tier capital for the purpose of calculating the Bank's capital ratio).

**Purchase offer for all shares of Discount Mortgage Bank held by the public.** On March 14, 2007, the Bank issued a purchase offer for all the shares of Discount Mortgage Bank held by the public, i.e., 460,735 ordinary shares of NIS 1 par value each, comprising 34.93% of the issued and paid share capital and voting rights of Discount Mortgage Bank.

According to the offer, holders of the shares are invited to sell them to the Bank, until April 30, 2007 (hereinafter – "the last date of acceptance"), at a price of NIS 575 per share, under the terms detailed in the purchase offer issued by the Bank.

The total consideration that is expected for the shares is approximately NIS 256 million.

The Bank's commitment to purchase the shares under the purchase offer is subject to receipt of the following approvals: (a) Permit from the Governor of the Bank of Israel, in accordance with the conditions of Section 34 of the Banking Law (Licensing), according to which the Bank is permitted to hold the total means of control in Discount Mortgage Bank; (b) Approval from the Commissioner of Restrictive Trade Practices, insofar as required. In the event that the said approvals are not obtained until three business days prior to the last date of acceptance, the purchase offer will not become effective and the Bank will not purchase any shares in accordance therewith. The Bank's commitment to purchase the shares is also subject to receipt of acceptance notices for at least 394,777 shares (hereinafter – "the minimum acceptance rate"). If the acceptance rate for the purchase offer does not reach the minimum acceptance rate, the purchase offer will not become effective.

If the acceptance rate for the purchase offer is equal to, or higher than, the minimum acceptance rate, the Bank will purchase all the shares in respect of which acceptance notices were received and will act in accordance with the provisions of Section 337(a) of the Companies Law, and will purchase, by way of a forced sale, the balance of the shares held by the public, at the price determined in the purchase offer and under the same conditions, and thereafter will act to remove the Discount Mortgage Bank shares from trading on the Stock Exchange.

See Notes 19 C 14.4 and 15.5 to the financial statements for details of the uncertainties relating to the Discount Mortgage Bank Ltd. in the matter of charging commission in respect of life assurance and property insurance of borrowers and in the matter of insuring property for amounts exceeding its reinstatement value.

#### FIRST INTERNATIONAL BANK OF ISRAEL LTD.

The First International Bank of Israel Ltd. ("FIBI") is an affiliated company of the Bank. As of December 31, 2006, 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 FIBI** in 2006 totalled NIS 135 million, compared with NIS 122 million in 2005.

**Return on shareholders' equity** in 2006 was 12.2%, similar to 2005.

**The ratio of capital to risk assets** stood at 10.1% on December 31, 2006, compared with 11.7% at the end of 2005.

**Provision for impairment in value.** For details regarding a provision for impairment in value made in the financial statements as of March 31, 2003 according to an instruction of the Supervisor of Banks, see Note 6 F and A to the financial statements. The Bank received an opinion and updates thereto according to which the recoverable value of the investment does not fall below the equity value of the investment on all reporting dates since December 31, 2002. For details as to the reversal of the provision in the financial statements as of March 31, 2006, see Note 6 F 3 to the financial statements.

**Purchase of holdings in Otsar Ha-Hayal Bank Ltd.** On August 17, 2006, FIBI signed an agreement with Bank Hapoalim Ltd. (hereinafter – "Hapoalim") according to which it will purchase the full holdings of Hapoalim in Otsar Ha-Hayal Bank Ltd. (hereinafter – "Otsar Ha-Hayal"), namely, 68% of the equity and 66% of the voting rights in Otsar Ha-Hayal, in consideration for NIS 721 million. The agreement determined also arrangements with respect to several issues including arrangements relating to the credit card field (see above "Activity in the credit card field" in the section "Additional details as to operations in certain products" and Note 34 to the financial statements). On August 10, 2006, FIBI received the permit for the control and the holding of means of control in Otsar Ha-Hayal Bank and on August 17, 2006 the transaction was completed.

**Public issuance by FIBI.** In an immediate report dated March 13, 2007, FIBI announced that its Board of Directors decided to act towards the possibility of increasing its share capital through issuance of rights to shares and/or issuance of rights to other securities, which would improve its capital structure, to be offered to all its shareholders, including a possible benefit component relative to the market price of its shares.

It should be noted that in view of its share capital structure and the provisions of the Securities Law, FIBI may issue and list for trading on the Stock Exchange only shares and/or rights to shares of NIS 0.01 par value each, which are the class of shares with preferred voting rights thereby may change.

Management of FIBI recommends preparations for the raising of capital in the amount of NIS 500 million to NIS 700 million.

FIBI noted that no certainty exists that the offering and/or offerings will, in fact, materialize and, if materialized, that the structure of the offerings and/or the amount to be raised thereby may change.

The bank is considering its position and actions as regards the said public issue. At this stage, as no details are available as to the planned public issue, if at all executed, it is not possible to assess its impact on the Bank.

The bank is considering its position and actions as regards the said public issue. At this stage, as no details are available as to the planned public issue, if at all executed, it is not possible to assess its impact on the Bank.

For details regarding a legal action filed against FIBI in the matter of life assurance commissions and property insurance in contravention of the law and regarding a request to approve it as a class actions, see Note 19 C 17 to the financial statements.

### ISRAEL CREDIT CARDS LTD.

Israel Credit Cards Ltd. ("ICC") is a subsidiary of the Bank. As of December 31, 2006, the Bank owned 68.24% of the equity and 76% of the voting rights in ICC and in Diners (for details as to the acquisition of the control in ICC, see Note 34 A to the financial statements). ICC issues and operates "VISA", "Diners" and "MasterCard" credit cards.

**Acquisition of the ICC shares held by Fishman Chain Stores. Fishman Chain Stores Ltd.** (hereinafter – "Fishman") informed ICC and its shareholders on May 31, 2006, of its intention to sell all of its ICC shares, which are 24% of ICC's equity, as one package along with all the rights and liabilities of Fishman as a shareholder in ICC, in return for an amount reflecting a company value of approx. NIS 1.5 billion, subject to adjustments and terms detailed in the announcement.

The shareholders of ICC have the right of first refusal in respect of the shares offered for sale, commensurate with their proportionate holdings in ICC.

On July 28 and 31, 2006, the Bank and FIBI, respectively, announced the exercise of their right of first refusal in acquiring the said shares. Concurrently, the Bank and the FIBI reached agreements with respect to the adjustments and changes in the arrangements between them as regards their holdings in ICC, to apply following the acquisition of the offered shares. At the beginning of August 2006, the Bank and FIBI, announced the exercise of their right to acquire the balance of the offered shares, which was not exercised by Harel.

On December 10, 2006, the transaction was completed for the purchase by the Bank of 17.2% of the equity and 13% of the voting in ICC in consideration for NIS 232 million, following the fulfillment of all related conditions (the said amount is after the deduction of dividends distributed by ICC to Fishman in November 2006, in the amount of NIS 10 million, in respect of the shares purchased by the Bank). The consideration may increase depending on the results of ICC for 2006, but not in excess of NIS 21.5 million, linked to the CPI of April 2006. Since the completion of the acquisition of the Fishman shares in ICC, the Bank holds 68.2% in the equity and 76% in the voting rights in ICC, while FIBI holds 26.8% in the equity and 20% in the voting rights in ICC.

**Sale of ICC shares held by Harel.** On May 1, 2007 the Bank and the First International Bank entered into a transaction whereby they would acquire the shares of ICC held by Harel (5%) according to their proportional share in ICC.

The price of the transaction would be the same price determined in the transaction for the sale of the ICC shares held by Fishman to the Bank and to the First International Bank. Accordingly, the price to be paid for the shares to be purchased by the Bank amounts to approx. NIS 48.7 million. The additional consideration, according to the results of ICC for 2006, was set at 4.4 million. The basic consideration and the additional consideration have been deposited in a trust account in Harel's name.

Closure of the transaction is subject to fulfillment of suspending conditions, including regulatory approvals, where required.

Once the acquisition of the Harel shares in ICC is completed, the Bank will hold 71.8% in the equity and 79.0% in the voting rights in ICC, while FIBI will hold 28.2% in the equity and 21.0% in the voting rights in ICC.

**Total assets** amounted, at the end of 2006, to NIS 6,148 million, compared with NIS 5,622 million at the end of 2005, an increase of 9.4%.

**Total capital resources** amounted, at the end of 2006, to NIS 335 million, similar to the end of 2005. In 2006, ICC distributed to its shareholders a dividend amounting to NIS 110 million (2005: NIS 50 million).

**The ratio of equity to risk assets** at December 31, 2006, was 11.25%, compared with 12.7% at the end of 2005. **Total income** amounted in 2006 to NIS 802 million, compared with NIS 703 million in 2005, an increase of 14.1%. **Net earnings** amounted in 2006 to NIS 126 million, compared with NIS 108 million in 2005, an increase of 16.7%. **Return on equity** reached 39.3% in 2006, compared with 41.1% in 2005.

**The contribution of the Bank's investment in ICC to the net results of the Bank** in 2006, amounted to NIS 54 million, compared with NIS 43 million in 2005.

**Public offer of shares.** ICC is considering the possibility of an offer of its shares to the public. At this early stage, no date for the issue, if at all, has been determined, neither the volume nor the structure of the issue and the price at which the securities would be offered to the public.

For details regarding the activity in the credit card field, see "Credit Card Operations Activity" under "Further details as to activity in certain products" above. As for details regarding changes in arrangements concerning the credit card field in Israel, see Note 34 B to the financial statements.

#### ISRAEL DISCOUNT CAPITAL MARKETS AND INVESTMENTS LTD.

Israel Discount Capital Market and Investments Ltd. (hereinafter: "DCMI"), a fully owned and controlled consolidated company of the Bank, is engaged (through a subsidiary) 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, 2006 amounted to NIS 240 million, compared with NIS 226 million at the end of 2005, a decrease of 6.2%.

**Net income** in 2006 amounted to NIS 19 million, compared with net loss of NIS 1 million in 2005.

**Return on equity** in 2006 reached a rate of 14.2%, compared with a rate of loss 0.75% in 2005.

In March 2006, DCMI received approximately US\$1.75 million, being the share of the proceeds received from the sale of an affiliated company (held directly by DCMI and indirectly through a capital fund in which it participates). The said affiliate was sold for US\$50 million in cash and additional US\$90 million to be received subject to the attainment of certain milestones, as specified in the sale agreement. The maximum remaining amount which DCMI is due to receive once all the said milestone are attained, is expected to reach US\$3.1 million, which will be recorded in full as gains.

In May 2006, a transaction was signed for the sale of a company held by a venture capital fund, in which DCMI, through a subsidiary, has an investment. The transaction was concluded in July 2006, the immediate consideration received by DCMI in August 2006 amounted to US\$1.5 million. In September 2006, a milestone was reached which entitled Discount Capital Markets to an additional amount of US\$0.7 million.

During 2006, Discount Israel Capital Markets and Investments Ltd., through a subsidiary, participated in 26 public offerings of securities with a total volume of approximately NIS 4.8 billion (15 public offerings with a total of approximately NIS 1.9 billion in 2005), and in 30 private placements of securities with a total volume of approximately NIS 7.4 billion (31 private placements with a total volume of approximately NIS 3 billion in 2005). As to an indictment filed against DCMI and against two of its former employees, see Note 19 C, paragraph 16.4 to the financial statements.

## HUMAN RESOURCES

### LABOR FORCE AND PAYROLL COSTS

The average monthly number of employees, based on full-time positions, in the Bank in Israel (not including overseas branches) amounted to 5,552 in 2006, as compared with 5,499 in 2005, an increase of 53 employees on a monthly average, 1 %.

There were 5,674 employees in full-time positions in the Bank in Israel at the end of 2006, compared with 5,660 at the end of 2005, an increase of 0.2%.

The average monthly number of employees in full-time positions in the Group, both in Israel and abroad, at the end of 2006, was 9,196, compared with 8,921 at the end of 2005, an increase of 2.7%.

There were 9,301 full-time positions in the Group at the end of 2006, compared with 9,195 at the end of 2005, an increase of 1.2%.

Following are the labor force data of the Group and the Bank, in terms of positions<sup>(1)</sup>:

	As of December 31		Monthly average in	
	2006	2005	2006	2005
The Bank in Israel	5,674	(2)5,660	5,552	(2)5,499
Domestic subsidiaries	2,799	7,653	2,732	2,559
Group total in Israel	8,473	8,313	8,284	8,058
Overseas branches	31	28	30	29
Overseas subsidiaries	797	854	852	834
Group total overseas	828	882	882	863
Group total overseas and Israel	9,301	9,195	9,166	8,921

(1) Position – Full-time position, including specific overtime hours, hours worked by subcontractor employees and others.

(2) An amendment in respect of positions of computer employees, the expense in respect of which have been reclassified from "Other expenses" to "Payroll expenses".

Following are details of the cost per position, in NIS thousand:

	2006	2005	change in %
The annual average direct cost per employee position in the Bank in Israel	247	222	11.4%
The annual average direct cost per employee position in the Bank of Israel, disregarding bonuses <sup>(1)</sup>	219	213	2.7%
The total annual average cost per employee position in the Bank in Israel, not including voluntary early retirement expenses	356	331	7.5%
The total annual average cost per employee position in the Bank in Israel, not including voluntary early retirement expenses, bonuses, value added tax on salary relating to the change in the law and the provision relating to the change in the mortality tables	322	320	0.6
The average annual overall payroll cost per employee of the Group in Israel and abroad, excluding the change in the salary tax expense.	349	332	5%

(1) 2006: An award regarding the sale of the controlling interest in the Bank. 2005: An additional award in respect of 2004.

## LABOR RELATIONS

**General.** Labor Relations at the Bank are based on the Labor Charter, collective labor agreements and employment arrangements that are consummated mainly in negotiations between the Bank's management and the employees' representatives.

**Labor Charter.** "Labor Charter for the Employees of Israel Discount Bank Ltd.", which was signed in 1974 (hereinafter – "the Labor Charter") constitutes a wide base outlining and incorporating employment conditions, disciplinary provisions, arbitration procedures and additional procedures and regulations. During the last thirty years, dozens of collective labor agreements were consummated in addition to the Labor Charter. These other agreements include wage and other agreements intended to supplement and expand the Labor Charter, to change the Labor Charter or to cancel certain provisions of the Labor Charter.

The "Employee Agreement" signed on February 1, 2005 (see "Employer agreement" under "Control of the Bank" below), inter alia, extends the validity of the Labor Charter as a collective labor agreement at Discount Bank for a period of five years, i.e. until December 31, 2009, and states that at the end of this period the parties will act with respect to the validity of the Labor Charter, in accordance with the provisions of the Charter. The Labor Charter provides that it remains in effect until March 31, and unless notified otherwise three months prior to that date, by the Bank's management to the Employees' Representative Committee, or by the Employees' Representative Committee to Bank's management, it will remain in effect for an additional year, and will be renewed automatically for additional years.

**Rights of association.** The tenured employees of the Bank are organized within the framework of the national Employees' Representative Committee. The Representative Committee is divided internally in such a way that employees at the clerical level are included in the come under the Clerks' Committee and authorized signatories and managers are organized under the Managers' Representative Committee. Most of the issues are agreed and signed between the Bank's management and the Employees' Representative Committee. A retirees' Committee also exists, under which retirees of the Bank are organized.

**Bank participation in the budget of the Employees' Representative Committee.** The Bank contributes monthly to the budget of the Employees' Representative Committee, in an amount double the monthly amount contributed by the employees. Five out of the 21 Committee members are officers of the Committee engaged on a fulltime basis and receiving a full salary. The other members of the Committee fulfill various positions in the Bank and serve as Committee members in addition to their regular work. In addition, the Bank provides office premises for the Committee's use and covers the maintenance costs thereof.

The Bank also participates in the budget of the retirees committee, providing the committee with premises for its activities, bearing maintenance costs and paying salaries of the committee's employees. The Bank also finances the maintenance and operation costs of retirees clubs in Jerusalem, Jaffa and Haifa.

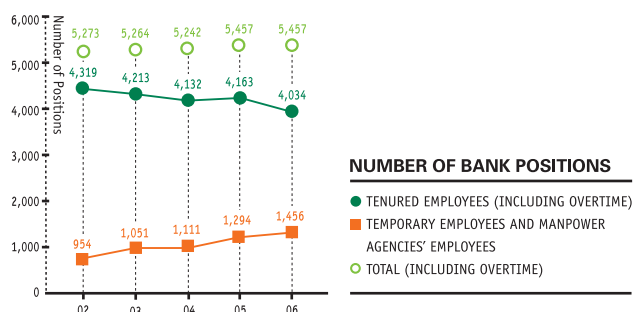
## PRINCIPAL CATEGORIES WITH RESPECT TO EMPLOYMENT CONDITIONS

Employees of the Bank are classified into three categories for purposes of employment conditions:

**Tenured employees.** The employment terms of tenured employees are arranged, as stated, in accordance with the Labor Charter, special collective labor agreements and other employment arrangements. On December 31, 2006, there were 3,887 tenured employees in the Bank (December 31, 2005 – 4,028 tenured employees). The majority

of the tenured employees are permanent employees of the Bank, while a minority constitutes new employees on a trial period.

**Temporary employees.** The employment conditions of temporary employees are arranged mainly in several special collective labor agreements, which detail the conditions and maximum period of their employment. Their maximum period of employment is five years that, under special circumstances, may be extended up to seven years. Temporary employment may be terminated at any time, at the discretion of management. On December 31, 2006, there were 1,293 temporary employees in the Bank (December 31, 2005 – 959 temporary employees). Furthermore, in accordance with an agreement between the Bank and the employees' representatives signed in 2002, 140 employees, known as "temporary computer staff" are employed by the Bank. These employees are engaged in the information technology systems and may be employed for up to seven years as temporary personnel. According to the agreement between the Bank and the Employees' Representatives Committee, the total number of temporary employees is limited to 30% of the total number of employees of the Bank (including temporary personnel but



excluding cleaning personnel, and temporary computer personnel).

**Personal employment contracts:** Employees engaged under personal employment contracts sign, prior to their engagement with the Bank, a personal contract, which precludes the Labor Charter and the collective labor agreements for these employees. Employees engaged under a personal contract include members of Bank management, part of the information technology staff and a defined and specified agreed list of position holders, mainly senior personnel. At present, the scope of personnel employed in accordance with personal employment agreements may reach approximately 80 positions. As of December 31, 2006, the Bank employed, in practice, 48 personnel (including members of management) under personal employment agreements.

In addition, the Bank acquires services of manpower company employees and software houses.

As of December 31, 2006, 300 manpower company personnel were employed by the Bank. These employees are engaged mainly in security, cleaning and short working week employees (employees that serve as backup staff following the transition to a short working week) and teller task (as of December 31, 2005: 200 manpower company personnel). As of December 31, 2006, 1,000 software house personnel were employed in the Bank. These employees are engaged mainly in software development tasks (as of December 31, 2005: 900 software house personnel).

To date, the Bank's supervision of manpower companies focused mainly on the agreement aspect, including

compliance with appropriate provisions ensuring the social benefits of such personnel employed in the Bank. In view of the increased awareness regarding vulnerability of such employees, and following a Labor Court ruling that determined, in the case of another bank, that the said bank was a co-employer of a cleaning woman employed through a manpower company, the Bank is increasing its supervision, inter alia, by supervising the wage components of manpower company personnel employed by the Bank.

#### DEVELOPMENT IN LABOR RELATIONS

**Labor Relations in 2006.** On January 1, 2006, sanctions were taken by the Employees' Representative Committee because of the failure to reach a wage agreement. The sanctions were carried out intermittently at various units of the Bank. On January 11, 2006, the Committee held a meeting during Banking hours, thus bringing the Bank's operations to a halt on that date. On January 24, the parties signed a wage agreement for the years 2004 –2006 in which the following was decided: the rate of the selective wage increments for the years 2004-2006, an additional monthly payment for staff working split hours, and the amounts of staff bonuses. It was also agreed that labor disputes with regard to bonuses, wages and provident funds would be called off.

On February 23, 2006, an agreement regarding the manner of allocating the bonus in respect of the sale of the Bank to the staff was signed.

On July 16, 2006, the Ma'of Federation of Labor proclaimed a labor dispute and a strike in the matter of "a demand for a collective agreement to regulate the rights of the employees following the workload at the branches and the Head Office, caused, among other things, by the joining of many new customers on the one hand and the retirement of many employees in recent years on the other hand".

On August 2, 2006, the Ma'of Federation of Labor announced the annulment of the said labor dispute, this "in view of the positive trend that prevailed during the negotiations between the parties during the cooling-off period, and in order to enable continued negotiations in the same spirit".

**Labor Relations in 2007.** On January 17, 2007, the Ma'of Federation of Labor declared a labor dispute and a strike with respect to the following matters:

- Unilateral measures and organizational changes implemented by Management, with significant impact on the employees, without required prior consultation;
- Material impairment of employees' work conditions, including work during exceptional hours, sometimes until the start of the Sabbath;
- Impairment of employees' organizational power and representation rights, through decrease in the relative number of permanent employees relative to temporary personnel and personnel employed through manpower companies;
- Increase in employees' work load without appropriate remuneration;
- Demand for signing a special collective labor agreement to resolve the above disputes.

In its declaration, the Federation stated that if such an agreement is not signed by January 31, 2007, the employees would be enabled to strike as from February 1, 2007.

The Bank is currently negotiating with the employees' representatives regarding the matters in dispute. As from February 14, 2007, the staff of the computer operating unit began to apply sanctions. These sanctions were intensified on February 18, 2007, in a way that, in Managements opinion, endangered the business operations of the Bank, and accordingly, Management was forced to decide on the closure of the Bank as from February 19,

2007. During the course of that day, Management reached an agreement with the staff's representatives, following which, the sanctions were withdrawn allowing the opening of the Bank. The agreement provided, among other things, that industrial peace be maintained regarding the matters in dispute and in the matter of employee remuneration until May 20, 2007.

## EMPLOYEE REMUNERATION

The principal salary components include the basic salary and a seniority increment (0.7% of the basic salary for each full year of employment up to a maximum of 40 full years of employment). The basic salary constitutes the basis for salary increments and for the payment of split working hours' remuneration at the rate of 4% of the salary (to entitled employees only), shift remuneration (to entitled employees only), overtime and 13th month salary. Part of the employee's remuneration is linked to the CPI. Employees are also entitled to various additional benefits. Bank employees are promoted by grades only and are also entitled to a long-service bonus equal to several monthly salaries plus additional vacation days, at the end of 20, 30, and 40 years of service in the Bank. Part of the employees is entitled to global overtime payment and, for other employees, payable overtime is subject to approval by the employee's authorized superior. The Bank does not have a computerized system for determining the number of hours actually worked by the employees ("time clock").

Most of the Bank's employees are entitled to recreation pay in an amount significantly higher than the amounts provided by law. Employees are also entitled to accepted provident and continuing education funds contributions. The Bank's liability to severance pay for its employees is calculated according to the employee's basic salary, global overtime payment, 1/12 of the employee's 13th month salary and other additional benefits.

Bank employees are also entitled to certain benefits after their retirement.

For additional details, see Note 16 to the financial statements.

## SPECIAL REMUNERATION TO MANAGERIAL PERSONNEL

A managerial rank employee who has been promoted is entitled to a 5% salary increase (provided that at least 12 months have elapsed since the date of his last entitlement to such increase due to promotion and/or transfer). A managerial rank employee who has been transferred to another position is entitled to an increase of 2% to 7% of the salary according to the salary table (basic salary components), at management's discretion, taking into account the additional responsibility and/or the special managerial effort required for adaptation to the new position following the transfer, and provided that at least 12 months have elapsed since the date of his last entitlement to such increase due to promotion and/or transfer.

Employees of the three most senior ranks (senior manager, assistance CEO, senior assistance CEO) are entitled to a company vehicle and to full reimbursement of expenses in respect of one telephone line in the senior employee's home.

## OFFICERS AND SENIOR MANAGEMENT MEMBERS GROUP OF THE BANK

Members of this group of employees are subject to a prior notice period larger than the period set by the law, and to a defined period of limitation on occupation (between two to twelve months), in respect of which they are entitled to an adaptation grant (2-12 monthly salaries).

For details regarding a stock option plan for senior officers of the Bank (excluding the Chairman of the Board of

Directors and the President and CEO), see Note 14 D to the financial statements. For details regarding an award plan for members of the Bank's management, see Note 16 to the financial statements.

#### AWARD PLAN TO EMPLOYEES AND MANAGERS OF THE BANK IN 2007

In March 2007, the Board of Directors approved an award plan to employees and managers of the Bank for 2007. The budget for the plan would be determined on the basis of the annual return to capital of earnings from ordinary operations. The awards would be granted according to the rate of return. The aim of the plan is to create a structured relation between the success of the Bank and the remuneration of employees and managers in the short and long term.

#### WORK ON THE DAY OF REST

Personnel on duty at the computer center and security personnel of the Bank work on rest days as defined in the Work and Rest Hours Law, 1951. Work on these days requires a special permit, which has not yet been issued to the Bank. For details of an investigation conducted in the matter of work on the weekly day of rest in contradiction to the Law, see "Proceedings regarding Authorities" under "Legal Proceedings" below.

#### RETIREMENT OF EMPLOYEES

In the years 2000-2006, 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. One of the goals of the human resources activity includes encouraging retirement, with the employee's consent and without pressure or imposition. Retirement promotes targets such as the reduction in the average cost per employee position and rejuvenation of the workforce.

262 employees retired during 2006, of which 205 employees took early retirement. 53 employees retired during 2005, of which 3 employees took early retirement. 175 employees retired during 2004, of which 142 employees took early retirement.

In total, 1,369 employees retired from the Bank in the period 2000-2006, of which 970 took early retirement. **Program for the encouragement of early retirement (2005).** In January and February 2006, the board of directors approved a plan for the encouragement of early retirement, at beneficial terms, of employees of 50 years of age and over, employed at head offices and branches. The financial statements as of December 31, 2005, include a provision of NIS 196 million in respect of the said plan.

**An early retirement plan at IDB New York.** In July 2006, the Board of Directors of IDB New York decided on a plan for the encouragement of early retirement of members of management and of some 120 employees. The financial statements include a provision of NIS 73 million in respect of the said plan (see "Discount Bancorp, Inc." under "Main Investee Companies" above). The total number of staff, including members of management, who have retired from the bank in New York is 127. 77 employees retired under a voluntary retirement plan.

**A plan for the encouragement of early retirement (2007).** Additional alternatives were offered in 2007 for severance indemnities: severance payment at the rate of 100% and the conversion of the award into a gross monthly payment, kinked to the CPI, for a period to be determined by the employee but not in excess of 25 years from retirement. The employee would be entitled to determine the date on which the monthly payments would begin, provided the last payment shall not be later than the above date (25 years since retirement). The payment

plan elected by the employee is guaranteed in any case, including death of the retiree.

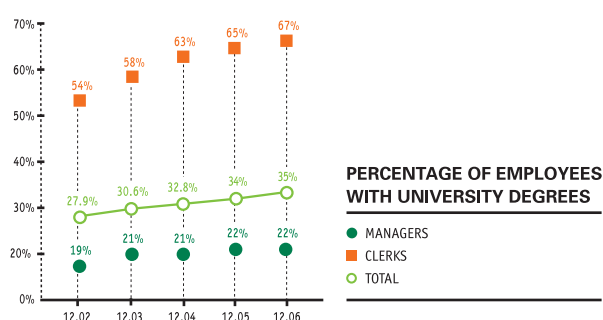
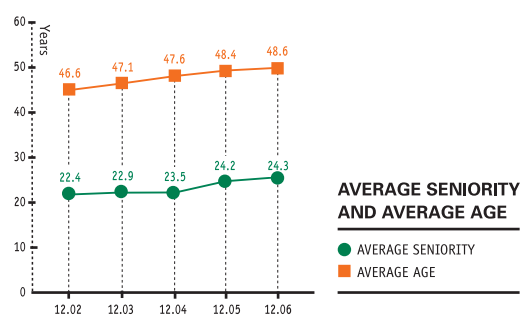
Following an agreement with the Employees Committee, a further alternative is made possible, according to which the employee would receive immediately the tax exempt part of the severance pay, while the balance (the amount exceeding the exemption and the additional award) would be paid in monthly installments.

70 employees took early retirement in the period from January to March 2007.

## DEVELOPMENT OF HUMAN RESOURCES

Development of human resources at the Bank reinforces the Bank's ability to address successfully its business and organizational challenges, through:

- Constructing, cultivating and reinforcing the Bank's comprehensive managerial backbone by means of a managerial training plans which support the strategy, including three managerial training courses: training reserves for position appointments (junior management, intermediate management and senior management



levels), position maintenance training and customized training for managers in various departments.

- Formation and absorption of career courses for core banking positions: from formation and internalization of career courses for temporary personnel (in branches, in personal service sectors and in concept branches), through development of courses for investment consultants and for career management personnel.
- Organizational development activity in an organic unit with a multi-disciplinary approach adapted to the needs of the unit.

Professionals from various disciplines (management development, organizational consulting, training and know-how management) assist the unit manager in order to create a vision for the unit, diagnosing the unit's present situation and devising an operational development program to narrow gaps between them, through development of the human resources and improvement of work procedures in the unit.

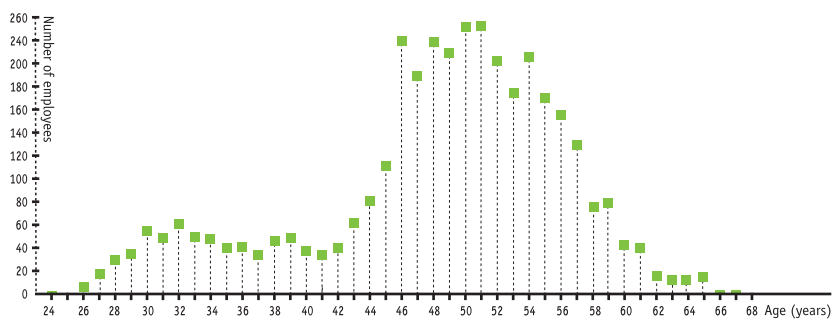
As part of the activities of the organic units, several units commenced upgrading of business promotion and business management skills, including formulation of theory, processes and procedures adapted to the unit's business activity and absorption thereof.

In 2006, four units.

## IMPROVEMENT OF SERVICE

In a dynamic organizational reality of constant change and strong competition, the key factor for survival and success of business entities is their relationship with the customer. In an organizational environment where products and prices are similar, competitive advantage is enabled only when significant added value is produced. Discount Bank's customer service is regarded as the component that produces such an advantage, and therefore the Bank's comprehensive resources are invested in a continuous effort to produce a special and unique service experience for the customer.

Discount Bank is currently in the midst of a multi-annual process of transition to a culture that places the customer at the center of the organizational existence. Several years ago, management of the Bank etched on the Bank's banner the strategic target according to which each customer (whether internal or external) will be satisfied. For this purpose the Bank began extensive operations among the staff intended to create within the staff a developed service conviction moved by the understanding of and identification with customers. In addition



**DISTRIBUTION OF THE PERMANENT  
STAFF ACCORDING TO AGE —  
WORK FORCE AT DECEMBER 2006**

the activity is directed towards providing suitable tools, including infrastructure, processes and organizational structures supporting the creation of an outstanding service experience. The process of the cultural change relies primarily on implanting within all managers in the organization the conviction that they in fact manage service units (both internal and external).

Based on a structured methodology named "Shir" (service improvement) an active absorption of the service management principles has been conducted in over 250 head office and line units, the managers and staff of which were presented with a unique and specially designed absorption process. The implementation of this culture engulfed all the course of organizational life of the staff, starting with selection and recruitment, which were redesigned so as to include the necessary component of "service awareness" as a threshold condition for acceptance. Further down the road, the "contribution" of each employee to the success of the service improvement process is measured within the framework of annual evaluation processes or feedback mechanism.

Position surveys conducted in recent years among Bank employees indicate clearly the profound transformation of the service concept in the organization.

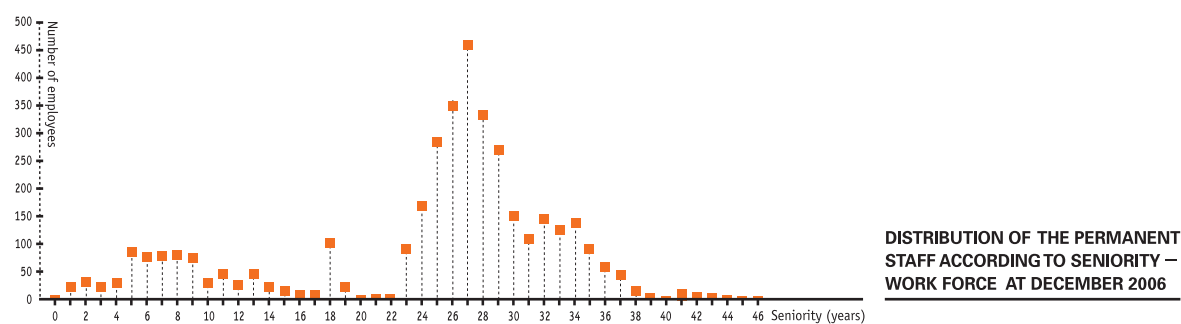
As a rule, the quality of service provided in actual fact to external and internal customers, is tested at many crossroads: telephone service, face-to-face service, handling of complaints and internal interface. The various grades received as a result of the periodic tests, feed the professional decision making process and the systems

for acknowledgement and appreciation of employees, managers and organizational units. The “outstanding unit” competition, for instance, has been redesigned to include many parameters derived from service controls – and therefore provides further indication as to how critical and central this subject is.

In a dynamic organizational reality of constant changes and fierce competition, the relationship with the customer is the key factor for survival and thriving of business entities. In an organizational environment where products and prices are generally similar, the competitive advantage exists only where it is possible to produce a significant added value. At Discount Bank, the subject of customer service is considered a component that would create such an advantage, and thus the full resources of the Bank are directed towards the continuous effort of creating a unique and unforgettable “service experience” for the customer.

### INFORMATION MANAGEMENT

The information management at the Bank constitutes part of the work procedures, which include cooperation and



the transfer of information among the many professional systems, and contributing to the enhancement of the professional level of the staff, advancement of the business goals and a growth leverage.

The organization portal on the Intranet turned into a central tool of information management. The portal provides infrastructure for the supply of relevant, readily available and up-to-date information. The professional sites and the information communities are connected to the core business activity and to central organizational processes, and thus support the enhancement of the professional level of staff and the satisfaction of customers.

Some 20 information communities and information sites are updated by 150 substance experts, providing the general population of the Bank with the professional and personal information required for their current operations.

An upgraded and updated system of procedures and circulars has been developed, which provides advanced retrieval and distribution possibilities, while facilitating these processes and use of computerized media only.

Additional organizational and cultural processes, such as the selection of outstanding employees, accompanied by designated sites planned to provide a response both as to current information regarding the process and as to the possibility of interactive staff operation.

Statistical data indicate the increasing use made by the staff in this channel allowing the optimal participation in professional information.

Drawing of conclusions, the transfer of duties and congruent period processes are also accompanied by designated

management and information tools. Also developed are tools and forms for varied operational purposes, while emphasizing efficiency and savings aspects.

The information management operation serves an essential layer of staff professionalism management in the organization, which provides an answer to several central challenges:

- Transfer of the center of gravity of the professional information from head office to the field units by assembling knowledge and insight from the field and constructing its distribution to the entities requiring it;
- The turning of covert knowledge to overt knowledge and knowledge management through cooperation and study processes;
- Shortening of reaction time and the transfer of required knowledge in the fastest and most efficient manner;
- Presentation of an updated picture of the professional level of the organization;
- the improvement of operations and complying with the business goals of the organization.

### TRAINING

In 2005, the staff at the Bank received a widespread response to their professional requirements through extensive and focused training and guidance.

The knowledge gaps in various areas were filled in during the year according to the identification of needs conducted at the various units.

In addition, a training response was given to unplanned training requirements that arose from provisional directives and/or regulatory decisions having an impact on the banking industry, such as: the law prohibiting money laundering, management of credit facilities, etc.

Part of the training is provided through "information headlines", unique in reaching the employee's desk immediately and providing a uniform and clear message to a large population.

All learning processes of general banking are available on the "Knowledge" system (a distant learning system), when in 2005 the system was upgraded and many improvements were introduced thereto.

With the view of training, the new employees recruited for the branch system in a professional and speedy manner, the training and tutorship of new employees has been restructured.

One of the goals of Discount College for 2005, was the creation of learning flashes supporting staff professionalism. The learning flashes are designed to update or inform the staff at large of changes, innovations or particular emphasis relevant to their work as well as to refresh existing knowledge.

The uniqueness of learning flashes is in their ability to swiftly reach the employee's desk and to transmit uniform and clear information to a particularly large population.

An initiated move was made in the reported year for the identification of extra-banking professional needs of the staff of the various units. These needs were addressed in courses organized by the College, as part of closed seminars for Discount Bank, which were tutored by lecturers of the first line.

Staff of all departments of the bank took part in this activity and it spanned a variety of subjects – computerization, organization, project management, bridging, etc.

In 2006, the retail training activity was launched with a view of positioning the Discount Bank as a leading bank in the retail culture in Israel, the goals of which are increased profitability and customer share, locating and recruitment of new customers, maintaining customer loyalty and preventing customers from leaving the Bank.

As part of improving professionalism and within the policy framework of providing a professional and direct

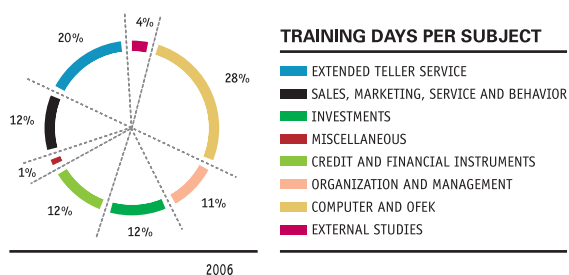
response to all professional issues relating to investment consultants, the Bank provided special training this year for investment consultants, focusing on three areas: bonds and debentures, capital market taxation and continuous trading.

All branch management personnel participated in training in retail issues in 2006, in order to promote the Bank's position as the leader in retail culture in Israel.

**"Ofek"**. Ofek's (the Bank's new computer system) third rollout was launched in 2006 in four stages. The training process accompanying this launching included 23 different courses, developed as an appropriate response to the needs of the various departments and their personnel.

The training process lasted about seven months and involved 2,300 personnel from all units of the Bank.

The training courses combined frontal learning and theoretical studies at Discount College and its extensions – Haifa and the North, the Sharon and Jerusalem regions – individual study through way of audio-visual means, practical studies through a simulator operating at the College and field study.



The number of training days in 2006 reached 37,198 compared with 25,767 training days in 2005.

The data indicate a significant increase of 44%, derived mainly from increased training in the installation of the "Ofek" system.

The data relate to actual training days on the College premises, and do not reflect individual study activity that was widely implemented with respect to all subjects and sectors.

**Investment in training.** The Bank's investments in training and in the development of human resources amounted to NIS 22 million in 2006, compared with NIS 18 million in 2005. The amount includes the training of employees on various subjects of (developing and conducting training activities as well as training consultation). The amount also includes the cost of financing academic studies for Bank employees as well as expenses for professional training, seminars, etc. The amount does not include indirect expenses for instructors fees and rent of premises. The amount does not also include the relative part of employee payroll in respect of the participation of the staff in providing training courses, in the training framework of the Bank, in self study by means of the distant learning computer systems and participation in outside training frameworks.

Furthermore, for the purpose of conducting the training, the Bank appoints mentors and training partners who are 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. It should be noted that the above

stated amount in respect of 2005, does not include the cost of training for the “Ofek Project”, and accordingly, the change in the reported expense in 2006 as compared with 2005, does not necessarily represent an increase in expenses.

## 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, 1993, (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, 1993, 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.

Up to January 31, 2006 the State held 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.

On January 31, 2006 (hereinafter: “the closing date”), upon the closing of the transaction for the sale of controlling interest in the Bank, as described hereunder, control of the Bank was transferred to the Bronfman-Schron Group.

## ENTITIES IN POSSESSION OF BANK SHARES

According to information provided to the Bank, upon the closing of the Agreement for the Sale of a Controlling Interest in the Bank the Bronfman-Schron Group holds 254,966,194 ordinary A Shares of NIS 0.1 each par value of the Bank, comprising approx. 26% of the outstanding capital of the Bank and of the voting rights therein, the State held 304,904,204 ordinary A Shares of NIS 0.1 each par value of the Bank (hereinafter: “the ordinary shares”), comprising at that date approx. 31.09% of the outstanding capital of the Bank and of the voting rights therein. The Bronfman-Schron Group has an option to purchase a further 25% of the outstanding capital of the Bank and of the voting rights therein.

See hereunder for details as to the effective price of the transaction for the sale of the control core of the Bank, in accordance with the Opinion provided to the Bank by M.I. Holdings Ltd. and for the price paid for the balance of the shares held by the State.

The Bronfman-Schron group’s holdings in the Bank’s shares are as follows:

152,979,716 ordinary shares, representing approx. 15.6% of the Bank’s issued capital and of the voting rights therein, are held by the limited partnership Treetops Acquisition Group LP (hereinafter: “Treetops”);

101,986,478 ordinary shares, representing approx. 10.4% of the Bank's issued capital and of the voting rights therein, are held by the limited partnership Treetops Acquisition Group II LP (hereinafter: "Treetops II").

Treetops is a limited partnership that was incorporated in the Cayman Islands. The limited partners in Treetops are members of the Bronfman Group, as set forth below:

- Edgar Miles Bronfman IDB Trusts A through G (seven trusts), the beneficiary whereof is Edgar M. Bronfman, hold approx. 64.273% of Treetops;
- Matthew Bronfman personally holds approx. 6.424% of Treetops;
- Matthew Bronfman IDB Trust, the beneficiary whereof is Matthew Bronfman, holds approx. 6.424% of Treetops;
- Holly B. Lev IDB Trust, the beneficiary whereof is Holly B. Lev, holds approx. 6.424% in Treetops;
- Adam R. Bronfman IDB Trust, the beneficiary whereof is Adam R. Bronfman, holds approx. 6.424% of Treetops; Edgar M. Bronfman is the father of Matthew Bronfman, Holly B. Lev and Adam Bronfman. All the trusts specified above are hereinafter jointly referred to as "the Bronfman Trusts". The trustees of each of the Bronfman Trusts have empowered the beneficiary of the Trust (and with regard to the Trusts the beneficiary whereof is Edgar M. Bronfman, the head of the family - the power of attorney has been given to Edgar M. Bronfman and Matthew Bronfman, provided that in the event of a dispute between them, Mr Edgar M. Bronfman's opinion shall prevail) to make all the decisions with regard to the investment in the Bank, save for matters of replacement of the power attorney (subject to the Bank of Israel's prior approval), making further investments in Treetops and/or the Bank and a sale, entering into and agreement for a merger agreement or any transfer of the interests of the Trusts, in Treetops and/or the Bank.
- PLM/IDB Investment LLC, a company fully owned by Philp Millstein, holds approx. 6.424% in Treetops;
- Rubinoff IDB Holdings LP, a limited partnership fully owned by Michael Rubinoff, holds approx. 3.207% in Treetops.

In addition to the Bronfman Group members the limited partnership Treetops Special Limited Partner LP (hereinafter: "SLP"), incorporated in the Cayman Islands, holds approx. 0.2% of Treetops, as limited partner. The limited partners in SLP are Matthew Bronfman (approx. 65%) and Michael Rubinoff, through Rubinoff IDB Holdings LP (approx. 35%). The SLP's general partner, is Treetops SLP Ltd., (a company fully owned by Matthew Bronfman, incorporated in the Cayman Islands) holds approx. 0.2% of SLP).

Treetops' general partner, that holds approx. 0.2% of Treetops, is Treetops Acquisition Group Ltd (hereinafter: "Treetops Ltd."), a company incorporated in the Cayman Islands. The means of control in Treetops Ltd. are held by the Bronfman Group members, in accordance with the ratio of their holdings in Treetops.

Treetops II is a limited partnership incorporated in the Cayman Islands. The limited partner of Treetops II is Cam Discount Ltd. (hereinafter: "Cam Discount"), that holds approx. 99.8% of Treetops II. Cam Discount is a company incorporated in the Cayman Islands, all the means of control wherein are held by Rubin Schron.

Treetops II's general partner, that holds approx. 0.2% of Treetops II, is Treetops Acquisition Group II Ltd (hereinafter: "Treetops II Ltd."), a company incorporated in the Cayman Islands, all the means of control wherein are held by Cam Discount.

For details regarding the transaction for the sale of a controlling interest in the Bank, and the arrangements between the buyers and the government and arrangements among the buyers, see this chapter hereunder.

As a result of a report submitted by Mr. Len Grunstein to IDB New York, information has recently reached the Bank

that Mr. Grunstein has an economic interest in the holdings of the Schran Group in the Bank. Until the date of printing of the Annual Report, the Bank has not been able to clarify the nature of the said interest and its scope.

### SALE OF A CONTROLLING INTEREST IN THE BANK

According to the information provided to the Bank, on January 31, 2006, the transaction for the sale of a controlling interest in the Bank, entered into on February 1, 2005 by M.I. Holdings Ltd. and the Government of Israel (hereinafter – “the Government”) on the one hand, and the Bronfman-Schron Group (hereinafter – “the Buyers”) on the other hand, (hereinafter – “the Agreement for the sale of a controlling interest in the Bank”), was completed.

In the Agreement the Bronfman-Schron Group had purchased shares in the Bank comprising 26% of its issued share capital (hereinafter “the control nucleus”) and was granted an option for a period of three years from date of the closing of the transaction, to purchase further shares comprising up to an additional 25% of the issued share capital of the Bank, all for the consideration of approximately NIS 1.3 billion ( that was approximately NIS 5.1 per share), together with interest accrued until the closing date. Regarding the effective price per share, see “The effective price of the transaction for the sale of the controlling interest of the Bank” below.

On the closing date the Buyers paid the sum of US\$241,649,508, together with interest of US\$7,925,895, totalling US\$249,575,403. the balance of the consideration in the sum of US\$55,765,271 (hereinafter - “the balance of the consideration”) together with the interest accrued thereon until the closing date, in the sum of US\$1,829,053, totalling US\$57,594,324, was translated into new shekels in accordance with the representative exchange rate of the dollar on the closing date.

On the closing date the undischarged balance of the consideration shall be linked to the index and bear annual interest of 4%. The balance of the consideration shall be paid by the Buyers by the first business day that shall occur after the end of 36 Gregorian months from 31 December 2005 (hereinafter referred to as “the first period”), save for the interest amounts that shall be paid by the Buyers in annual payments.

For details regarding the credit terms see “Credit agreement” hereinafter.

In light of the above, the price per share, according to which the sale transaction was carried out, calculated as to the closing date, according to the sum of the first installment, together with the interest accrued thereon until the date of the closing, in addition to the sum of the balance of the consideration, together with the interest accrued thereon until the date of the closing, divided by the number of the sold shares – is approx. US\$1.2047 for one share (the option to purchase shares comprising 25% of the Bank’s outstanding capital, was not taken into account, within the above calculation; the above calculation does not include also the additional consideration, which is conditional, as detailed below).

For details about the calculation of the effective price per share in the Agreement for the sale of a controlling interest in the Bank, as was done for M.I. Holdings Ltd. shortly after entering the agreement, see “the effective price per share in the Agreement for the sale of a controlling interest in the Bank” below.

In the event that the option to purchase a further 245,159,802 shares will be 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).

The exercise price for each of the option shares is NIS 5.0824 per share, linked to the increase of the index as of

the index published on December 15, 2004 with adjustment provisions that were prescribed in the agreement. The option is exercisable by the Buyers or either of them in accordance with the ratio of their holdings of the control nucleus.

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 during the period from October 1, 2004 to September 30, 2008. If the terms and conditions for the payment of the additional consideration are fulfilled, the Buyers shall pay it as follows: 50% out of sums received as dividend as from December 31, 2008 or 100% of monies that shall be received, as from the said date, in respect of a sale of the control nucleus shares or the option shares that shall be charged to the Government (if they shall be charged and for so long as they shall be subject to a charge), and all at the rates and upon the terms and conditions prescribed for such purpose in the agreement (see "Credit agreement" hereunder). In the event that a dividend is not distributed, although no legal or statutory constraint exists for such distribution, half of the additional consideration in the year in which no such constraint for non-distribution exists and half in the following year.

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 financing 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 sales of the shares of the Bank. The State will repay the interim financing as follows: At any date on which the State will sell shares of the Bank, the State will pay to the purchasers a proportionate part of the consideration receivable, based on the ratio of the number of shares sold to the number of the options not exercised. The balance will be payable within eight years.

For arrangements that have been made between the Government and the Buyers as to the coordination of their voting and of their exercise of control of the Bank see "Arrangements with Regard to Cooperation Between the Buyers and the Government, in Respect of Holding Shares of the Bank and Exercising the Control in the Bank", below.

### THE GOVERNOR OF THE BANK OF ISRAEL'S PERMIT FOR THE CONTROL AND HOLDING OF MEANS OF CONTROL IN THE BANK

The Governor of the Bank of Israel, after consultation with the licensing committee, granted on January 29, 2006, a permit to Edgar M. Bronfman, Mathew Bronfman, Adam R. Bronfman, Holly B. Lev, Michael Rubinoff, Philip Milstein and Rubin Schron (hereinafter: "the Group"), to jointly control and hold means of control in the Bank in a percentage of 26% of any type of means of control in the Bank. In addition the Governor permitted the Group's members to hold additional means of control in the Bank, in a percentage not exceeding 40% of any type of means of control, all subject to the percentage determined in such regard in respect of each of the Group's members in the annex to the permit. The annex to the permit details the holding of each member of the Group in the Bank and in Treetops and Treetops II partnerships, as detailed in "Entities in possession of Bank shares" above. The corporations and trusts details as aforementioned are prohibited from engaging in any business other than holding

the means of control in the Bank. Further detailed in the annex to the permit are the additional percentages of means of control that any one of the members of the Group is permitted to hold beyond his or her share in the controlling interest. It is further determined that additional percentages of means of control will be held in the same manner as that of the controlling interest.

The said permit also includes a permit to control and hold means of control, through the Bank, in banking corporations controlled by the Bank, and in which it duly holds the means of control, all as shall be from time to time.

Following are the main conditions of the permit:

1. "Controlling interest" or "minimum percentage" means at least 26% of any type of means of control in the Bank, divided amongst the Group's members in the manner and ratio detailed in the annex to the permit.
2. If the Bank issues, after the grant of the permit, rights to shares or any other security convertible int shares, the Group shall maintain the minimum percentage holdings, computed on the basis of full dilution.
3. (a) For a period of five years subsequent to the date of the grant this permit, the Group shall not directly or indirectly sell or transfer means of control in the Bank, if as a result thereof it is left with means of control of any type in a percentage lower than the minimum percentage. Any one of the Group's members may sell means of control from the additional percentage exceeding his or her share in the controlling interest, provided that a minimum of six months have elapsed since the last purchase affected by such Group member (in such regard, the exercise of the option from the government shall not be deemed a purchase act).
- (b) Five years from the date of the grant of this permit, the Group may sell or transfer its means of control, provided that it sells or transfers the entire means of control constituting the minimum percentage, to an individual or a Group that has duly received a permit for the control and holding of the aforesaid means of control.

In the Supervisor of Bank's letter annexed to the permit (hereinafter: "the letter annexed to the permit") it was stated that in the event that after five years from the date of the grant of the permit a decision is made by the Buyers to sell means of control in the Bank from the controlling interest such that after the sale none of the Group's members or the buyers require a permit for the control or holding of the means of control in the Bank, pursuant to the law, the following provisions shall apply:

- The two Buyers shall approach the Governor of the Bank of Israel, notify him of their decision and detail the manner of the sale planned by them;
- Before the sale of the means of control, as aforesaid, the Buyers shall make a preliminary with the Governor of the Bank of Israel, regarding the arrangements that shall be mae, including the modification of the permit and the trust instrument, in order to allow them to effect the sale of the shares within a reasonable period of time (hereinafter: "the transitional period"), taking into account, inter alia, the implications on the Bank's management and transfer thereof, business relations with the Bank, the market conditions and the quantity of shares being sold, and the format of holding and voting in respect of the Bank's shares constituting a holding of more than 5% of the means of control in the Bank during the transitional period (without such derogating from the Buyers' fundamental right to effect the sale, as aforesaid).

- (c) Notwithstanding the abovesaid, an additional member may be added to the Group and each of the Group's

members may, at the end of five years as aforesaid, transfer or sell the means of control held by him and constituting his share of the minimum percentage, or part thereof, provided that the transferee or buyer cooperate on a regular basis with the rest of the Group pursuant to the Summary of Principal Terms entered upon by the Group as aforementioned, or another agreement approved the Supervisor of Banks, and that a permit was duly granted for the control and holding of the aforesaid means of control. Notwithstanding the above, an additional member may be added to the Group and a Group member may transfer or sell means of control as aforementioned also during the five year period from the grant of the permit, provided that the conditions set forth above had been fulfilled, and provided that the Group will continue being the leading factor both in regard to the percentage holdings as well as with regard to the cooperation between them.

4. (a) The Group's members and the entities through which the means of control are held shall act in accordance with the Summary of Principal Terms approved in advance and in writing by the Supervisor. The beneficiaries of the trusts from the Bronfman Group shall act in accordance with their undertakings to the Bank of Israel, which were approved in advance and in writing by the Supervisor.
  - (b) The Group's members shall at all times hold the control and means of control in the Bank in the percentages and manner set forth and specified in paragraph 4 and in the addendum in respect of each of them, and shall not sell or otherwise transfer to another, including to corporations or other entities controlled by them, directly or indirectly, means of control in the Bank or in any of the entities detailed in these paragraphs, even if such sale or transfer does not require a permit pursuant to section 34 to the Law, unless otherwise provided in this permit or unless the Supervisor grants his prior written consent thereto.  
In this regard, "sale" – includes a charge, save for certain charges within the Group specified in the permit.
  - (c) Notwithstanding the aforesaid, for a period not exceeding three years from the date of the grant of this permit, the provisions of sub-paragraph (b) regarding a charge shall not apply to 6% of the means of control in the Bank that will be charged to the Government of Israel to secure the debt of Treetops and Treetops II to the Government.
5. (a) The Group's member shall not expressly or impliedly agree to the imposition of an attachment on the means of control in the Bank or any of the entities detailed in paragraph 4 and in the addendum; the Group's members shall not act in any manner that is such as to actually alter the ownership rights in these means of control or the rights embodied therein and detailed in the definition of "means of control" in section 1 of the Law.
  - (b) Should an attachment be imposed despite the aforesaid, over means of control as aforesaid held by a member of the Group, the said member shall act in a way available to him for the immediate removal of the attachment.
6. The means of control in the Bank which are held directly shall be deposited by the Group, for the Group's members or for the Group's members and the government, as the case may be, with one or more Israeli resident trustees whose identity, trust instruments and the instructions given to them within the trust instruments shall be subject to the Supervisor's prior written approval.
  7. The Group's members, their relatives or corporations under the control of any one of them shall not receive management fees or any other consideration neither from the Bank nor from corporations under the Bank's control; however, they may provide services ordinarily provided by the providers thereof, at market prices,

provided that prior written notice has been given to the Supervisor regarding the nature of the service and the consideration, at least 14 business days prior to providing of the service; if the Supervisor has given notice that the service is not of the type ordinarily provided to others or that the consideration for the service is unreasonable, the service shall not be provided.

The provisions of this paragraph shall not apply to directors' remuneration that is paid in an indential amount to all the Bank's directors.

8. (a) No dividend shall be distributed from the Bank's profits that accrued prior to September 30, 2004. If losses accrued after this date, no dividend shall be distributed until after these losses have been covered; in addition, no dividend shall be distributed from profits from the sale of material assets of the Bank for five years from the date of the grant of this permit. Thereafter, dividend may be distributed from the sale of assets as aforesaid, subject to the Supervisor's prior written approval.
- (b) Notwithstanding the aforesaid, dividend may be distributed from profits from a sale of material assets of the Bank in the five years following the date of the grand of the permit, on the fulfillment of all the following conditions:
  - (1) The sale derives from legal requirements governing the Bank;
  - (2) The distribution of dividend from profits from a sale of such assets does not result in a reduction in the minimum capital ration of the Bank existing prior to the sale of the said assets;
  - (3) The Bank's board of directors approves the distribution after examining the Bank's needs and its business plans;
  - (4) The Supervisor gives his prior written approval to an aforesaid distribution, after examining the Bank's capital adequacy and the board of directors' decision and the basis thereof.
9. (a) Without the Supervisor's prior written approval, the Group's members or any of them, or corporations under their control, shall not engage in any business, in Israel or abroad, of receiving deposits – even from less than 30 people, or granting credit, or any other financial business in Israel that is such as to compete with the Bank's business.
- (b) Without the Supervisor's prior written approval, the Group's members or any of them, or corporations under their control, shall not be interested parties, directors or senior managers in corporations engaging in business of the type mentioned in sub-paragraph (a) above; in such regard, "interested party" means someone holding 5% or more of any type of the means of control.
10. 100% of the total balance sheet assets of each of the purchasers is to be financed from capital. Notwithstanding, the purchasers will be entitled to finance the acquisition of the controlling interest by way of a debt to the Government of Israel. Financing of the purchase of the means of control in the Bank, including the grant of guarantees for financing as aforesaid, shall not be provided, directly or indirectly, by the Bank or by banking corporations under its control.
11. The Bronfman and Schron Group shall reduce their liability to the Bank in order to comply with Proper Banking Management Directive No. 312 concerning a banking corporation's business with related persons, unless otherwise approved by the Supervisor, in advance and in writing.
12. The Group shall do the utmost to ensure that the memorandum, articles of association and all the procedures of the Bank will match and conform with, insofar as required and at any time, with the provision of the permit.

## ARRANGEMENTS WITH REGARD TO COOPERATION BETWEEN THE BUYERS AND THE GOVERNMENT, IN RESPECT OF HOLDING SHARES OF THE BANK AND EXERCISING THE CONTROL IN THE BANK

In the Agreement for the sale of a controlling interest in the Bank arrangements and various undertakings have been prescribed with regard to cooperation between the Government and the Buyers, in respect of their holdings of shares of the Bank, and with regard to the exercise of control in the Bank by the Buyers. Furthermore, contingencies were determined regarding the provisions of the Bank Shares Arrangement Law (see below) the principal aspects whereof are as follows:

- Provisions were prescribed that will apply for as long as the period for the exercise of the Option shall not have ended (meaning until the end of 2008 or before that due to the Full Exercise of the Option) (hereinafter “the Support Period”) with regard to coordinating the manner of voting, by virtue of the Buyers’ holding of the Bank’s shares and by virtue of the holding of the Government of the option shares, at the Bank’s general meetings and also with regard to the appointment of directors to the Bank’s board of directors, pursuant where to four directors who were proposed for election by the Government and nine directors who were proposed for election by the Buyers shall be appointed (and if the Government’s holdings in the Bank fall below 10%, two directors proposed by the Government for election and 11 directors proposed by the Buyers for election shall be appointed). It was also prescribed with regard to determining the identities of the candidates to serve as external directors of the Bank, that the first will be proposed by the purchasers and the second by the Government and all for the period and on the terms and conditions prescribed for such purpose in the and all for the period and on the terms and conditions prescribed for such purpose in the agreement.
- It was prescribed that during the Support Period, the Parties will employ their best efforts to cause that on all of the key committees of the board of directors of the Bank there will serve. At least one Director proposed by the Government will be appointed; in addition, for as long as the Bank remains the controlling shareholder of material companies, and directors of the Bank are appointed as directors of the aforesaid companies, and as long as the Bank has the right to appoint more than one director. At least one Director proposed by the Government will be appointed as a director on behalf of the Bank in each one of the aforesaid companies, and all on the terms and conditions prescribed for such purpose in the agreement.
- It was prescribed that during the Support Period, and on condition that the Buyers and those participating with the Buyers in the control nucleus shall hold at least 26% of the Shares of the Bank, shall fulfill their undertakings pursuant to the Agreement, and cause the Bank to comply with all of the provisions which the Buyers are required to cause the Bank to comply with the Government Representatives will refrain at the general meetings of the Bank, from exercising the voting rights pertaining to the Option Shares held by the Government, up to such portion that the Shares being held by the Buyers and by anyone participating with the Buyers in the control nucleus will confer 50.1% of the voting rights of the totality of Shares voting, for or against, at such meeting. It was agreed that representatives of the Government are entitled to vote in accordance with their own judgment, in respect of transactions with interested parties. Also, it was determined that, at the request of the purchasers, the representatives of the Government will be entitled to vote together with representatives of the purchasers instead of abstaining, all according to the conditions set in the agreement. During the Support Period the Government shall refrain from giving an instruction in accordance

with Section 28(a)(3) of the Bank Shares in Arrangement Law. (Regarding the provisions of this law, see the "Bank Shares Arrangement Law" below).

- **In this clause -**

**"The restriction period"** means the period commencing on the closing date and continuing: (1) for so long as the Government and any party on its behalf jointly hold no less than 10% of the Bank's issued share capital or (2) until the end of four years from 31st December 2005 in an event in which the Buyers have not fully exercised the option, or (3) until the end of three years from 31st December 2005 in an event in which the Buyers fully exercised the option, whichever is the shortest period.

**"The additional period"** means the period commencing at the end of the restriction period and continuing: (1) for so long as the Government and any party on its behalf jointly hold no less than 5% of the Bank's issued share capital; (2) until the end of three years from the end of the restriction period; or (3) until after the full exercise of the option, whichever is the shortest period.

- During the restriction period the Buyers shall not carry out any of the following actions and they shall use their best endeavors to ensure that the Bank refrains from executing them, unless the action has been given the Government's prior written consent: (a) the voluntary winding up of the Bank; (b) a split of the Bank, merger of the Bank with companies that are not fully owned subsidiaries, a settlement or arrangement, within the meaning thereof in the Companies Law, 5759-1999, to which the Bank is a party, and any similar operation that affects the Bank's issued share capital; (c) an allotment of shares, change of the rights attached to shares, increase of capital (authorized or issued) and the distribution of bonus shares or the issue of rights by the Bank; (d) payment of management fees or the grant of another benefit by the Bank or corporations of the IDB Group (within the definition thereof in the sale agreement) to interested parties in the Bank, save for determining the terms and conditions of the chief executive officer's employment, and every exceptional transaction in which an interested party at the Bank has a personal interest; (e) a change in the Bank's documents of incorporation.

Pursuant to the provisions of the agreement, the Government shall not refrain from granting its consent to the actions as set forth in sub clause (b) above and to the actions as set forth in sub-clause (c) above, that are required for such purpose, save on reasonable grounds, relating to a material change of the Government's rights pursuant to the Agreement for the sale of a controlling interest in the Bank or an impairment to the value of the Bank's shares that the Government holds or an impairment to its ability to sell them.

- The Buyers have undertaken to use their best endeavors, subject to every law, in order to ensure that during the restriction period the Bank shall refrain from issuing shares and securities convertible into shares, save with the prior written consent of Holdings and the Government, and subject to the matters set forth below: (a) the Government and Holdings shall not refrain from agreeing to the issue of shares of the Bank in accordance with a written initiated demand of the Supervisor of Banks of the Bank of Israel, in accordance with his authority at law; (b) any issue as aforesaid to which the Government or Holdings have given their consent and also any issue of shares by the Bank, during the additional period, shall be effected in coordination with the Government, and the Bank shall enable the Government to join the sale with shares of the Bank out of the shares that it holds, at a rate of up to one half of the total number being sold in any offer, and all subject to the terms and conditions prescribed for such purpose in the sale contract.
- It has been prescribed that in the event of a sale of the control of Discount Bank New York, all the

consideration in cash received in respect of the sale shall be transferred to the Bank and it shall not be possible to draw a dividend from the monies of such consideration until five years from the date of signing the Agreement for the sale of a controlling interest in the Bank have elapsed, unless otherwise agreed upon with the Bank's workers' committee.

- Restrictions as to a transfer of the holdings of the parties to the agreement in the Bank during the course of the restriction period and/or during the course of the additional period were prescribed. The Buyers are entitled to transfer Shares or to issue shares to whom ever shall be a Participant in the control nucleus, only after the Buyers shall purchase from the Government at least 35% of the Issued Share Capital of the Bank. Any sale by the Buyers to a transferee which shall not be a Participant in the control nucleus, including sale offer of Shares of the Bank by means of a prospectus, provided that the Government shall be afforded the right to join in the sale and exercise its tag-along right, to sell Shares from the Bank's Shares held by the Government, and all on the terms and conditions prescribed for such purpose in the agreement.
- The Buyers have undertaken to cooperate with the Government and Holdings and to use their best endeavors such that the Bank and its officers and the other corporations in the IDB Group (as defined in the agreement) and the officers thereof shall cooperate with the Government and Holdings, at the Bank's expense (save with regard to the payment of underwriting and distribution commissions that shall apply to the Government), with the intention of assisting the Government and Holdings to sell the balance of the Bank's shares and such being in accordance with their duties pursuant to the Bank Shares in Arrangement Law, and pursuant to the existing cooperation agreement between the Bank and Holdings and subject to every law, and also in accordance with the provisions prescribed for such purpose in the agreement.
- It was prescribed that for as long as the Buyers control the Bank, the Buyers undertake to act so that the directors and officers who served in the Bank prior to the Closing Date will be afforded exemption, indemnification and insurance terms identical, inasmuch as possible, to the terms which shall be adopted by the Bank in relation to directors and officers who shall be appointed in commencing from the Closing Date in such manner as shall secure them insurance coverage, exemption and indemnification as aforesaid also with respect to their actions during the period preceding the Closing Date. The Buyers agreed that the aforesaid will also apply to the officers of the subsidiaries of the Bank.
- It was prescribed in the Agreement for the sale of a controlling interest in the Bank with regard to Section 41 of the Bank Shares in Arrangement Law, that the provisions contained in the Agreement will prevail over any provisions to the contrary in the Law. Without derogating from the generality of the foregoing it is agreed that the provisions of the Agreement will prevail over the provisions contained in Sections 18, 19(e), 23 and 24 of the Bank Shares in Arrangement Law with regard to the manner of appointment of the directors of the Bank and will prevail over the provisions contained in Section 21(b) with regard to the term of office of external directors. The provisions of the Agreement supplement the provisions contained in Section 33 of the Law with regard to cooperation with the Government and delivery of any information to the Government for the purpose of sell of the balance of the Bank's shares that the Government holds. The provisions contained in Section 22 of the Law with regard to the consent of the committee to the appointment of the chairman of the board of directors will not apply. The provisions contained in the Agreement will prevail over the provisions contained in Chapter F of the Bank Shares in Arrangement Law, with regard to the restriction of the exercise of the voting rights of the Government.

## ARRANGEMENTS BETWEEN THE MEMBERS OF THE BRONFMAN-SCHRON GROUP

According to information provided to the Bank, Treetops and Treetops II (hereinafter – “the Buyers”) as well as the members of the Bronfman Group and Rubin Schron (hereinafter – the members of the Bronfman Group and Rubin Schron are named together: “the Investors”) entered into an agreement with respect to their investment in the Bank, which includes a Summary of Principal Terms detailing the manner of the cooperation between the Investors, which was approved by the Bank of Israel (hereinafter – “the Cooperation Agreement”). Furthermore, the investors signed a Clarification Letter, which clarifies and/or adds to the terms of the Cooperation Agreement (hereinafter – “the Clarification Letter”). On January 24, 2006, Bank of Israel informed the investors that the sale of shares constituting part of the controlling interest without the prior coordination with the Governor of Bank of Israel, even if effected more than five years after the date of receipt of the permit, would most probably breach the conditions of the permit. Notwithstanding, the Bank of Israel advised that it has no objection to the Clarification Letter being signed for the purpose of determining certain accords between the Investors, provided that the Clarification Letter would be amended or replaced after the Bank of Israel had examined it. To the best of the Bank’s knowledge, the Bank of Israel has not raised the issue matter again and, as of date of publication of this report, the letter of clarification has not been amended or replaced.

The Cooperation Agreement determines, among other things, that of the number of directors that the Buyers are entitled to appoint to the Bank’s board of directors, the Bronfman Group and Rubin Schron (hereinafter named: “the Schron Group” and together with the Bronfman Group – “the Groups”) are entitled to appoint directors in proportion to the relative percentage of each group in the total ownership rights of all the Investors being limited partners in the two Buyers together (the overall ownership rights as above, in the two Buyers together are hereinafter: “the Interests”). To date, according to the Agreement for the Sale of the Controlling Interest, the Bronfman Group is entitled to appoint five members to the board of directors and the Schron Group is entitled to appoint four. In addition, the Bronfman Group is entitled to appoint the first outside director that the two groups would be entitled to appoint, when such office becomes vacant, whereas the Schron Group would be entitled to appoint the second outside director (as to the subject of agreements between the Buyers and the Government regarding the appointment of outside directors, see above). The identity of the members of the board of directors recommended by each Group is to be determined by the majority of shareholders in the general partner of each of the Buyers. The Buyers would vote by power of their shares in the Bank for the appointment to the board of directors, as aforesaid.

The Cooperation Agreement further stipulates that the Buyers would vote jointly on all issues brought before a General Meeting of shareholders of the Bank. For this purpose, prior to every such general meeting, each Buyer shall hold a meeting of shareholders in its general partner, during which each shareholder would state how, in his opinion, the Buyers are to vote with respect to the issue in question. Excluding decisions regarding specific matters that require a special majority vote of over 67%, as stated below, and with respect to the appointment of members of the board of directors, as stated above, the Buyers shall not vote in favor of any issue brought before a General Meeting of shareholders of the Bank, unless such vote is supported by shareholders holding together over 50% of the Interests.

It has been stipulated that with regard to the following resolutions, a special majority of over 67% of the Interests would be required: sale of Bank shares by the Buyers; a significant raising of capital in which the Bank is involved;

mergers, splits, significant acquisitions or sales in which the Bank or the Buyers are involved; issuance of capital or debt securities by the Buyers; any amendment to the rights attaching to the Interests; liquidation (including voluntary) of any of the Buyers; appointment of the chairman of the board of directors of the Bank.

The Cooperation Agreement further stipulates that the net consideration, which each of the Buyers would receive for the sale of shares in the Bank or dividends and other payments that would be received from the Bank, would be distributed by each Buyer as follows: (1) firstly, each Buyer would distribute to each of its Investors a proportion of the said amounts according to the relative share of its investor Interests in that Buyer, until the recovery in full of the amounts invested by him in that Buyer; (2) secondly, each Buyer would distribute to each of the investors in it an amount equal to 8% per annum (cumulative) on his investment in that Buyer; (3) after having made the payments as described in (1) and (2) above, Treetops (and not Treetops II) would distribute 15% plus as additional amounts to SLP, and the balance (85% excluding the additional amounts) would be distributed to the investors in Treetops, pro-rata to their share, all as detailed in the Cooperation Agreement. Certain amounts paid to SLP by Treetops would be distributed to Mr. Matthew Bronfman, to a corporation owned by Mr. Michael Rubinoff as well as to Cam Discount, all according to the distribution and terms stipulated for this purpose in the Cooperation Agreement.

The Cooperation Agreement stipulates that, at the request of shareholders of the general partners in the Buyers who hold not less than 67% of the Interests, the Buyers would exercise the option granted to them according to the Agreement for the Sale of the Controlling Interest. In as much as it would be decided by the shareholders, as above, that the exercise of the option would be effected by means of additional capital investment of the Investors in the Buyers, then each investor would be entitled not to exercise his right, and in such a case other members of his Group would be entitled to exercise his proportionate share in the option. If all the Investors in any Group elect not to exercise their share in the option, then members of the other Group may do so in their stead. If the option is not exercised in full up to 180 days prior to the expiration of the option, then any Investor may cause the exercise of the option by giving notice, and, in such a case, if Investors holding less than 67% of the Interests would agree to finance the exercise of the option, then the Buyers shall divide, pro-rata, the rights to exercise the option to the Investors interested in exercising it or to entities under their control.

The Cooperation Agreement further stipulates that the Investors in each Buyer will have the right to participate in future allotments of shares by the Buyer in which it has an interest. It is also stipulated in the Cooperation Agreement, that during the first five years from date of acquisition of the controlling interest (or any shorter period that the Agreement for the Sale of the Controlling Interest allows), no sale, exchange, pledge or transfer (hereinafter together – “transfer”) of any of the interests in any Buyer (excluding transfers to family members or family entities) would be permitted without the consent of the general partner of that Buyer. In the event that permission for the transfer has been granted, or subsequent to the said period, any transfer would be subject to the right of first refusal granted to Treetops or Treetops II, as the case may be, and to any other investor, as well as subject to a Tag Along right. In addition, members of the Bronfman Family will continue to hold, at all times, at least 50.1% of the Interests held by members of the Bronfman Group, and Rubin Schron will continue to hold, at all times, at least 50.1% of the Interests held by the Schron Group. It is further stipulated in the Cooperation Agreement that if those who hold over 55% of the Interests would decide to sell over 55% of the Interests, they would be entitled to force the other Investors to sell, under the same conditions, the balance of the Interests held by them.

It was decided that the unanimous approval of Mr. Mathew Bronfman, Mr. Leonard Grunstein on behalf of Mr. Rubin Schran and Mr. Michael Rubinoff, is required to change the controlling shareholders' agreement.

The Clarification Letter stipulates that as from the end of five and one half years from date of closing of the transaction, each Buyer would be entitled to decide to surrender the Bank of Israel permit, for the purpose of the sale of the controlling interest shares, according to the letter attached to the permit (as described above). A Buyer choosing to do so is to inform the other Buyer accordingly, and in such a case the other Buyer would have the right of first refusal or the Tag Along right in respect of all the shares held by him, all subject to and in accordance with the terms to be agreed upon (in the future) between the Buyers regarding this matter. The sale of shares in accordance with this paragraph will not require a majority of 67% of the Investors (as required for the sale of shares according to the Cooperation Agreement).

The Clarification Letter further stipulates that the Cooperation Agreement would be valid so long as anyone of the Buyers holds, directly or indirectly, over 5% of the share capital of the Bank. It is further stipulated that the provisions of the Cooperation Agreement which apply to the controlling interest shares, shall apply also to shares acquired, directly or indirectly, by the Buyers or the Investors through the exercise of the option, including together with others. The voting rights attached to the shares so acquired as well as to other shares held by the Buyers or Investors, including together with others, shall be used in accordance with the manner in which the Buyers of the controlling interest shares vote, as detailed above.

## CREDIT AGREEMENT

According to the information provided to the Bank, the Buyers shall be entitled to pay the balance of the consideration on dates and under terms detailed below, subject to the signing at date of closing of an Annex to the Sale Agreement, which will include 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 by the end of 36 months from date of closing of the transaction (hereinafter – “the First Period”).

The exercise price of the option or any part thereof shall be paid upon the exercise of the option, unless a part of the payment has been deferred in terms of circumstances determined for this purpose in the credit agreement.

- 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 a permit from 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, 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 collateral to 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 includes events of default and other circumstances in which the debt will become immediately payable.

### THE BANK SHARES ARRANGEMENT LAW

As stated above, the Bank Shares Arrangement Law was enacted in order to regularize the holdings of the State in the shares of the banks and the voting rights attached thereto as well as other related matters, this in order to enable the Government to sell the bank shares transferred to its ownership, in a manner deemed appropriate to it, and to avoid involvement in the current management of the business of the banks in the period until these shares are sold, while preserving the proprietary interest of the State in the shares and to allow structural changes in the banking industry according to Government policy and any law. The Law stated that the use of the voting rights attached to the shares in the name of the State and on its behalf shall be made by a committee for the bank shares (hereinafter – “the Committee”), which shall be appointed separately in respect of each bank, by a public body to be appointed by the Government. On December 22, 2005, the Bank Share Arrangement Instruction (Temporary Provision)(Appointment of other committees and the period of their tenure), 2005, was published in the Official Gazette, which determined that where the State has transferred control of a bank to another entity, the appointment of the Committee shall terminate. Notwithstanding, in response to an approach by the representative of the purchasers, the representative of the State informed on April 10, 2006, that the Committee for the shares of the Bank shall continue to act on behalf of the State for the purpose of voting by power of the Bank shares in its possession.

### PRINCIPAL PROVISIONS OF THE LAW

Section 41 of the Law states that upon sale of shares by the Government in a transaction designed to lawfully transfer of control over a bank, the provisions of Sections 3 and 5, Chapters E and F and Sections 33 to 36 will apply, subject to provisions specifically determined for this purpose in the sale agreement. Described hereunder

are the said provisions of the Law that are still relevant, and the amendments thereto according to the sale agreement, which is the agreement for the transfer of the control core of the Bank.

The agreement for the transfer of the control core of the Bank states that the provisions of the Bank Shares Arrangement Law with respect to the appointment of Directors (Chapter E of the Law) shall not apply. As to the provisions of Chapter F regarding General Meeting of shareholders, the agreement states that the provisions relating to the Committee shall apply to representatives of the Government even though they do not constitute the Committee. The provisions of Chapter F state that the Committee is bound to participate in general meetings of shareholders of the Bank, and to vote by power of the shares held by the Government in the manner decided upon by the Committee.

In the event that a proposal was tabled at a General Meeting to change the documents of incorporation of the Bank, the Committee shall vote in accordance with its good judgment, provided only that it should vote against any change that might be detrimental, directly or indirectly, to the rights attached to the shares or the ability to sell them, or to the Government policy relating to the sale of the shares, or to anything relating to structural changes in the banking system, and in the case of doubt, the Committee has the right to consult with the Minister of Finance or with whoever he appoints for this purpose.

As to the matter of approval of Directors' remuneration, the Committee is not permitted to vote for an increase in the remuneration in excess of the increase in the average wage in the economy, unless the results of the Bank justify such an increase.

Section 28 of the Bank Shares Arrangement Law states that the Minister of Finance, with the approval of the Government or of a Ministerial Committee authorized by the Government, shall be permitted to instruct the Committee to request the calling of a General Meeting of shareholders of the Bank, to participate therein and to vote in accordance with his instructions on any matter, including the amendment of the documents of incorporation, if, in his opinion, this is required for the achievement of any of the following objects:

- (1) Effecting the sale of the shares, including the fulfillment of obligations and realization of the rights determined in the sale agreements, and including the passing of resolutions as to changes in the share capital required to facilitate the trading in the shares as well as other related actions;
- (2) The avoidance or minimizing of an actual impairment, direct or indirect, of the rights attached to the shares, of the ability to sell them or of the proceeds of their sale;
- (3) Effecting structural changes, including the sale of material assets of the Bank or a reorganization of the Bank and companies under its control, required by law or which the Government has decided upon before October 31, 1993, however if shares of the Bank were sold to the public in accordance with a Prospectus, this authority shall be acted on only if the proposed structural changes are required by law or were specifically stated in the Prospectus, or if these matters shall not be detrimental to the Bank. This Section shall not apply during the support period;
- (4) Adoption of a policy for the distribution of dividends out of the earnings of the Bank, subject to limitations set by the Supervisor of Banks regarding the preservation of the stability of the Bank;
- (5) The assignment of authority as regards matters mentioned in (1) to (4) above, to the General Meeting of shareholders.

Section 33 of the Bank Shares Arrangement Law states that the Bank and every officer thereof, as well as any

company controlled by the Bank and any officer thereof, shall cooperate with whoever is engaged with the sale of the shares of the Bank. It is further stated that the manner of the cooperation of the Bank would be in accordance with the provisions of the agreements signed between the Government and the M. I. Holdings and the Bank, and everything as detailed in the said Section.

### THE EFFECTIVE PRICE OF THE TRANSACTION FOR THE SALE OF A CONTROLLING INTEREST OF THE BANK

On May 17, 2005, M.I. Holdings Ltd. provided the Bank with an opinion given the Goren Capital Group Ltd. which was prepared for M.I. Holdings Ltd. and the Finance Ministry in the matter of "The estimated economic value of the package of shares and options which constitute the controlling interest in the Israel Discount Bank".

In the summary of the Opinion, it is stated that:

- The consideration in the amount of NIS 1,300 million, received by the sellers from the Buyers for the package of shares and options, reflects an effective price for the transaction of between 74% and 81% of the equity of the Bank at date of the sale, and an effective price for the transaction of between NIS 4.67 and NIS 5.20 per share.
- The estimated effective consideration took into account the weighted value of the options granted to the Buyers, these being based on an estimate of 50% of their value according to the B & S model, which reflects, according to the Goren Capital Group Ltd. estimate, a fair economic value, considering the many restrictions imposed on the options, their exercise and the receipt of the potential benefit inherent in them following their exercise.

This Opinion was attached, with the consent of the authors thereof, to an immediate report issued by the Bank in the above matter on May 23, 2005.

It should be mentioned that the Bank was not a party to the process of the sale and that it was neither involved in commissioning the valuation nor in the formation of the Opinion.

### THE PRICE IN THE TRANSACTION FOR THE SALE OF THE BALANCE OF THE STATE'S SHARES IN THE BANK

Pursuant to a notice received by the Bank from the State of Israel on May 11, and May 15, 2006, the State sold shares comprising 6.09% of the issued share capital of the Bank in consideration of approximately NIS 553.7 million. (As abovementioned, the said parcel of shares constitutes the balance of the State's holdings in the shares of the Bank, i.e. the shares held by the State over and above the number of shares in respect of which the State granted the option to the Bronfman-Schron Group). The price of the transaction was determined at NIS 9.268 per share.

### 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 (see hereunder). 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.

Set out 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 above-mentioned concession, the employees will receive from the Government a 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 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 the following dates; (1) an amount of NIS 205 million payable in September 2005 or immediately following the closing, according to the later date; (2) an amount of NIS 45 million payable not later than the end of three years from date of closing, or close to the date of exercise of the option by the purchasers, in the event that the purchasers will exercise their right to exercise the option, in whole or in part, according to the earlier date (in practice, as stated below, the total bonus was paid in full immediately following the closing date).
- 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 the 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 (see "Mercantile Employees Agreement" hereunder).

- The power of the Labor Charter as a collective labor agreement at Discount Bank, shall be extended for a period of five years, namely until December 31, 2009. At the end of this period, the parties shall act with regards to the power of the Labor Charter, in accordance with section 3 thereto.
- 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 Israel Discount Bank of New York is sold, then the full cash proceeds of such sale will be transferred to the Bank, and that no dividend shall be distributed out of such proceeds for a 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 for 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 be made by any of the parties that are not compatible with the Labor Charter. No strike or closing-down measures, in whole or in part, will be taken, nor will anything that might impair Labor Relations and orderly work procedures be brought into effect.

The Employees Agreement was subjected to the approval of the authorized institutions 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). On April 5, 2005, the General Meeting of Shareholders of the Bank approved the Bank joining the Employees Agreement. Within the approval, it was stated that the total cost to the Bank (employer's cost) will be NIS 130 million (and shall not exceed that amount).

The Employees Agreement was also subject to the approval of the Finance Committee of the Knesset. The Finance Committee approved the Employee Agreement.

Soon after the closing of the agreement for the sale of a controlling interest in the Bank, which occurred in the first quarter of 2006, the Bank and its relevant subsidiaries paid the overall bonus agreed upon in the Employees Agreement. The total cost of this bonus, including related expenses (payroll VAT and National Insurance contributions) amounted to NIS 305 million. Accordingly, the bonus that is to be paid by the State will amount to NIS 175 million, of which NIS 120 was paid in March 2006, and the balance will be paid upon the exercise of the option by the Bronfman-Schron Group.

**Mercantile Employees Agreement.** On May 22, 2005, the Histadrut, The Representative Committee of Mercantile Discount Bank Employees and the Accountant General at the Ministry of Finance signed an agreement, which, inter-alia, is subject to Mercantile Discount Bank's approval (see hereunder). The Mercantile Employees Agreement is intended to settle several demands raised by employees of this bank regarding their rights in light of the sale of the controlling interest in the Bank by the State.

The terms of the Mercantile Employees Agreement are as follows:

- 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 Discount Bank which are held by the State, at a 25% discount, and to a subsidized loan to finance this purchase, as is customary in privatization of banks being part of the "Share Arrangement".
- In exchange for the above-mentioned concession, the employees will receive from the Government a 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.
- The employees would be entitled to receive from Mercantile Discount 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 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 amount of the bonus payable to the employees of Mercantile Discount Bank will be the proportional amount applicable to the Mercantile Discount Bank out of the total amount of the bonus (NIS 250 million) as defined in the said Employee Agreement. The said bonus will be paid to the employees subject to the closing of the agreement for the sale of a controlling interest in the Bank, and at dates specified in the Agreement (regarding acceleration of part of the bonus payment, see details of the conditions of the Employee Agreement, above).
- The employees entitled to the Total Grant are those who, at date of closing, are employees of Mercantile Discount Bank and of the wholly owned subsidiaries of Mercantile Discount Bank in Israel, and who are tenured and permanently employed, and also those employed under personal employment agreements, which, at the closing date have been with the Bank for at least one year.
- The validity of the collective agreements at Mercantile Discount Bank (as the term is defined in the collective agreement dated December 21, 2004 and all its Annexes) will be extended for a specified period until December 31, 2009. At the end of this period, the parties shall act as regards to the validity of the collective agreements, in accordance with the terms of Section 5 of the labor agreement dated May 17, 1968.
- The labor dispute announced at Mercantile Discount Bank on March 29, 2004, with regard to the privatization of Discount Bank, shall be terminated immediately upon the approval of the Mercantile Employees Agreement.
- Immediately following the approval of the Mercantile Employees Agreement, the employees of Mercantile Discount Bank will cooperate in any matter or action required for the closing of the transaction for the Sale of the Controlling Interest in Discount 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 Mercantile Employees Agreement, the parties to the Mercantile 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 collective labor agreements. No strike or closing-down measures, in whole or in part, will be taken, nor will anything that might impair Labor Relations and orderly work procedures be brought into effect.

The validity of the Mercantile Discount Bank Employees' Agreement was subject to approval of the authorized

institutions of this bank, approval of Mercantile Discount Bank Employees' Council and the approval of the Finance Committee of the Knesset. On May 30, 2005, the Representative Committee of Mercantile Discount Bank Employees approved the Mercantile Employee Agreement. The Board of Directors of Mercantile Discount Bank approved the agreement on June 9, 2005, and the General Meeting of shareholders of Mercantile Discount Bank approved the agreement on June 20, 2005. The Finance Committee of the Knesset approved the Agreement.

In an Annex to the Mercantile Discount Bank Employees Agreement, which the signatories thereto (the New Histadrut Federation of Labor, Mercantile Discount Bank Employees' Committee and Mercantile Discount Bank) agreed to be an integral part of the said agreement, it has been agreed that despite the time schedule determined in the Mercantile Discount Bank Employees' Agreement, the date of payment of one month salary shall be advanced, and that following the approvals by the Mercantile Discount Bank institutions and by the Employees' Council of Mercantile Discount Bank, it will be payable to whomever at date of payment will comply with the entitlement terms prescribed in the Mercantile Discount Bank Employee Agreement. With this, all the claims of the employees of the Mercantile Discount Bank as regards to the bonus in respect of 2004 have been exhausted. The said payment will be deducted from the payment that will be carried out according to the Mercantile Discount Bank Employees' Agreement.

As stated above, the award to the employees of Mercantile Discount Bank was paid in the first quarter of 2006, soon after the closing date of the agreement for the sale of controlling interest in the Bank.

#### THE ACCOUNTING TREATMENT OF THE EMPLOYEE AGREEMENT

The financial statements for 2004 included a provision in respect of the bonus for 2004, to the amount 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 the financial statements for the first quarter of 2006, in which the conditions precedent in the Employees Agreement were 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 175 million, including 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, in the first quarter of 2006, along with recording the provision for the special bonus.

## 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 and 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.

### REFORM IN THE STRUCTURE OF THE ISRAELI CAPITAL MARKET AND IN THE ACTIVITY OF THE BANKS AND OTHER PLAYERS IN THE CAPITAL MARKET FIELD

Towards the end of 2004, the Government adopted the recommendations of the inter-office committee, headed by the General Director of the Ministry of Finance (the Bachar Committee) and during the year 2005, the legislation designated to carry out the Government's decisions in these areas, was formed and approved. This concluded in fact the legislation work intended to formulate arrangements in various areas relating to the activity of the banking industry, as to which decisions were taken by the Government as early as 1993.

In August 2005, three comprehensive laws were published relating to the activity of the banks and other players in the capital market: The Law for Increasing Competition and Reducing Concentration and Conflicts of Interest in the Capital Markets in Israel (Legislation amendments), 2005; The Supervision of Financial Services Law (Provident Funds), 2005; The Supervision of Financial Services Law (Consulting and Marketing of Pension Schemes), 2005. In the course of 2005 and also in 2006 and 2007, Rules and Regulations were published in order to complete the arrangements through secondary legislation. Furthermore, many proposed Bills and Standards were also published, which amend or update the arrangements with respect to the capital and pension savings

market. In this context, a proposed Bill was published in March 2007, for the increase in the rate of participation in the workforce and for the decrease in social gaps (negative income tax, compulsory pension, reduced tax rates and legislative amendments), 2007, which deals, among other things, with the establishment of compulsory pension for every worker.

The new legislation is designed to bring about a change in structure of the capital market and in the role of the banking industry therein. Banks are required, within a transition period as determined in the legislation, to discontinue their form of activity which existed until then in the field of provident and mutual funds, and to transfer the management and ownership thereof to other capital market players, thereby turning into consultants in the capital market and pension fields, who do not have a direct interest in the products that are being sold to their customers. Within the framework of the new legislation, the provident fund field has been regularized for the first time by primary legislation, and a new law was passed regarding the pension industry, dealing with pension consultancy and marketing.

For a condensed review of the principle changes in legislation and their implications, see Note 33 to the financial statements. For details regarding the Bank's preparations in respect of the Israeli capital market reform and changes in legislation, see "Non-financial companies sub-segment" under "Activity of the Group according to Principal Segments of Operation" and "Operations in the Capital Market" under "Further details regarding activity in certain products".

### CLASS ACTION SUITS LAW, 2006

In March 2006, the Knesset passed the abovementioned law, which determines a general arrangement for the filing and management of class action suits, and replaces, among other things, the provisions regarding class actions against banks included in the Banking Law (Customer service), 1981. The law broadens the causes for filing class action suits against banks, and determines that a class action suit may be filed against a bank "in respect of a matter between the bank and the customer, whether they have entered into a transaction or not". Further causes have been determined, which might serve as a basis for an action against banks, such as a cause deriving from the affinity to securities or to a participation unit in a mutual fund, and so forth.

The law is forthcoming to plaintiffs and allows the Court extensive judgment as regards the approval of an action as a class action, and in this regard the conduct of the class action, defining the group and subgroups, replacing the representative plaintiff or representative attorney, attaching representative plaintiff or a representative attorney, permitting a public service organization to participate in the hearing. The law requires a closer supervision than previously on the withdrawal of a class action by the representative plaintiff and on compromise arrangements and determines the possibility of ruling for compensation in favor of the appellant and to the representative plaintiff even when the class action was not approved or was not ruled in favor of the group.

The law provides protection to certain entities, including banks, both at the approval stage of the class action and at the stage of ruling for damages in favor of the plaintiffs, in cases where the action has been admitted, and allows the Court to take into consideration the damage that could be caused to the defendant and to the public using the services of the defendant or to the public at large, as opposed to the benefit of conducting the class action or of the compensation granted. However, the damage to the defendant that the Court may take into consideration is a damage that might be caused "as a result of impairment to the economic stability of the

defendant”, a condition the realization of which as a result of a single action (albeit a class action) served against a bank, is remote.

The law is also forthcoming regarding the limitation provisions, in that, among other things, it determines that in cases where the Court has dismissed or removed a motion for approval of a class action, a claim of a person belonging to the group (or an individual in respect of whom it was determined that he should not be a party of the group) shall not be subject to limitation unless one year has passed since the date on which the motion for approval became definitive.

The transitional provisions of the law applies the new law to class actions and motions for approval of class actions that were pending at date of publication of the law, and provisions were set to avoid the extension of the period of limitation in respect of such motions and motions that had been dismissed prior to the publication of the law. The new law is intended to encourage the submission of class actions, and it is reasonable to assume that a larger number of class actions would now be served generally and against banks in particular. However, at this stage it is yet unknown how the Courts will interpret and implement the provisions of the law in the future. Accordingly, it is not possible to assess the law’s impact on the Bank.

## LEGISLATION PROPOSALS AND ARRANGEMENTS REGARDING BANKING COMMISSIONS

In recent years various matters pertaining to commissions charged by banks appeared on the public agenda, including their rates, types, the disclosure given to customers with regards thereof and supervision thereof. In this respect, a large number of private bills have been tabled before the Knesset, concerning limiting the ability to increase commission rates, limiting the total income from commissions, prohibiting charging commissions in respect of certain services and more, a bill proposing the establishment of a Fair Trade Authority which will be responsible for various matters, including the regulation of bank-customer relations as well as a proposal presented by various entities for the imposition of controls and more. The matter was also examined by various professional teams who have submitted their recommendations thereon.

During 2004, the Commissioner of Restrictive Trade Practices informed that he is considering using his authority under the Restrictive Trade Practices Law in order to determine that five banks, among which the Bank is included, form a “concentrated group”, and following this even published a proposal for the amendment of the Restrictive Trade Practices Law in the matter of regulating his authority with respect to “concentrated groups”.

In July 2005, the Supervisor of Banks and the banks reached an arrangement, with respect to commissions charged from household accounts. The Supervisor informed the Knesset Economics Committee of this arrangement, and on July 14, 2005, issued to the banks a letter detailing the principles for the implementation of the “package deal” in the matter of commissions pertaining to current accounts of private customers.

During 2006, this matter was discussed from time to time, and a parliamentary commission of inquiry was appointed, at the beginning of 2007, to examine all aspects thereof.

The proposal determines also a reporting format for the supervision of banks with respect to commissions charged, which would also serve for comparative publication, as well as instructions regarding the reduction of costs and facilitating the transfer of accounts from bank to bank.

On January 30, 2007, Bank of Israel submitted to the Ministry of Finance a proposed law intended to arrange bank commissions charged to homeowners. The proposed law is based on a proposal drafted by Bank of Israel in 2004,

with several innovations, including authorizing the Supervisor of Banks to determine uniform criteria for the names and content of the commissions, a significant reduction in the number of commissions and the requirement to publish commissions charged to households separately from the published tariff for other commissions. In addition, the law would entitle the Supervisor of Banks to supervise and intervene in respect of prices in the retail banking sector (e.g. in circumstances in which the commission may affect competition, in circumstances in which a customer is charged a commission for services that the bank is committed to provide, the commission is charged for a vital service relating to a current account and in circumstances in which a commission is charged without adequate justification). The proposal determines also a reporting format to the Supervisor of Banks with respect to commissions, which shall be used also for a periodic comparative publication, as well as directives regarding the reduction in costs and facilitating the transfer of customers from bank to bank.

These proposals will be discussed in the Finance Committee of the Knesset as part of the general discussion regarding bank commissions. The Rule of Continuity was also applied to the proposed Bill tabled by the Economics Committee of the Knesset, for the amendment of the Restrictive Trade Practices Law in the matter of prevention of a non-competitive practice by a monopoly, which authorizes the Commissioner to issue instructions to members of a monopoly in the matter of avoidance of impairment of competition and the removal of barriers regarding entry into the market and the transfer of accounts.

For further details see "Retail sector – Household segment", in the section "Activities of the Group according to principal segments of operation".

## PROHIBITION OF MONEY LAUNDERING AND PROHIBITION OF THE FINANCING OF TERROR ACTIVITIES

**Prohibition of money laundering.** The Prohibition of Money Laundering Law, 2000 (hereinafter: "The Prohibition of Money Laundering Law") came into force on August 17, 2000. The Law, inter alia, provides that a person knowingly effecting an operation with prohibited property (i.e., an asset resulting, directly or indirectly, from the commitment of a transgression, an asset that was utilized for the commitment of a transgression and an asset that enabled commitment of a transgression), 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 provides, inter alia, that a person reporting actions as aforesaid shall be exempt from liability.

Following the legislation, regulations were enacted, orders were issued and proper banking management directives were determined (directive no. 411), applying to banking corporations and other entities, including subsidiaries of the Bank. In this respect, principles have, among other things, been determined, regarding the identification, reporting and recording management, determination of policy, monitoring certain accounts and the treatment thereof, and more.

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, 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.

**Prohibition of the financing of terror activities.** In December 29, 2004, the Knesset passed the Prohibition of the Financing of Terror Activities, 2004 (hereinafter: “the Prohibition of the Financing of Terror Activities”), which came 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 any such action actually taken, and that the non-reporting also constitutes a felony.

The Law evoked many ambiguities as to what is required from the banks, in particular, as to the ability of a bank to locate and prevent transactions of terrorists, whose names do not appear on lists published by law, and the capability of the Bank to monitor and prevent the transfer of funds to and from residents of the Palestinian Authority, which might be used for the encouragement of terror activities. In May 2006 the Bank informed the banks operating in the Palestinian Authority, to which it provides clearing services, that these services would be terminated within periods of three and six months.

The implementation of this Law required 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.

Following the announcements by the Bank and by other banks (hereinafter – “the representative banks”), the Governor of the Bank of Israel has asked the representative banks to reconsider their position. Concurrently, the Bank of Israel together with the Prevention of Money Laundering Authority, the Ministry of Justice and the Ministry of Finance, initiated the amendment of the existing provisions and regulations with a view of reducing the uncertainty and risk to which the representative banks are exposed while providing clearing services to the banks operating in the area of the Palestinian Authority and to regularize the duties and operations in this area. In view of the above, the Bank informed the Palestinian banks on September 6, 2006, that the engagement with them would be extended until December 31, 2006.

In December 2006, a special permit concerning the activity of correspondent banks was granted. The Permit includes the Bank and Mercantile Discount Bank, with the banks of the Palestinian Authority and their customers, via a correspondent account conducted by them. An amendment to the Prohibition of Money Laundering Law (Obligations of identification, reporting and maintenance of records by banking corporations for the prevention of money laundering and the financing of terror), 2001, and the Prohibition of the Financing of Terror Regulations (Permission for transactions in assets), 2006 was published. In view of the forthcoming amendments, the Board of Directors had authorized the Management to continue the engagement with the banks of the Palestinian Authority for the granting of clearing representation services, subject to Management’s business discretion.

The said amendments to the order and to the regulations include, inter alia, the following:

- Expansion of identification, examination and reporting requirements, following enactment of the Prohibition of Terror Financing Law, including the requirement to ascertain the identity of parties to a transaction against identifying details of terror organizations and persons declared as terror activists; changes in reporting requirements based on the amount of the transaction (a reporting threshold of NIS 5,000 was determined with respect to transactions with high risk countries and territories); addition of relevant terror financing indicators

- for the purpose of reporting an unusual transaction; restriction on exemptions with respect to transactions for import and export of goods, in order to exclude such transactions between a country and a high risk territory;
- Application of the order to credit card companies;
  - Extensions/relief in accordance with accrued experience, including the requirement to maintain documentary evidence of examinations to verify identity; determination of verification procedures and details and obtaining alternative documentation; extension of exemption relating to a beneficiary declaration.

The order provides for gradual implementation dates for the various provisions, according to the required preparation period.

Part of the instructions were implemented concurrently with publication of the order. Instructions requiring extensive preparation will be implemented within six or nine months, and the Supervisor of Banks is authorized, in certain circumstances, to extend these periods for additional similar periods.

**The Bank's preparations.** The Bank is preparing for the implementation of that which is required from it in accordance with the Law for the Prohibition of Money Laundering and the Law for the Prevention of Financing of Terror and the related secondary legislation. The Bank is acting to acquaint all relevant employees with the procedures relating to money laundering prohibition and the prevention of terror financing. In this respect, systems for the identification and location of customers and activities and reporting them to the Authorities are being developed and currently improved, work procedures are being brought up to date, and new procedures determined, where necessary, and study and training means are provided to managers and employees.

Considering the many changes that are taking place in the primary and secondary legislation regarding the prohibition of money laundering and regarding the prevention of financing of terror, the preparations and assimilation is a continuous activity, both by the Bank and its relevant subsidiaries.

**Audit regarding the implementation of the Prohibition of Money Laundering Law.** During the second half of 2005 and in the first months of 2006 the Audit Department of the Bank of Israel conducted an extensive audit at the Bank regarding the Bank's handling of the prohibition on money laundering.

The audit report is expected to be submitted to the Bank in the coming months.

The extensions of the Bank abroad have completed in 2006 the performance of an audit performed by independent auditors, with respect to the compliance of the extensions of the Bank with regulations relating to the prohibition of money laundering and of the finance of terror activities, applying in each of the extensions' location, as well as with the Group's policy on these matters. The audit reports that were issued do not disclose material findings. The audit reports were tabled for discussion at the foreign extensions committee of the Board.

**Suspected violations of the Prohibition of Money Laundering Law.** Two employees of the Bank received a notice in July 2006 that an investigation file in their case had been submitted for review of the Prosecutor's Office and that they may present their arguments prior to the submission of an indictment against them. In October 2006, the Prosecution's Office informed of the closure of the case against the employees due to lack of fault.

For details regarding violations of the Prohibition of Money Laundering Law in Mercantile Discount Bank, see "Proceedings regarding authorities" under "Legal proceedings".

## GUIDELINES OF THE SECURITIES AUTHORITY REGARDING OBTAINING INFORMATION ON REQUIREMENTS AND INSTRUCTIONS OF A CUSTOMER SEEKING INVESTMENT CONSULTING

In January 2007, the Israel Securities Authority published guidelines for obtaining information on requirements and instructions of a customer seeking investment consulting. The guidelines detail and expand the responsibilities of an investment consultant in respect of obtaining information on requirements and instructions of a customer seeking consulting and advice. The directive requires, inter alia, adoption of an investment policy for the customer by determining several possible risk levels, in accordance with the customer's requirements and needs, and coordination of several potential investments channels for each risk level. The guidelines relate to customers applying for investment consulting as from November 1, 2007, and to customers already receiving consulting services during 18 additional months. The Bank started preparing to implement these guidelines.

## DRAFT REGULATIONS REGARDING DOCUMENTATION OF INVESTMENT CONSULTING

In June 2006, the Securities Authority issued draft regulations and guidelines regarding documentation of investment consulting. The draft expands and details the duties imposed upon investment consultants regarding the above matter.

## PROPOSED AMENDMENT TO THE DEBT EXECUTION LAW, 1967

In October 2006, the "Arrangements in the Economy" law proposal for 2007 was published, which includes a chapter which deals with an amendment of the Debt Execution Law, 1967, was published in September 2006. The law proposal passed its first reading together with the Budget Law. Subsequently, this chapter was detached from the Economic Arrangements Law and is presently under discussion in the Knesset.

According to the said Law proposal, its aim is to propose changes that would improve efficiency of the debt execution system, reduce the burden and increase debt collection. Among other things, the Law proposal includes changes, which in the Bank's opinion, may impair the ability of realizing collateral received to secure credit, a matter that might have an effect on the willingness of banks to provide credit against such collateral. At the present stage, it is not possible to assess what would be the final wording of the law, if it will pass, and how it would affect, if at all, the conduct of the banking corporations and their customers.

## "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).

In 2001, the Commissioner informed the banks that the principles of conduct do not constitute a law, they are not enforceable, and the Commissioner is no longer bound by them.

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. In addition, the Bank, similarly to other banks, has applied for exemption from a binding arrangement as regards the authorization for debiting accounts.

**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.

The Bank has submitted to the Commissioner a computation providing the basis for the commission collected in respect of the withdrawal of cash using automatic teller machines. 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.

**Authorization for debiting accounts.** Following discussions and various notices of the Commissioner and of the Supervisor of Banks in this matter, the Supervisor of Banks informed on July 7, 2003, that for a period of one year, all banks will pay inter-bank commissions at a uniform rate determined by him, both for establishing a new authorization as well as for each entry, provided that the banks have not reached an agreement involving lower commission rates. The Supervisor further informed that he would conduct examinations during the year as to the proper commission rate. Since then the Supervisor of Banks did not inform the banks otherwise, and the banks are continuing to act according to the said notice from the Supervisor of Banks dated July 2003.

**Consortium agreements.** On August 18, 2002, the Commissioner informed Bank Leumi, Bank Hapoalim and the Bank that at this stage he is not able to determine the terms for a "class exemption" regarding consortium

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

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

Since then the Commissioner has extended from time to time the validity of his notice,

During the period, banks were asked to address the possibility that the said terms would be regularized by a class exemption, and to submit to the Commissioner various details regarding the consortium arrangements made. The exemption was further extended in March 2007, until March 8, 2008, and the minimum amount for a consortium, in which also Bank Hapoalim and Bank Leumi participate, was raised to NIS 300 million.

### AMENDMENT NO. 3 TO THE INCOME TAX REGULATIONS (RULES FOR APPROVAL AND MANAGEMENT OF PROVIDENT FUNDS)

The above Regulations were published on April 14, 2005, in which, among other things, the Minister of Finance determined that the deposit of funds with a provident fund should be made only after certain amounts had been deposited in respect of each member with a pension provident fund. Implementation of this provision will begin gradually as from January 1, 2006. Starting with January 1, 2006, provident funds (savings) shall not be permitted to receive deposits from self-employed members who do not comply with the rules.

The Regulations have also restricted the right of a self employed member, to withdraw amounts from the fund until reaching the age of 60 on condition that he has been a member of the fund for at least five years (and not at the end of 15 years from the first deposited amounts with the fund). This provision applies to deposits made from January 1, 2006.

Neither Discount Management of Provident Fund Ltd. nor the Bank have any information as to the deposits in respect of pensions for each of its members.

In the last quarter of 2005 Discount Management of Provident Fund informed all members of its provident funds of the principal anticipated changes in the rules. Where appropriate, members were requested to sign an attached declaration as to their eligibility in accordance with Regulation relating to depositing money for pension.

Efforts were made during 2006 to obtain signed declarations from customers as required. As from January 1, 2007, customers who are required to sign a declaration, as stated, and have not done so, were precluded from making deposits with provident funds.

The said Regulations have an adverse effect on the attractiveness of investments in provident funds.

### FINANCIAL ASSETS CONTRACTS LAW, 2006

In February 2006, the Knesset passed the abovementioned law, designed to provide legal and business certainty

to parties involved in repurchase of securities transactions (REPO) as well as the validity of framework agreements and netting agreements, regulating several transactions between the same parties. These agreements include provisions allowing the parties to terminate all the transactions between them and to offset the values of all these transactions, so that only one of the parties would be required to pay the other party a certain amount. The agreements in question are agreements where one of the parties is a financial institution or the State which are executed according to clearing house principles.

The Law enables to consider all the transactions involved in such agreements as one piece and to offset mutual charges between the parties, even when one of the parties turns insolvent. The transactions are considered as sale transactions and not credit transactions, and the provisions of the Pledge Law would not apply to them – which would absolve the parties from the registration duty required in a pledge transaction. Thus the Law has removed the uncertainty that has prevailed in the Israeli law regarding such matters, and it will enable the integration of Israeli entities in the regular activity of the international financial markets.

### ABUNDANCE OF LEGISLATION INITIATIVES

The year 2006, as its preceding years, was typified by an abundance of legislation initiatives. Many private law proposals have been tabled recently (part of which supported by the Government) regarding the imposition of restrictions on banks (by law or by regulations under it) applying to various fields of activity, including: restrictions on the granting of credit, restrictions on the charging of commissions, restrictions on the payment and/or collection of interest, etc. These law proposals and other similar ones, if passed, might have a material adverse effect on the activities of the Bank and its subsidiaries and on their results of operations in the future. The Bank is not able to evaluate which of these law proposals will in fact be passed and what would be the scope of their effect.

The year 2006 was also characterized by an abundance of regulatory directives, both Proper Banking Management Directives and various instructions regarding reporting to the public issued by the Supervisor of Banks. To these were added instructions by the Commissioner of the Capital Market, Insurance and Savings of the Ministry of Finance and by the Securities Authority, as to issues under their control. The implementation of the various instructions requires, on more than one occasion, preparations involving the investment of resources, and sometimes it has a possible adverse impact on the income of banking corporations from various sources.

### 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 of Banks and according to rates set by him.

Once in every quarter, Management of the Bank examines the credit portfolio with the aim of evaluating the possible loss inherent therein. The process of the loss evaluation includes two stages:

- Identifying customers, the ability of whom to honor their obligation to the Bank has changed, and their resulting classification as "problematic debtors", in accordance with the classes of debts specified in the instructions of Bank of Israel and the criteria determined therein: "doubtful debts", "non-performing debts", "debts that have been restructured", "debts temporarily in arrears", "debts under special supervision".
- Creating provisions that reflect the anticipated loss in respect of "doubtful debts". In determining the provisions Management relies on information at hand regarding the debtor: his credit rating, history of honoring obligations to the Bank, quality of the collateral given by him and the risk level of the economic sector in which he operates. In addition Management takes into account when making the provision, additional

factors, such as: The quality of the debtor's management, his repayment ability and financial flexibility. The process of assessing the loss inherent in the credit portfolio, as described above, is based on significant assessments that involve extensive uncertainties (such as: the 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 FAS 5 – "Accounting for Contingencies" and its related guidelines, and in accordance with the guidelines and clarifications of the Supervisor of Banks, including public reporting directives in the matter of "Accounting for Contingencies". In assessing the required provision, it is necessary to examine the probability of a loss and to assess its amount. These evaluations affect both the duty itself of creating a provision in respect of the claim and the mode and scope of the disclosure in the financial statements.

According to FAS 5 there are three levels for evaluating the loss: (1) Remote; (2) Reasonably possible; (3) Probable. The 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 until recently, class actions related to specific laws, to specific causes and to various effective dates (the date on which the relevant law adopted the option of a class action suit). Also as to the interpretation of these issues contradicting judgments had been given.

The new Law regarding class actions, passed by the Knesset in 2006, regularized all the arrangements made in the matter of class actions in the framework of one law, and extended the causes in respect of which a class action may be brought against banks, over and above those that were included in legislation until now.

The law also applies to class actions and motions for approval of class actions pending at the Courts at date of its publication. The new provisions determined by the law and the fact that these have recently been tested in Court rulings, add a new dimension of uncertainty to everything concerning the assessment of the prospects and results of class actions and motions for approval of class actions (for details as to the Class Actions Law, 2006, see the section "Legislation and supervision").

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.

On January 10, 2006, the Supervisor of Banks distributed a public reporting directive in the matter of "The accounting treatment of contingent claims".

It has been determined in the 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.

The financial statements include appropriate provisions for claims in respect of which realization of the related risk exposure is probable.

According to the Directive only in rare cases a banking corporation is entitled to state in its financial statements that in its Management's opinion, based on Counsel's opinion, it is not possible to assess the prospects that a risk exposure would materialize in respect of an ordinary legal action and an action approved as a class action. As to a motion for approval of a class action, the banking corporation is entitled to determine that it is not possible to assess the prospects of realization of the exposure to risk 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 to the financial statements states separately the outstanding claims, in respect of which a reasonable assessment of the exposure is not possible.

The banking corporations have been asked to determine for themselves a graded disclosure level relating to the classification of the proceedings according to the assessment of the risk involved therein. Accordingly, the financial statements include disclosure of material legal proceedings conducted against the Bank and Group companies, based on the following criteria: as a general rule, a material legal proceeding is one where the amount claimed is in excess of 0.5% of the equity capital of the Bank, and if it is not possible to assess the prospects of the risk materializing; 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.

The banking corporations have also been asked to provide disclosure regarding the total exposure in respect of claims that have been assessed, in whole or in part (in respect of the relevant part), as "reasonably possible". Disclosure as above is given in Note 19 to the financial statements.

It should be 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.

An increase of 1% in the discount rate would result in a reduction in liabilities in the amount of approximately NIS 21 million, while a decrease of 1% in the discount rate would result in an increase in liabilities in the amount of approximately NIS 22 million.

## E. DEFERRED TAXES

Deferred taxes are recorded in respect of temporary differences between the value of assets and liabilities in the balance sheet and their value for tax purposes.

Deferred tax assets in respect of timing differences are recorded only if it is probable that a tax savings will accrue upon reversal of the difference and deferred tax assets in respect of carry forward losses for tax purposes are recorded only if the realization of the tax asset in the foreseeable future is not in doubt.

Accordingly, when deferred tax assets are being recorded, the Bank is required to perform assessments and estimates as to the probability of realization of these assets in the future. For further details see Note 29 to the financial statements.

## 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. On January 30, 2006, the Bank was served with a demand based on Section 194 of the Companies Law, 1999. The appellant alleged that she held 1,000 shares of the Bank as of submission of the claim. The demand relates to "a derivative claim in the matter of the payment of a fine of US\$25 million to the New York Authorities",

and as part thereof the Bank is requested to claim the damage suffered by it from various officers, as follows: the directors and officers, the internal auditor and the independent auditors of IDB New York, in respect of breach of duties of care by act or omission to act; the directors, the internal auditor of the Bank and members of the Bank's management in charge of the operations of IDB New York, in respect of breach of their duties to supervise the subsidiary and establish proper control procedures at the subsidiary and/or at Discount Bank, with a view of assuring adequate control of Discount Bank over the subsidiary.

The board of directors of the Bank discussed the said demand and decided, in the existing circumstances, to reject it.

2. The former President and CEO of IDB New York filed a claim on May 31, 2006 against IDB New York for the payment of damages alleging that the termination of his employment is in violation of the law against discrimination, as well as demanding severance payment in accordance with his employment agreement. In its defense brief and the counter claim filed, IDB New York argues that the former President is not entitled to damages and severance pay as he had violated his employment agreement as well as the duty of trust. The claim does not state an amount. IDB New York, based on Counsel's opinion, estimates the maximum amount of the damage at not more than US\$2.5 million.
3. On July 24, 2006, a criminal charge was filed against the Bank and against several of its officers, including one member of the Bank's management and the Bank's Internal Auditor. According to the charge, in 2003 the accused disclosed confidential information regarding the plaintiff's account, taken from the data base of the Bank, without the plaintiff's consent. As alleged, the information was passed on to third parties, which utilized this confidential information willfully and maliciously, for the purpose of ex parte foreclosure, in contradiction to the protection of privacy law and in violation of the Bank's confidentiality commitments towards the plaintiff. On November 19, 2006, the public prosecutor announced that he would not join the proceedings due to lack of public interest. The accused responded to the charges and denied their content and substance.
4. In October IDB New York received a Subpoena for the disclosing a large number of documents and information. The Subpoena was issued as part of a civil action filed by a number of plaintiffs against the Arab Bank. The action is being heard by the District Court of the State of New York, and apparently had been filed by victims of terror actions claiming that the Arab Bank assisted in the finance terror activities. The Subpoena relates to the period from November 1, 1995 to date, and involves documents and/or forms and/or information with respect to accounts with Israel Discount Bank Ltd. and/or its subsidiaries and/or IDB New York that are managed and/or had been managed by charitable entities mentioned in the Subpoena. The Subpoena also includes an order to submit documents with respect to the investigation that had been conducted against IDB New York in the matter of money laundering and the actions taken pursuant to the requirements of the Authorities in New York, as well as copies of all procedures, circular letters, guidelines, instructions and such like relating to the conduct of the business of the banks detailed in the Subpoena with any person or corporate body residing or operating in the territories of the Palestinian Authority. On December 20, 2006, Counsel for the Bank informed the Arab Bank that that the Bank objects to the disclosure of the information, among other things, due to the lack of judicial authority vis-à-vis the Bank, the lack of a legal disclosure order and due to banking confidentiality. The Arab Bank motioned the Court in the United States for an Order obliging the Bank and IDB New York to

respond to the Orders and disclose the information and documents relating to accounts that are held or were held with the Bank in the name of charitable entities.

The Arab Bank argues that a perusal of documents published by the Bank and also the website of the Bank show that in actual fact there is no separation between the Bank and IDB New York, therefore the Subpoena served on the Bank by means of IDB New York has been legally delivered. It is also argued that in view of the close relationship between the Bank and IDB New York, IDB New York is bound to disclose the documents that are in the hands of the Bank.

In its response to the request filed with the Court, the Bank argues that the status of IDB New York as a subsidiary of the Bank does not allow it to pass on to the Bank the Subpoena served on the subsidiary.

### SIGNIFICANT LEGAL PROCEEDINGS SETTLED IN 2006

1. 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 was NIS 6. The claimant estimated that the class numbers about 375,000 members and the amount of the class action was 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 did 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.

On May 25, 2005, a request was submitted to the Court, with the consent of both parties, to delay the hearing of the case until a verdict is given in another action submitted against the Bank in respect of a similar cause of action.

The Bank informed the Court on July 14, 2005, that the plaintiffs in the other action had requested its dismissal. Following this, proceedings in this case have been renewed. On January 1, 2006, the Court dismissed the plea and the claim without an order for costs.

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 was NIS 320 million, and it purported to represent all businesses, which since 1999 were charged by ICC with "manual statement commission" and with "minimum commission".

The claimant argued 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 dismissed the claim on January 16, 2006.

3. On June 19, 2002 a lawsuit was filed 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 class action against all the defendants, which the Court was asked to approve, was valued by the claimant at NIS 967.5 million. It should be noted that the First International Bank, an affiliated company of the Bank, is also a defendant in this suit.

The cause for the claim was 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.

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 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.

On November 11, 2003 the Court decided to dismiss the action in limine. On February 18, 2004, the plaintiff filed an appeal with the Supreme Court against this decision. On November 28, 2005 the Supreme Court dismissed this appeal.

On December 13, 2005, the plaintiff filed for an additional hearing at the Supreme Court, requesting an exemption from depositing a bond of NIS 50,000, needed as the condition to the holding of an additional hearing. Following the dismissal of this request by the Supreme Court, on March 26, 2006, the plaintiff requested the Supreme Court, on April 11, 2006, dismiss its request for an additional hearing. The Supreme Court acceded to this request on that date and the request for an additional hearing was dismissed.

## PROCEEDINGS REGARDING AUTHORITIES

1. For details regarding various proceedings conducted by the Commissioner of Restrictive Trade Practices and concerning the Groups activities in the credit card field, see Note 34 to the financial statements and "Credit card operations" under "Further details as to activity in certain products".
2. For details regarding various proceedings conducted by the Commissioner of Restrictive Trade Practices concerning the "Principles of Conduct Document", see the chapter "Legislation and supervision" 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".

On several occasions in July 2005, investigators of the Restrictive Business Practices Authority revisited several of the Bank's units and seized documents and computer material. In addition, Bank employees, including a member of Management, were summoned for interrogation at the Restrictive Business Practices Authority on

several dates in July and August 2005.

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.

4. The Commissioner of Restrictive Trade Practices decided on November 2, 2005, that the exclusivity arrangement existing between Harel Mall Ltd. and the Bank constitutes a binding arrangement and that the absence of an approval by the Commissioner to such a condition constitutes a violation of the provisions of the Restrictive Trade Law. On July 26 2006, the Bank withdrew the appeal filed with the Restrictive Trade Practices Court against the decision of the Commissioner.  
This decision may have an implication on exclusivity stipulations, which are customary in rental agreements for commercial areas.
5. In November 2005, Tachlit was requested by the Israeli Securities Authority to hand over various documents in connection with a review of disciplinary transgressions conducted by the Securities Authority. Two executives were also asked to submit statements. In January 2006, the Securities Authority informed Tachlit that the case had been closed for lack of guilt.
6. For details of the investigation regarding matters relating to the prohibition of money laundering, conducted at IDB New York, see "Discount Bancorp, Inc." under "Main investee companies" above and Note 6 D to the financial statements.
7. For details of an investigation regarding suspected violations by employees of the Prohibition of Money Laundering Law, see "Prohibition of Money Laundering Law and Prohibition of the Financing of Terror Activities" above under "Legislation and Supervision" and "Mercantile Discount Bank Ltd." above under "Main investee companies".
8. For details regarding the inspection conducted by the Securities Authority at the Bank in the matter of the sale of structured products, see "Operations in the capital market" in the Chapter "Further details as to activity in certain products" above.
9. In November 2006, the Israel Securities Authority informed of its decision to impose on the Bank a civil fine. The fine was imposed since in a notice sent to customers investing in a mutual fund, that had changed its investment policy, it was not explicitly stated that such change might materially affect the fluctuations in price of fund units and withdrawals from the fund, as was stated in the immediate report of the fund's manager. The amount of the fine is negligible.
10. Following audits conducted at the Bank on August 12, 2006 and September 8, 2006, the enforcement of labor laws division at the Ministry of Industry, Trade and Labor initiated an investigation in the matter of illegal employment during weekly hours rest, suspicion of prima facie commitment of an offence in respect of the Hours of Work and Rest Law, 1951, i.e. employment of Bank personnel during the weekly resting day on the said dates. As part of the investigation, an employee of the Bank was called for interrogation under warning and was ordered to submit documents.

The Bank is applying for a permit for employment of required personnel on the weekly resting day.

## MATERIAL AGREEMENTS

Hereunder is presented a summary description of agreements, entered into outside the ordinary course of business, that might be considered material, to which the Bank is a party, or which according to its best knowledge, the Bank is a beneficiary in terms thereof, including agreements that were valid in the period covered by this annual report, or which affected the Bank's operations during such period.

### A. AGREEMENT FOR THE ACQUISITION OF MEANS OF CONTROL IN THE FIRST INTERNATIONAL BANK ("FIBI")

According to an agreement dated July 31, 1983, between the Bank and FIBI Holdings Ltd. and one of its subsidiaries, in terms thereof the Bank acquired ordinary shares of a par value of NIS 5 each in FIBI, which granted the Bank approximately 26% share in the equity and 11% share in the voting rights of FIBI, it was agreed, among other things, that the Bank shall not be involved in the management of FIBI.

The agreement provided that so long as the Bank is in possession of at least 80% of the shares in FIBI acquired by it under this agreement (including bonus shares and rights in respect of these shares), FIBI Holdings will see to it that one quarter of the members of the board of directors and of board of directors' committees of FIBI will be members recommended by the Bank, on condition that the Bank will not recommend persons the appointment of whom might, in the opinion of the Governor of the Bank of Israel, create a conflict of interests. In addition, the said agreement provided that each of the parties thereto shall have the right of first refusal in respect of the acquisition of shares in FIBI held by the other party, whether such sale shall be made on or off the market. The right of first refusal does not apply to sales of up to 20% of the total holdings of each party effected on the Tel-Aviv Stock Exchange in the ordinary course of business. Furthermore, the right of first refusal does not apply in the case of a sale of FIBI shares by any of the parties to its parent company or to a company controlled by such party.

The acquisition of the said shares was made in terms of a permit for the acquisition of means of control, under Section 34 of the Banking Law (Licensing), 1981, granted by the Governor of the Bank of Israel on July 20, 1983, in the framework of which the Bank was permitted to acquire up to 30% of the issued and paid share capital of FIBI. As part of the process of obtaining the permit to acquire means of control, the Bank has made a commitment to the Bank of Israel that FIBI will be managed in an independent manner, and that all members of the Board of Directors of FIBI shall be appointed by FIBI Holdings Ltd., 25% thereof to be appointed in accordance with the recommendation of the Bank as approved by the Governor of the Bank of Israel. It was further agreed that the Governor would not withhold his approval of the recommendation of the Bank as above, unless based on reasonable grounds and considering the possibility that such appointments might create a conflict of interests.

### B. OBLIGATIONS OF THE BANK WITH RESPECT TO CAPITAL MARKET OPERATIONS

In October 1983, within the framework of the "bank shares arrangement", the Bank informed the Minister of Finance and the Governor of the Bank of Israel that, among other things, it would not initiate, either directly or indirectly, orders for the purchase or sale of securities within the orders submitted to the Stock Exchange prior to the beginning of trading ("Leaders"), or as part of the setoff of purchase or sale orders prior to the

beginning of trading.

The Bank further confirmed that it would prevent, either directly or indirectly, any transaction in securities issued or which would be issued by banks or bank holding corporations, unless such transactions are on behalf of its customers, including provident and mutual funds. However, the Bank noted that nothing in the above would avoid transactions effected in the ordinary course of business.

#### C. LETTERS OF INDEMNIFICATION TO WHOEVER ACTS OR HAS ACTED AS DIRECTOR IN INVESTEE COMPANIES OF THE BANK

The previous version of the Articles of Association of the Bank, which was amended in March 2002, included provisions regarding the indemnification of whoever acts or has acted, at the request of the Bank, as director in another company, in which the Bank has an interest, as detailed in Note 19 C 10 a to the financial statements. Accordingly the Bank had issued at that time letters of indemnification, unlimited in amount, to the acting directors or who have acted at the request of the Bank in other companies owned by it.

#### D. COMMITMENT FOR COOPERATION DURING THE PROCESS OF SALE OF THE BANK'S SHARES

In an Annex to the agreement dated August 29, 1991, between the Government of Israel, in the name of the State of Israel, M.I. Holdings Ltd.(hereinafter – “M.I. Holdings”), Israel Financial Holdings and IDB Holding Company Ltd., the parties thereof are M.I. Holdings and the Bank, the Bank committed to cooperate with M.I. Holdings and assist in the process of sale of the Bank's shares, this, subject to adherence to any law and the guidelines of the Supervisor of Banks, and subject to the matters detailed in the Annex. Among other things, the Annex determined that the Bank will provide information to assessors acting on behalf of M.I. Holdings and on behalf of potential buyers, everything subject to the limitations and confidentiality arrangements detailed in the Annex.

As determined in the Annex, M.I. Holdings has agreed to indemnify and/or compensate the Bank and/or any member of the Board of Directors of the Bank and/or any employee of the employees of the Bank in respect of any damage suffered by the Bank and/or any of the above, as applies, and /or any of the customers of the Bank (on condition that the Bank or any of the above would be charged in respect of any damage determined by a Court's verdict) as a result of the performance of the Annex and everything related to it; however, the commitment to indemnify and/or compensate as above, shall not apply to responsibility for or in respect of a violation of the Securities Law, 1968. It shall also not apply to damage resulting from error, misrepresentation or omission in the information, documents or presentations made by the Bank in accordance with the Annex, if it is proved that the error, misrepresentation or the omission were caused intentionally or not in good faith. The form of the cooperation in accordance with the said agreement was later formalized in the The Bank Shares in Arrangement (Temporary Provision) Law, 1993. The said agreement has been amended several time with the consent of the parties.

## E. AGREEMENT FOR THE ACQUISITION OF MEANS OF CONTROL IN ICC

An agreement dated January 3, 2000, according to which the Bank acquired from Leumi Financial Holdings Ltd. (hereinafter – “BLL”) means of control in ICC and in Diners, including a commitment of BLL to indemnify the Bank in respect of claims detailed in the agreement, as discussed in Note 34 A to the financial statements. According to this agreement BLL is committed to indemnify the Bank also in respect of amounts that ICC or Diners shall be liable to pay to the Tax Authorities in respect of certain tax years mentioned in the agreement and/or in respect of events the cause of which occurred up to the date of the agreement, as well as in respect of amounts that ICC shall be liable to refund AlphaCard Ltd. regarding issuer commissions following an agreement dated July 7, 1998.

## F. AGREEMENTS FOR THE SALE OF MEANS OF CONTROL IN ICC TO STRATEGIC PARTNERS

In the course of the years 2000-2002, the Bank sold to strategic partners shares in ICC comprising 49% of the equity and 37% of the voting rights, and shares in Diners comprising 21.4% of the equity and voting rights, at a price based on the value of ICC and Diners as determined in the agreement for the purchase of means of control in ICC (see E above).

The agreements with Fishman Chain Stores Ltd. are dated June 25, 2000 and December 13, 2001; the agreement with Harel Insurance Investments Ltd. is dated June 22, 2002; and the agreement with FIBI is dated September 29, 2000.

According to the said agreements, the strategic partners are committed to releasing the Bank from and indemnifying it in respect of a proportional share of the guarantees and/or liabilities provided by the Bank for ICC or Diners in favor of VISA International Service Association (as described in Note 19 C 12 to the financial statements) and in favor of businesses in accordance with engagement agreements between them and ICC. The partners have also committed to indemnify the Bank in respect of: (a) the amounts that the Bank will have to refund to BLL out of the amount of damages that BLL will pay, if at all required to pay to ICC, as part of the disputes relating to the “Buy and Bonus” Club; (b) amounts of indemnity to officers of ICC and Diners, to the extent that such indemnity would be required in accordance with the agreement for the purchase of means of control in ICC; (c) any amount that would be paid under a guarantee or commitment for indemnity that the Bank would be required to provide as a shareholder (and due to being a banking institution) for the purpose of operations in the credit card field of ICC or Diners, all in proportion to the rate of their holdings in ICC or Diners, as the case may be.

On the other hand, the Bank is committed to transfer to the strategic partners a proportional share (according to their rate of holdings) of any amount that would be received by it from BLL in respect of the indemnity granted to the Bank as part of the agreement for the purchase of means of control in ICC, provided that the amount transferred to each of the partners should not exceed on a cumulative basis, the amount of the consideration paid by that partner in accordance with his agreement with the Bank. The said agreements also include provisions with respect to the use of the voting rights in ICC and Diners, in a manner that established the exclusive control of the Bank in ICC and Diners. On the other hand, provisions were also set in them regarding special majority demands of 68% for the purpose of passing certain material decisions. Furthermore, the said agreements granted the strategic partners certain minority rights, the principal of which are: the right

to appoint the minority of the directors and preferential rights as to the acquisition of shares in the case of a private placement. In addition, the said agreements determined provisions regarding restrictions on the transfer of shares in ICC and in Diners, the right of first refusal, the right of participation and the right of a compelled sale.

#### G. AGREEMENTS FOR THE ACQUISITION OF MEANS OF CONTROL IN ICC FROM CERTAIN OF THE STRATEGIC PARTNERS

On December 10, 2006, the Bank and the First International Bank signed an agreement with Fishman for the purchase of his holdings in ICC. On March 1, 2007, the Bank and the First International Bank signed an agreement with Harel for the purchase of its holdings in ICC. For additional details see Chapter "Main investee companies" above and Note 34 to the financial statements.

#### H. AGREEMENT FOR THE ACQUISITION OF MEANS OF CONTROL IN ILANOT DISCOUNT

An agreement was signed on September 21, 1999, between the Bank, Ilanot Batucha Investment House Ltd. (hereinafter – "Ilanot Batucha") and Ilanot Discount Ltd. (hereinafter – "Ilanot Discount"), according to which, it was agreed, among other things, on the acquisition of control by the Bank in Ilanot Discount.

The agreement included consents and additional provisions, including changes in the distribution agreements and brokerage services that existed between the Bank and Ilanot Discount. The Bank continued to receive from Ilanot distribution fees in accordance with the format, the principles of which have been agreed by the parties, until March 31, 2006.

The agreement granted each of the parties the right of first refusal and the right of participation, which would apply in the case of the sale of holdings in the company by the other party.

For details as to the exercise of the right of first refusal, see above, under "Capital market activity" under "Further details as to activity in certain products", and Note 6 E to the financial statements.

This agreement is not valid any longer, and the rights of the Bank under it as regards management fees, have been assigned to Clal Finance Batucha Investment Management Ltd., within the terms of an agreement whereby all the rights of Ilanot Discount were sold to it, as stated in subsection J above.

#### I. AN AGREEMENT IN PRINCIPLE FOR THE SALE OF ILANOT DISCOUNT LTD. AND THE PROVIDENT FUND ACTIVITY

For details as to the agreement in principle for the sale of the shares in Ilanot Discount Ltd. and the provident fund activity, see above "Capital market activity" under "Further details as to activity in certain products" and Note 6 F to the financial statements.

#### J. AGREEMENT FOR SALE OF ALL MEANS OF CONTROL IN ILANOT DISCOUNT

For details regarding the agreement dated April 11, 2006, according to which all the shares in Ilanot Discount Ltd. were sold to Clal Finance Batucha Investment Management Ltd., see "Capital market activity" above, in the Chapter "Additional details regarding the activity in certain products" and Note 6 to the financial statements.

#### K. AGREEMENT FOR THE SALE OF THE OPERATIONS OF THE BANK IN THE PROVIDENT FUND MANAGEMENT FIELD.

For details regarding the agreement dated January 29, 2007, between the Bank and Discount Provident Fund Management and Clal Insurance Company Ltd., for the sale of the operations of the Bank in the provident fund management field, see "Capital market activity" above, under "Additional details regarding the activity in certain products" and Note 6 to the financial statements.

#### L. AGREEMENT FOR THE ACQUISITION OF MEANS OF CONTROL IN HAREL

On December 28, 2000, the Bank signed an agreement with the Hamburger Group for the purchase of means of control in Harel and for the regularization of the relations between themselves as shareholders in Harel. The agreement determines, among other things, that the Board of Directors of Harel will number ten directors, and so long as the Bank is a shareholder in Harel having between 15% and 20% of the voting rights therein, the Hamburger Group would vote for the appointment of two directors recommended by the Bank. So long as the Bank holds between 10% and 15% of the voting rights in Harel, the Hamburger Group would vote for the appointment of one director recommended by the Bank.

The agreement determines that the Hamburger Group would vote in the general meetings of shareholders of Harel and of its principal companies against a resolution regarding certain material actions, unless the prior consent of the Bank has been obtained (liquidation, merger or reorganization; sale, disposal or suspension of the insurance activities; changes in the capital structure of Harel that would result in a dilution of the Bank's holdings, and so forth). In addition, the Hamburger Group has committed that to the best of its ability it would cause material resolutions of Harel and other resolutions of Harel as determined from time to time, as well as resolutions of the Boards of Directors of any one of the significant companies regarding matters that require immediate reporting (even if the relevant company is not a public company) and also material transactions with interested parties from the Hamburger Group and transactions in which interested parties from the Hamburger Group have a personal interest, even though they are not exceptional, to be brought for a prior discussion by the Executive Committee that would be established for this purpose among directors of Harel, in which at least one member would be appointed at the Bank's recommendation.

The agreement also includes provisions regarding the right of participation of the Bank in a sale of means of control in Harel by the Hamburger Group, in whole or in part, under conditions determined in the agreement, as well as the right of first refusal of the Hamburger Group in the sale of the shares of the bank in Harel, that would arise to the Harel group under certain circumstances determined in the agreement. This agreement terminated upon the consummation of the agreement according to which the Bank sold 10.1% of the share capital of Harel, as stated in subsection M hereunder.

#### M. AGREEMENT FOR THE SALE OF MEANS OF CONTROL IN HAREL

On November 1, 2006, the transaction was consummated for the sale of 10.1% of the share capital of Harel and the receipt of an option for the sale of the remaining shares that the Bank holds in Harel (5.79% of the share capital). For additional details see "The non-financial companies sub segment" under "Activities of the Group according to principal segments of operation".

## N. AGREEMENT WITH THE EMPLOYEES

An agreement dated February 1, 2005, signed concurrently with the agreement for the sale of a controlling interest in the Bank, between the New Histadrut Federation of Labor, the Representative Committee of Discount Bank Employees and the Accountant General of the Ministry of Finance, which was later joined by the Bank, following approval by the Bank's authorized organs, and which is intended to regularize certain demands raised on behalf of the Bank employees in the matter of their rights on the background of the sale of a controlling interest in the Bank by the State, everything as described in "Employees Agreement" under "Control of the Bank" above.

## 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 December 2005, the Supervisor of Banks issued an 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 2006

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.

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, including:

Discount Mortgage Bank Ltd. and its subsidiaries, Discount Provident Fund Management Ltd., Israel Discount Capital Market and Investments Ltd. and its subsidiaries, Tachlit Investment House Ltd., Discount Trust Ltd., Discount Leasing Ltd., BDL Computer and Administration Services Ltd.

He serves as internal auditor of Discount Manpikim Ltd. since April 1, 1999, and of Manpikim Financial Operations Ltd. since December 8, 2004.

During the reported period, the average number of positions subject to the internal auditor was 66.5, and 6 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., Bancorp Inc. IDB New York, Discount Bank Latin America, Discount Bank (Switzerland) SA – the number of positions during the reported period was 41.6. (including 2 position in the fold of customer service positions at Mercantile Discount Bank). In addition, outsourcing services with a scope of 2.6 positions

were acquired, including one full-time position in the Bank, one full-time position in Israel Credit Cards Ltd., a 50% position in Mercantile Discount Bank and a 10% position at Discount Bank (Switzerland).

The annual and multi-annual work plans are structured on the basis of risk focused methodology that maps all units of the Bank in accordance with the probability of the risk materializing and its implications. The multi-annual work program is reviewed annually and is updated as required.

The work plan for 2007 was structured according to international methodology and standards accepted in Israel and overseas, according to guidelines of the Bank of Israel with reference to Basel II guidelines for internal audit and the risk management approach presented by COSO.

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.

Each audit report is submitted by the internal auditor to the chairman of the board, to the President and CEO of the Bank and to the Bank's auditors. 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 Chairman of the Board, to the President and CEO and to all Board members, so that at each quarter they have a very detailed picture as to the findings of all audits performed by the internal auditor, the response to these findings and the manner in which audit findings had been treated. The audit committee of the board discusses the quarterly report.

In addition, the audit committee of the board discusses specific audit reports regarding the Bank's units, in cases where the chairman of the board, the chairman of the audit committee and/or the internal auditor consider that the findings in these reports or the significant issues which they raise require special attention.

Once a year, the internal auditor submits to the Chairman of the Board, to the President and CEO and to all Board members an annual report (in addition to the four quarterly reports). This report details the principal matters that were audited during the year, the manner in which the findings and recommendations were treated. 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 2006 were submitted and discussed by the audit committee of the Board, as follows: First quarter report – submitted on May 18, 2006 and discussed by the audit committee of the Board on June 26, 2006; Second quarter report – submitted on August 8, 2006 and discussed by the audit committee of the Board on September 19, 2006; Third quarter report – submitted on October 29, 2006 and discussed by the audit committee of the Board on December 24, 2006; Fourth quarter report – submitted on January 24, 2007 and discussed by the audit committee of the Board on March 20, 2007.

The annual report for 2006 was submitted on March 11, 2007 and has not yet been brought up for discussion. The audit committee of the board also discussed in 2006 the annual audit report for 2005 (submitted on March 12, 2006 and discussed on May 9, 2006 by the audit committee of the Board and on June 28, 2006 by the Board) and the report for the fourth quarter of 2005 that was submitted on February 8, 2006 and discussed on March 20, 2006.

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, and to its auditors.

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.

In March 2006, the Supervisor of Banks directed the banking corporations to expand the involvement of the internal auditor of the parent company in the audit units of subsidiaries. Accordingly, a format was established and approved by the Audit Committee of the Board of Directors, for supervision and control of the audit units of the Bank's subsidiaries by the Bank's Internal Auditor.

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 2006 in the culture and arts field, providing sponsorship, "Tzlash" activities in the branches and donations.

The total volume of activities of Discount group in 2006, including the Lema'an Project, amounted to NIS 5,454 thousand, compared with NIS 5,184 thousand in 2005.

In 2006, the Bank continued the trend of supporting children and youth in various states of distress, and Art seeking youth.

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.

**Donations to the "Matriculation for Combat Soldiers" Project.** In January 2006, the Bank, through the LIBI Fund, contributed NIS 120 thousand to the "Matriculation for Combat Soldiers" Project NIS 120 thousand, of which NIS 100 thousand is earmarked for the Project itself and the balance of NIS 20 thousand for ten scholarships of NIS 2,000 each to outstanding soldiers participating in the Project.

The "Matriculation for Combat Soldiers" Project is the IDF's way of rewarding, through the LIBI Fund, combat army personnel and to thank them for their enlisted service, by enabling them to complete their matriculation studies before the end of their service period. The Project accepts men and women from combat units nearing the end of their military service, and who have to complete their studies for up to four required courses in order to complete their matriculation certificate. The Project is of particular importance in view of the fact that 60% of 18-year-olds in Israel do not have a matriculation certificate.

The "Matriculation for Combat Soldiers" Project is a joint project of the IDF and the Ministry of Education and is conducted in a non-military facility under boarding school conditions over a period of between seven to nine weeks, at the end of which the matriculation examinations take place. This Project shows most remarkable success results: some 93% of the soldiers taking these courses successfully completed the matriculation examinations

**Donation for the opening of the "Children House".** Concurrently with of the Bank's employees volunteering in the Haifa and Northern Regions in the context of the "Give a friend a helping hand" association, a monetary donation was granted to the association as assistance for the opening of an additional "Children's House" in Haifa. **"Ezra LeMarpe" Association.** A monetary donation was made in the first quarter of 2006 to the "Ezra LeMarpe" association. This is a voluntary association headed by Rabbi Elimelech Firer, which operates to relieve the suffering and distress of the sick and their families. The association provides assistance, medical advice and equipment to anyone applying to it.

**The "Reach out your hand and draw someone into your heart" project.** The Bank is assisting a project of the Reali High School in Haifa with the object of integrating Ethiopian youth at the school. The goal is to contribute to their successful integration in Israeli society. In this context the Bank granted a scholarship to two of the twelve youths taking part in the project.

**Scholarships to students involved in community work.** During the second quarter of 2006, the Bank granted scholarships to ten students actively and exceptionally involved in community work. Each scholarship amounted to NIS 2,500. The scholarships were granted within the framework of the cooperation of the Bank with the Jerusalem Club (a student club at the Hebrew University of Jerusalem, which is active in drawing people back to the City, and is active in the cultural and employment fields).

**A donation to the Rambam Health Care Campus.** Noteworthy, among other things, is a donation of US\$10,000 to the Rambam Health Care Campus in Haifa, as part of the assistance provided during the War in North Israel.

**"Alut Association".** Particularly noticeable, among other things, is a donation of US\$10,000 for the project of rehabilitation day care centers for infants run by the Alut Association. The project is intended for infants suffering from autism, and is designed to advance the infants to a higher level of performance and to allow them to integrate into the general education system and to teach them vital life skills.

**The New Jerusalem Fund.** The Bank made a contribution towards the construction of a promenade in the name of the late Shani Avitzedek, daughter of Bella and Elli Avitzedek – both employees of the Bank – who was killed in a terrorist act.

## 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 2006, the

effort was focused on voluntary activities through associations for youth in distress, children clubs and various associations that support the needy.

Presented below is a selection of examples of the activity within the framework of the "Lema'an" Project:

**"Oranit" Center – A convalescence home for juvenile cancer patients.** Within the framework of the "Lema'an" Project, employees of the Bank elected to contribute a specified sum to be debited monthly to their accounts, in favor of the "Oranit" Center. This initiative was formed following the presentation of the activities of the Center to the Bank employees and the Center's need for financial assistance in order to secure its continued activity. The "Oranit" Center belonging to the "Ezer Me'Zion" Association, provides a caring home to children suffering from cancer and their families residing in distant areas who have to come to the medical centers in central Israel and stay for long periods in order to receive treatment. The Center is located adjacent to the "Rabin" and "Schneider" Medical Centers in Petach-Tikva. Among other things, the Center provides enrichment activities such as a special petting zoo.

The Center is managed by a volunteer staff and is financed solely by donations. The contribution by Discount Bank employees is intended to enable the continued operation of the Center, which significantly relieves the suffering of the sick children and their families.

**"Adopt a combat soldier" Project.** Discount Bank has decided to join the enterprise established by the Friends of the IDF and take part in this project. Within this framework the Bank elected to adopt "Squadron 916" of the Israel Navy, which is entrusted with Israel's southern coastline.

The sponsorship ceremony took place at the beginning of August 2006, in the midst of the War in Northern Israel, and was held at the Ashdod Naval Base in the presence of Management of the Bank members and the managers of the Ashdod and Ashkelon Bank branches. The visit of Management members included a visit to the fighting vessels and a meeting with the commanding officers and enlisted soldiers of the Squadron.

The bank supports the Squadron with a monetary contribution as well as with voluntary work. The contribution is a yearly amount of NIS 100 thousand intended for financing activities for the welfare of the soldiers. In addition to the monetary contribution the Bank combines voluntary activity within the framework of "Lema'an", in which the Ashdod and Ashkelon branches of the Bank are the main participants.

**Donation by employees of the Bank to diabetic children.** As has been the custom in previous years, employees of the Bank donated in the second quarter of the year to children suffering from juvenile diabetes, an amount of NIS 61 thousand, raised in cash and by the redemption of vacation pay.

**Distribution of Purim gifts.** Hundreds of Purim Gifts have been distributed by employees of the Bank to children, youth, the sick, the handicapped, old people, etc.

**Assistance for the Passover and the Jewish New Year Holidays.** According to the tradition established at the Bank, this year the Bank also rallied to help needy families in the preparations for the Passover Holiday and the Jewish New Year Holiday. The assistance this year consisted of the purchase of food packages in contrast to previous years when food packages were collected at the branches of the Bank from customers and employees. The purchased items were distributed to the needy through some 20 associations all over the country. In certain locations, Bank employees helped in the distribution of the packages.

**"Place in the Heart".** Bank Employees assisted in the renovation of the "Warm House" operated by WIZO in Rishon LeTzion for girls in distress, turning it into a more happy and pleasant place for the girls. The Bank supplied the materials required for the renovation.

**“Our Children’s Horizon” Project.** During the summer vacation, visually impaired youth were employed by the Bank at its various branches around the country. Most of them were referred to the Bank by the “Our Children’s Horizon” Association – a national organization of parents of blind and visually impaired children.

**The warm House Association.** The cooperation with this Association continues, including volunteer work by Bank employees and a contribution to the Association, which serves as a center for children requiring special services, children suffering from various types of muscular atrophy and children with a low life expectancy. The assistance of the Bank is expressed in several areas: providing medication, financing special medical treatment as well as participation in the purchase of special foodstuff.

**Promotion of Education in Yaffo Association.** The cooperation with this Association continues, including volunteer work by Bank employees at the clubs of the Association and a financial contribution by the Bank. The Association provides a variety of education programs, welfare and enrichment to thousand of children in risk situations. The assistance is provided to families of a low socio-economic background giving them higher prospects of success in life.

## 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.

**“Artist Wall” – A project for encouraging Israeli art and creativity.** “Artist Wall” is an additional layer in the wide range of activities carried out by the Bank for the benefit of the community, which combines support of the art with community activity.

Within the framework of this Project, the Bank offers its branch facilities all over the country to serve as a platform where artists would be able to exhibit their works to the public. The Bank is committed to purchasing one work from each exhibition, and, concurrently, the exhibiting artist will also donate one item. At the conclusion of the Project, which would last for about one year, an exhibition would be held in which all the works purchased by the Bank and donated by the artists would be offered for sale. All the proceeds from the sale would be used for financing projects in aid of children and youth with special needs

**Dis-Cover.** As part of the activities of the Mifalot Discount Fund for Culture and Art, a new enterprise has been launched for the enhancement of youth studying within the framework of youth boarding schools in the field of art product design. The enterprise, a joint venture with the Ministry of Education, the Holon Technological Institute and others, in which students studying industrial design at the Holon Technological Institute tutored pupils of Youth Boarding Schools, acquainting them with basic concepts of design teaching them how to design applied art products, which would be sold to business corporations. Income from these sales is designated for higher education scholarships for pupils of youth boarding schools.

**2006 Duet Festival in Yaffo.** As part of the cooperation with the Jewish-Arab Community Center the Bank contributes to the Festival “Duet in Yaffo” 2006, where Jewish and Arab musicians in Israel meet in order to expose their work to a mixed Arab-Jewish public and to create a model of Arab-Jewish cooperation through artistic experience and joint creation.

**Engravings Dossier.** In 2006, the Bank produced Dossier No.13 containing six engravings created by the artists Jan Rauchwerger, Alex Kramer and Jacob Dorchin at the engravings workshop at Kibbutz Cabri. Copies of the Dossier have been donated to all museums.

## SPONSORSHIPS

During 2006, the Bank granted sponsorship to entities promoting social, cultural, sporting, art and educational goals

### CULTURAL AND ARTISTIC SPONSORSHIP

**“Teheran Children”.** Support for the production of a documentary film about a group of children, most of them orphans, who survived World War II and came to Palestine via Teheran in 1943.

**“Dream Place” exhibition – the works of Reuven Rubin.** The exhibition was shown at the Tel Aviv Museum of Art. The sponsorship included a contribution of guided tours for groups of art loving youth from peripheral areas and groups of new immigrants, within the framework of the “Heznek” project.

**Carmiel Dance Festival.** This was the 19th year of the old established festival, which attracted thousands of dancers and dance groups from all over the country and the world as well as tens of thousands of visitors. The festival represents all varieties of dance: classical, popular dancing, ethnic, ballroom dancing, folk dancing and more.

**Theatre Festival.** This was the 16th year of this festival taking place in the Neve Tzedek quarter of Tel Aviv. It included theatre shows and street performances, dance, drama, satirical shows and music.

**100<sup>th</sup> Anniversary of the Bezalel Academy of Art.** A gathering organized jointly with the “Bezalel Friends Association”. All the income from this event was devoted to the support of young artists of poor means studying at the Academy.

**The Caesarea Port International Jazz Festival.** The Festival included Jazz performances of Israeli and international jazz musicians.

**Commemoration of Ethiopian folk tales.** This is a joint project with the Yavneh Promotion of Education and Sports Fund, within the framework of which ancient folk tales of the Ethiopian community are being preserved in writing and animation, in order to maintain the heritage for the younger generations. The project was conducted by children and youth aged 12 to 19.

### SPORTS SPONSORSHIPS

**Track and field.** This is the 13th year in which the Bank supports athletic activities. In this framework sponsorship was granted to the 70th Israel Athletics Championship and the Tel Aviv Track and Field Games, in which the best Israel athletes and distinguished international athletes participated.

In addition, as part of the encouragement of achievement and distinction, the Bank supports sports activities that emphasize these values. In 2006 the Bank granted sponsorship and support to the following activities and organizations: the Israeli Bridge Federation; the Ramat Hasharon basket ball team; the Ironi Iscar Strauss basket ball team; the Tel Aviv University Sports Club and more.

### DISCOUNT START-UP

Israel Discount Bank is a member of the “Sprint for the Future” Association, and has adopted the program focused on school age children from peripheral regions with difficulties in their studies. The aim of the program is to

provide assistance to school children so that they will be able to graduate high school, attaining a full matriculation certificate, enabling them to continue with higher education. The name of the program is "Discount Start Up".

The Bank is a party to both the financial support of the Association as well as to promoting and advancing its activities. Representatives of the Bank's management are members of the executive board of the Association and employees of the Bank have started voluntary activity in the framework of the Association's programs, among other things, in the form of the adoption by nearby Bank branches and Banks units of schools participating in the project. Thus for example, several branches in the Jerusalem Region adopts the Denmark School in the City, the Operations and Information Systems Division adopts the Ben Shaman Youth Village, the Marketing and Strategic Planning Division adopts the Remez School in Bnei Braq, etc.

The Bank also supports the excellence class of the School of Communication of the Natanya Academic College, and during the past year representatives of the Bank escorted students in their acquaintance with the world of advertising and marketing. Enrichment to students was provided with respect to professional and practical contents and students were acquainted with the "Discount Heznek" Project. At the practical experience stage, the Bank presented a challenge to the students: the production of an advertising campaign for the "Discount Heznek" Project, which includes clips to be shown on plasma screens at the Bank's branches, radio advertising jingles, advertising notices and vocal answering service at the branches.

**The late Nissim Alagem Fund.** The Bank has inaugurated a scholarship fund for academic studies. The Fund is named after the late Nissim Alagem, who passed away in 2006. Mr. Aladgem worked at the Bank for 40 years his last post being Vice President in charge of the Commercial Banking Division. Within the framework of the Fund, the Bank will grant an annual contribution to finance the academic studies of young persons, graduates of the "Discount Start-up" Project, who successfully completed their matriculation studies. The Fund will enable graduates of the "Discount Start-up" Project to continue their academic studies at higher education institutions.

### THE 2006 "GLOBES AWARD" – BUSINESSES IN AID OF THE COMMUNITY

The "Globes Award" – businesses in aid of the community, named after Chaim Bar-On – is an annual joint project of "Globes" newspaper and "Ma'aleh" organization. The Bank was awarded the 2006 "Globes Award" for the large corporation category.

The Badge constitutes a citation of excellence and public recognition and esteem of small and large business entities involved in the community, and is intended to increase the social awareness and accountability of business entities in Israel. Recognition of the selected businesses is based on their social achievements, leadership and their contribution to social advancement. The "Discount Start-up" Project described above, has drawn special attention.

### THE HAIFA MUNICIPALITY "VOLUNTEER AWARD"

In a ceremony held on June 21, 2006, in the presence of the Mayor of Haifa, Discount Bank received the "Volunteer esteem award". The Haifa Volunteer Council holds a annual event in honor of the volunteers in the city. This year the council decided to grant the esteem award to projects carried out jointly with the business sector. It should be noted that the majority of the Bank employees in Haifa take part in volunteer work in the city. The

various Bank branches in Haifa adopt, at their choice, various projects involving physically and mentally challenged children, youth and the elderly as well as other needy populations.

### “MA’ALEH” RATING

The “Ma’aleh” rating for social responsibility covers companies included in the Tel Aviv 100 share index, which engage in industry, trade, construction, infrastructures and services. The “Ma’aleh” index includes the twenty leading companies in the “Ma’aleh” rating for social responsibility, which comply with the entry terms of the TA 100 Index, and provides indication to investors who wish to invest their money in Israeli companies committed to and implementing social responsibility.

Discount Bank is rated among the first ten companies included in the “Ma’aleh” rating for social responsibility.

### MEGA PROJECT PRIZE

The Bank was awarded the first prize for 2007 in the “Mega Project” category, granted by the Institute of Information System Analyzers in Israel. The prize was awarded to the Bank in respect of the successful completion of the “Ophek” Project, the largest and most complex computer project of its kind carried out in Israel, in the framework of which infrastructure systems and business systems relating to core banking operations have been developed and integrated.

The Bank has decided to double the amount of the said prize and to award it to the “Tech-Career” College, a boarding educational center for computer and technology studies intended for students of Ethiopian community origin. The Bank, through its Operations and Information Systems Division representatives, maintains a direct connection with this College and several of the students, graduates of the last class, have been absorbed by the Bank.

### “THE MARCH OF THE LIVING”

In April 2006, a delegation of Discount Bank employees participated for the fourth time in the “March of the Living” from Auschwitz to Birkenau that takes place every year on the memorial day for the Holocaust and Heroism. The delegation numbered 100 of the Bank’s staff. 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. A delegation numbering 100 of the Bank’s staff is expected to participate in 2007 in the “March of the Living”.

## AUDITORS' REMUNERATION<sup>(1)(2)</sup>

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,			
	2006	2005*	2006	2005*
<b>For Auditing<sup>(3)</sup>:</b>				
To the joint auditors <sup>(5)</sup>	12,620	10,608	4,502	4,060
<b>For Other Services:</b>				
<b>Audit related services<sup>(4)</sup>:</b>				
To the joint auditors	3,592	2,090	2,275	1,933
<b>Taxation Services<sup>(6)</sup>:</b>				
To the joint auditors	2,550	1,898	848	712
<b>Other Services:</b>				
To the joint auditors	29,305	363	273	340
To other auditors		-		-
<b>Total</b>	<b>35,447</b>	<b>4,351</b>	<b>3,400</b>	<b>2,985</b>
<b>Total Auditors' Remuneration</b>	<b>48,067</b>	<b>14,959</b>	<b>7,902</b>	<b>7,045</b>

\* Reclassified and restated (in respect of an increment for 2005, agreed upon and paid during 2006).

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 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.
- (6) Of which, an amount of NIS 29,032 thousand, paid by IDB New York within the framework of preparing a comprehensive compliance program and conducting examinations as required by the letters of instruction (see Note 6D)

## REMUNERATION OF THE CHAIRMAN OF THE BOARD OF DIRECTORS AND SENIOR EXECUTIVE OFFICERS

### IN NIS THOUSANDS

2006

	Salary and bonuses*	Employer's provisions <sup>(1)</sup>	Supplemental reserves <sup>(2)</sup>	Total salary and related expenses**	Loans given on beneficial conditions <sup>(3)</sup>			
					Balance	repayment period (in years)	given during the year	given on usual conditions
Shlomo Zohar	<sup>(4)</sup> 3,845	<sup>(5)</sup> 1,117	<sup>(4)</sup> -	-	4,962	-	-	-
Giora Offer	<sup>(6)</sup> 4,039	<sup>(6)</sup> 634	<sup>(6)</sup> -	<sup>(6)</sup> 2,683	7,356	-	-	-
Eli Hoter	1,707	197	1,196	8	3,108	-	-	-
Shlomo Pitchon	1,697	150	997	6	2,850	-	-	-
Noam Hanegbi	1,799	124	1,196	9	3,128	-	-	-
Israel David	1,724	236	1,196	10	3,166	-	-	-

2005

Arie Mientkavich <sup>(7)</sup>	<sup>(10)(9)(8)</sup> 2,857	645	-	26	3,528	-	-	-
Giora Offer	4,925	685	-	32	5,642	6	0.21	-
Dr. Amnon Goldschmidt <sup>(11)</sup>	1,605	293	-	17	1,915	-	-	-
Reuven Spigel <sup>(12)</sup>	<sup>(13)</sup> 2,210	306	-	6	2,522	-	-	-
Shlomo Pitchon	1,551	229	-	28	1,808	-	-	-
Eli Hoter	1,757	309	-	5	2,071	-	-	-
Michael Fokschaner <sup>(14)</sup>	<sup>(15)</sup> 2,207	199	-	26	2,432	-	-	-

\* Excluding VAT on salary.

Not including information regarding loans granted under similar terms to those granted to Bank employees in general, which amounts have been determined on the basis of uniform criteria.

- (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, including the options plan, were approved by the audit committee and are subject to the approval of the Board of Directors and the general meeting of shareholders. The options plan is also subject to an increase in the registered share capital which in itself is subject to the approval of the general meeting of shareholders.
- (5) Including adjustment grant.
- (6) The remuneration and employment conditions, including the options plan, were approved by the audit committee and are subject to the approval of the Board of Directors and the general meeting of shareholders. The options plan is subject to an increase in the registered share capital which in itself is subject to the approval of the general meeting of shareholders.
- (7) Acted as chairman of the board of the Bank. Retired from office on January 31, 2006.
- (8) The remuneration and employment conditions, were approved by the general meeting of shareholders in meetings held on January 15, 1998, October 15, 1999 and June 14 2004.
- (9) At a meeting of the board of directors, held in May 2005, it was resolved (following the approval of the audit committee) to approve an award to the Chairman of the board in the amount of NIS 1,255 thousand. This matter has not yet been brought for approval of the general meeting of shareholder, but nonetheless, this item is included in the payroll expense data above.
- (8) For details as to the approach made by the controlling shareholders to the Accountant General at the Ministry of Finance and to the President of M.I. Holdings Ltd. as to the payments to the former Chairman of the board, including a special award of NIS 10 million, see Note 22 to the financial statements.
- (9) 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.
- (10) The Board of Directors in its meetings of August 2004 and October 2004 (after receiving the approval of the credit 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.
- (11) Retired from office on December 31, 2005.
- (12) Retired from office on February 23, 2006, upon being appointed President and CEO of IDB New York.
- (13) Including an appreciation award for his exceptional contribution to the development of the retail banking division and for accepting the challenge in New York.
- (14) Retired from office on December 31, 2005.
- (15) 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.

For details as to an option plan and an award plan to senior officers of the Bank, including the Chairman of the board of directors and the President and CEO, see Notes 13 and 22 to the financial statements.

## 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 the 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.

Following the amendments to the law and regulations, discussions were held with the Supervisor of Banks on the matter of adapting the reporting requirements set out in the regulations of the Israeli Securities Authority to the reporting requirements to be applied to banking corporations. On February 19, 2006, the Supervisor of Banks issued a provisional instruction regarding the description of the business of a banking corporation and with respect to forward-looking information in the directors' report, which applies to the annual report for 2005 and thereafter.

### 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 a directive regarding a declaration as to disclosure in quarterly and annual reports of banking corporations. This directive was applied for the first time in the financial statements for the second quarter of 2005.

The Bank and its banking subsidiaries in Israel have engaged an independent firm of Certified Public Accountants, to provide consultation, support and guidance to assist them in their preparations towards the signing of the required declaration.

In order to establish these declarations, the Bank, engaging outside assistance as stated, has examined the principal processes of production and delivery of information related to the financial statements by the various units of the Bank, as well as the controls applying to these processes. As part of this review, the processes of data communication have been mapped and documented in detail, including the controls implemented in these processes. Additional new controls have been formed, the absorption of which in the work processes is being implemented.

Based on the findings of the said detailed examination, the Bank's Management in conjunction with its President

and CEO and its Chief Accounting Officer have evaluated, on the basis of the said evaluation, the efficiency of the controls and procedures relating to disclosure at the Bank. Based on this evaluation, the President and CEO and Chief Accounting Officer have reached the conclusion that as of the end of the reporting period, the controls and procedures relating to disclosure at the Bank operate efficiently in order to record, process, summarize and report the information that the Bank is required to disclose in its quarterly report, in accordance with the directives of the Supervisor of Banks in the matter of reporting to the public.

During the quarter ended December 31, 2006, no change occurred in the internal control over the financial reporting at the Bank, which had a material effect or which is reasonably expected to have a material effect on financial reporting.

For details as to material weaknesses identified in the internal control over financial reporting, which did the Management of IDB New York report at the end of June 2006, see "Discount Bancorp, Inc." above. As stated, the new Management of IDB New York has already begun implementing corrective measures relating to the said material weaknesses, and as stated, the independent auditors of IDB New York informed that the identified material weaknesses had no effect on their unqualified opinion on the financial statements as of December 31, 2005.

It should be stressed that, at this stage, the declaration regarding disclosure in the financial statements (see above) is not supposed to cover the extensive aspects of evaluating the effectiveness of the internal control over the financial reporting determined in section 404 (see hereunder). Included in this, the Bank has not as yet used the internal control model for examining its effectiveness, as required by the said Section 404.

#### **CIRCULAR REGARDING "MANAGEMENT'S RESPONSIBILITY AS TO THE INTERNAL CONTROL OVER FINANCIAL REPORTING – SOX ACT 404"**

The Supervisor of Banks issued in December 2005 a draft circular in the above matter, according to which banking corporations are to prepare for the inclusion in their financial statements, starting with the financial statements as of December 31, 2008, a certification with regards the management's responsibility for the establishment and maintenance of a proper system and procedures for the internal control over financial reporting as well as an assessment as of the end of the fiscal year of the efficiency of the internal control system and procedures regarding financial reporting. At the same time, the independent auditors of banking corporations would be required to render an opinion on the assessment made by the management of the banking corporation, in the preparation of which they will be required to implement the relevant standards to be adopted or published by the Public Company Accounting Oversight Board (PCAOB). Everything in accordance with the provisions of Section 404 of the US Sarbanes Oxley Act and the directives issued by the SEC under it.

The circular requires the banking corporations to complete, until the date of issue of the report for the first quarter of 2006, the preliminary preparations for the implementation of the project – planning of the project (at the Bank and at the subsidiaries) – the appointment of a steering committee, the appointment of a project team, definition of the internal control and the scope of the work, its targets, interim products, the determination of a methodology, the identification of hardware and software to be used, establishment of work plans, budgets, employee training schemes, means of communication between the various factors, etc. The banking corporations must complete the overall project in the first half of 2008, so that the audit work of the independent auditors

would begin in June 2008 at the latest and should be completed until the reporting date (December 31, 2008). The circular states that the internal control model "COSO", to which the regulatory authorities in the United States refer, may be used by the banking corporations in Israel, within the framework of implementing the provisions of section 404, for the purpose of assessing the internal control. The COSO model defines the internal control, and provides methodologies and criteria according to which the effectiveness of the internal control system is to be examined.

The implementation of the Supervisor of Banks' requirements would require the upgrading and/or establishment of infrastructure systems of internal controls at the Bank, a matter that in the opinion of the Bank would require the allocation of large both financial and executive resources in the coming years.

The Bank and its banking subsidiaries in Israel have chosen an independent firm of Certified Public Accountants to assist, advise, guide and accompany them in their preparations for the implementation of the project.

### **SUMMARY OF THE PREPARATIONS BY THE BANK FOR COMPLIANCE WITH THE GUIDELINES OF SOX ACT 404, AS ADOPTED BY THE SUPERVISOR OF BANKS**

In the course of 2006, the Bank completed the planning and preparation stage for the implementation of the project. As part of this stage, the execution methodology has been defined, the COSO Model has been adopted as a model for assessing the internal control over financial reporting, and the project management and a guiding committee have been established. The planning stage included the conduct of a pilot project, in the course of which the work methodology and the structure of products have been tested. Furthermore, during the year, the Bank completed the mapping of the overall principal procedures that affect financial reporting, and has started the documentation and verification stage of a part of these procedures. During 2006 the Bank started the training of employee groups relevant to the project and the forming of training material to be studied in 2007.

The year 2007 is to be devoted to the documentation and mapping of financial reporting risks relating to the principal procedures, and the effective tests stage is to begin

The Bank is examining at present the acquisition of a project management system.

Mercantile Discount Bank and Discount Mortgage Bank have also completed in 2006 the planning and preparation stage for the execution of the project in an independent manner and separately from the Bank.

In accordance with a resolution of the Bank, IDB New York also began in 2006 preparations for the implementation of the SOX 404 requirements, as adopted by the Supervisor of Banks. Until date of issue of this Report, IDB New York has completed the preparation stage for the implementation of the project, including the adoption of a work methodology, the definition of products, the manner of reporting to the project management in Israel and the mapping of the overall procedures affecting financial reporting.

### **DRAFT GUIDELINES REGARDING THE FRAMEWORK OF INTERNAL CONTROL**

On June 4, 2006, the Supervisor of Banks issued draft guidelines regarding the framework of internal control at banking corporations.

The draft sets out milestones and criteria for the operation of an effective internal control system at a banking corporation involving all its operations. Also presented is a general evaluation framework, in accordance with an accepted methodological approach, intended to test and evaluate the quality and effectiveness of the internal

control system. Evaluation of the effectiveness of the internal control framework constitutes a material component of the risk management process of a banking corporation.

The draft guidelines is based on the principles presented in the report issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), regarding the framework of internal control as well as on the interpretation and amplification given to these principles in the recommendations of the Basel Committee Report, dealing with internal control systems at banking corporations.

The draft is intended to serve as an infrastructure both to the processes that are now being formulated by the banking corporations in accordance with guidelines already provided by the Supervisor of Banks – guidelines that relate to the application of the provisions of the Sarbanes-Oxley Act of 2002 regarding the evaluation of the controls over financial reporting, and to the guidelines dealing with the application of principles derived from the future operating environment under the Basle II rules.

The Supervisor of Banks has instructed the banking corporations to appoint senior management executives involved in risk control management, to take responsibility for the application of the guidelines. The Supervisor informed that he would hold further meetings with these officers and would develop with them the final format of the guidelines, and in continuation would later monitor the integration of such guidelines at the banking corporations.

A target date has not yet been fixed for the application of the guidelines presented in the draft.

The Bank has begun studying the issues covered by the draft.

### AN AWARD PLAN AND A STOCK OPTION PLAN FOR OFFICERS OF THE BANK AND THE ENGAGEMENT CONDITIONS OF THE CHAIRMAN OF THE BOARD

On March 26, 2006, the Board of Directors of the Bank resolved to approve an award plan to members of the Banks' management, as detailed in Note 16 I to the financial statements.

On March 26, 2006, the Board of Directors of the Bank resolved to approve the engagement of the Bank in a personal contract with the Chairman of the Board, as detailed in Note 22 I to the financial statement as of December 31, 2005. The said engagement includes, among other things, an annual award derived from the annual rate of return on equity. An identical provision was included in an amendment to the personal contract with the President and CEO, as detailed in Note 22 J to the financial statement.

On the same date, the Board of Directors of the Bank resolved to approve a stock option plan for officers of the Bank, including the Chairman of the Board and the President and CEO of the Bank, as detailed in Note 13 D to the financial statement.

On March 26, 2006, the Bank issued a notice for a special meeting of the Ordinary "A" shareholders of the Bank to be convened on April 26, 2006. The agenda for the meeting included, inter-alia, the following items:

- Approval of a proposed allotment of option warrants to the Chairman of the Board of the Bank, in a stock option plan to officers of the Bank;
- Increase of the registered share capital of the Bank by NIS 4,000,000 par value, and a respective amendment to the Memorandum and Articles of Association of the Bank;
- Approval of the terms of office of the Chairman of the Board of the Bank.

On April 20, 2006, the Israel Securities Authority (ISA) requested the Bank to provide explanations and documents

with regards to the general meeting of shareholders that was to be held in order to approve the matters stated above. The requested details related to the manner in which the remuneration plan for senior management had been formulated and to the procedure for its approval.

Requests for details and information were also made to members of the Board of Directors.

The said letter was received on the background of a public uproar with respect to the remuneration of senior bank executives in general and at the Bank in particular.

In view of the situation that has arisen, the Chairman of the Board and the President and CEO were of the opinion that the preoccupation at this time with the stock option plan that had been approved with respect to them, might divert attention from promoting the issues that are on the agenda of the Bank; therefore, out of concern for the Bank, and wishing not to delay the approval of the remaining issues that were to be discussed at the general meeting, and in order to avoid any possible damage to the Bank – the Chairman and the President and CEO requested the removal of items dealing with the granting of stock option warrants to them (including the increase of the registered share capital of the Bank) from the agenda of the general meeting. A notice to this respect was issued to the public on April 23, 2006.

At the request of the Chairman of the Board and to the President and CEO, their remuneration plan is being brought for reconsideration by the authorized organs of the Bank (see hereunder).

The said notice did not create any change in the plan for the granting of stock options to ten officers of the Bank (not including the Chairman and the President and CEO), and which can be carried out within the existing registered share capital of the Bank (without requiring its increase), in accordance with the terms of the option plan determined in their respect. Concurrently, the Bank responded to the said request of the ISA, however, on April 25, 2006, an additional letter from the ISA was received by the Bank, which among other things, requested additional information and clarifications as well as further questions, which in the opinion of the ISA, required further deliberations. In view of these requests and questions, the ISA was of the opinion that it was not proper to hold the general meeting convened for April 26, 2006, as planned. Under these circumstances, the Bank advised of the postponement of the general meeting.

The Bank has provided the Securities Authority with a legal opinion with respect to the procedure for the approval of the remuneration of the Chairman of the Board and has replied the questions asked.

In view of the questions referred by the Securities Authority, the Audit Committee and Board of Directors of the Bank reexamined the plan for the allotment of options to the other officers, including the Internal Auditor, and the award plan for members of management, including the Internal Auditor.

In discussions held on July 6 and 25, 2006, the Audit Committee and Board of Directors of the Bank ratified their decisions from March 26, 2006 regarding the approval of the award plan and the option plan.

On the Audit Committee and the Board of Directors meetings, it was noted with deep sorrow that Mr. Nissim Alagem, an Executive Vice President at the Bank, who was one of the offerees under the option plan had passed away. According to the terms of the plan, the option warrants that were designated for him would not now be allotted.

On August 4, 2006, the Bank allotted to a Trustee on behalf of nine officers (not including the Chairman and the President and CEO) 9,806,371 non-marketable option warrants, exercisable into ordinary "A" shares of the Bank of NIS 0.1 par value each, under terms and on dates determined in the plan. At the end of 2006, one of the other

officers retired from the Bank and the options that had been allotted to him expired.

On January 30, 2007, the Bank's Audit Committee approved a comprehensive remuneration plan for the Chairman of the Board of Directors and for the President and CEO. The plan was formulated by the Human Resources Committee of the Board that, inter alia, reviewed remuneration plans of large companies in Israel and abroad, formed (with the assistance of experts engaged for this purpose) several models of remuneration, and performed sensitivity analyses in this regard, taking into account also data for prior years.

Representatives of the Committee also conducted negotiations with the Chairman of the Board of Directors and the President and CEO, taking into considerations extensive appreciation for the activities of the Chairman of the Board of Directors and the President and CEO and the great importance that the Bank attributes to their continued activity in the Bank.

The remuneration plan approved by the Audit Committee is not similar, (in its conditions or in the amounts derived therefrom), to the remuneration plan approved as stated in March 2006, and was examined independently from the previous plan. The remuneration plan was formulated for a period of five years (as from February 2006) and includes short-term remuneration (salaries and annual bonuses) and long-term remuneration (stock option plan). The entitlement to annual bonuses and to the option plan are dependent on Discount Group's results and performance (that are measured in accordance with several parameters, mainly rates of change) and on the yield from the Bank's shares, both per se and in comparison to the other large banking groups. Entitlement to annual bonuses is limited to monetary ceilings.

In general (except regarding certain parameters relating to bonuses payable to the President and CEO upon retirement), linkage was maintained in the remuneration proposals to the Chairman of the Board of Directors and the President and CEO.

The remuneration plan for the Chairman of the Board and the President and CEO requires the approval of the Board of Directors. The remuneration plan for the Chairman of the Board also requires the approval of the General Meeting of Shareholders. The allotment of stock options according to the plan may be effected only if the Bank's authorized share capital would be increased and such matter also requires approval of the General Meeting of Shareholders. Accordingly, on February 19, 2007 the Bank requested the reaction of its principal shareholders (the controlling shareholders, on one hand, and the Accountant General in the Ministry of Finance and M.I. Holdings Ltd., on the other hand) regarding the said issues. At this stage, no response from any of the shareholders has been received, and no certainty exists regarding the timing and conditions for consummation of the said plan. The Chairman of the Board of Directors has been employed by the Bank for approximately one year but has not yet received any remuneration for his work (the Bank has recorded full provisions for salary and bonuses in accordance with the plan approved by the Audit Committee. No provisions were recorded in respect of the options component).

For additional details, see Notes 13 and 22 to the financial statements.

## 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

According to Section 92 (12) of the Companies Law, the board of directors must determine the required minimum number of directors having accounting and financial expertise, as this term is defined in Section 240 of the Companies Law.

In accordance with regulations enacted under the said Section 240, the evaluation of the accounting and financial expertise of a director shall be made by the board of directors, and, among other things, the following should be taken into account as part of the overall considerations: the director's education, experience and knowledge of the matters detailed in the Companies Regulations (terms and tests for a director having accounting and financial expertise and a director having professional qualifications), 2005.

In March 2004, the board of directors determined the minimum number of directors that should have accounting and financial expertise, in accordance with guidelines issued by the Securities Authority in October 2003, which was adopted by the Supervisor of Banks in December 2003.

In February 2006, the newly comprised board of directors, adopted, once again, the said resolution. Accordingly, the minimum number of such directors to serve on the board is three.

According to the directives of the Supervisor of Banks, a banking corporation must determine the minimum number of directors having accounting and financial expertise, who could properly serve as members of the audit committee of the board or of any other committee of the board which is empowered to discuss the financial statements of banking corporations.

In February 2006, the board determined that the minimum number of directors as abovementioned, who would serve on the audit committee of the board and on the financial statements committee of the board, is one.

The Directors having "accounting and financial expertise", and the factual background providing the basis for attributing these qualifications to them, are as follows. It should be mentioned that according to the reporting requirements of the Bank of Israel, against each name of a director it is stated whether he is a member of the financial statements committee of the board dealing with the Bank's financial statements and/or a member of the audit committee of the board.

**Shlomo Zohar** – Certified Public Accountant, Bachelor in Economics and Accounting and Master in Business Administration (specializing in accounting and finance).

From 1980 to the end of December 2005 was a partner in the accounting firm of Zohar, Zohar & Co., CPA (Isr). Also served as director in various companies.

As from 2006, Mr. Zohar serves as active chairman of the Bank's board of directors, as chairman of the boards of directors of Mercantile Discount Bank Ltd., Israel Credit Cards Ltd. and several other corporations within the Group and also as vice chairman of the board of directors of IDB New York.

Mr. Zohar serves as a member of the financial statements committee.

**Betzalel Eiger** – Bachelor in business administration, Masters in business administration (specializing in finance).

Chairman of the Board of Directors and CEO of Dorea Investments and Development Ltd., a company traded on the Tel-Aviv Stock Exchange, engaged in real estate mainly in income property segment in Israel and abroad. Chairman of the Board of Directors and CEO of Liberty Properties Ltd., a public company traded on the Tel-Aviv Stock Exchange, engaged in real estate. Serves as Director in Comsec Ltd, a public company engaged in data security. In the period from December 2001 until January 2006, served as outside Director in Adanim Mortgage Bank Ltd. In the period from 1987 to September 2003 served as Director in Neot Aviv Ltd. From May 2002 to March 2005 served as CEO of Giron- Development and Building Ltd. From 1979 to 1994 held various positions in Bank Leumi, including as a member of various credit committees of the bank. His experience includes analysis of financial statements.

**Gad Arbel** – Bachelor in Economics and Master of Business Administration. Engages in economic and financial consulting.

Serves as an outside Director in Psagot Mutual Funds Ltd. and as a director in Discount Bancorp, Inc. and in Israel Discount Bank of New York (where he had previously served as director). Member of the board of trustees, director and chairman of the audit committee of The College of Management and Academic Studies, member of the administrative committee of The Veteran Pension Funds.

Between the years 1971-1992, served in various capacities at the Ministry of Finance, including Deputy Accountant General, representative of the Ministry of Finance in the United States (1983-1987) and Commissioner of Capital Market, Insurance and Savings, Supervisor of Insurance as well as Deputy Chairman of the Israel Securities Authority (1988-1992). From 1992 to 1997 served as economic and financial consultant and as member of boards of directors of various companies, including Israel Discount Bank (also as chairman of the financial statements committee), Israel Discount Bank of New York, The Central Securities Company (Mutual Fund Management) (Chairman), Avner – Motor Vehicle Accident Victims Ltd., Yozma – New Pension Fund for Employees, and others. Until August 2005, served as a member of the audit committee of the Israeli Center for Management. Until April 2006 served as an outside Director in Nitsba Holdings 1995 Ltd. Until November 2006 served as outside Director in Psagot-Leumi Mutual Funds Management Ltd.

From 1997 to 2001, served as Executive Vice President of United Mizrahi Bank responsible for the capital market and investment areas, and from April 1999 acted as member of management in charge of the capital market and investments 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 Securities Rating Company.

Mr. Arbel serves as chairman of the audit committee.

**Itamar Givton** – Bachelor in economics and law.

Serves as Managing Director of the Automotive Equipment Group (since 1993) and as Director in Automotive Equipment Ltd and in Automotive Equipment and Vehicles (2004) Ltd, and their affiliated companies. He also serves as member of the Management Committee of Buxenbaum-Neta Fund (private fund), a member of management of Sheba Fund (endowment) and as chairman of the finance and investments committees of these funds.

Served as Director of the Tel-Aviv Stock Exchange Ltd. (1993-1995), Deputy General Manager and CFO of Automotive Equipment Group (1991-1993), Vice President and Acting Managing Director of Dor Energy Ltd. (1988-

1990) and Assistant General Manager Economics and Business Development of Dankner Investments Ltd. (1987-1991).

From 1979 to 1987 held several positions at the Ministry of Finance including Deputy Budget Director (1984-1987) and a member of the small team that prepared the program for the 1985 economic arrangement.

He also served as a member of the Board of Directors of various Government corporations including the Israel Electric Corporation Ltd. (1982-1989) and Israel Chemicals Ltd. (1985-1987)

Mr. Givton is a member of the financial statements committee.

**Ben-Zion Granit** – BSc. in Agriculture from Hebrew University with a minor in agricultural economics. Studied senior business management at the Business School of the Hebrew University and took courses in a wide range of financial subjects.

Served as chief internal auditor of Union Bank of Israel Ltd. and its subsidiaries (1993-2000), as executive vice president, member of management and head of the operations division at Union Bank (2000-2004), as risk manager (market and credit risks) of Union Bank (2004). He also served as CEO of Union - Systems Ltd. (2000-2004) and as director of Carmel Igud Mortgages and Investments, Ltd. and of Igudim Ltd. (2000-2004).

Mr. Granit serves as member of the audit committee and the financial statements committee.

**Zeev Vurembrand** – BSc. in industrial engineering and management specializing in financial management, Technion, Israel Institute of Technology.

Since October 2002, serves as CEO of Clalit Health Services. Prior thereto, from January 1995 to October 2002, served as vice president, finance. Clalit Health Services has a financial turnover of NIS 18 billion. As part of his duties he was occupied with auditing and reporting procedures similar to those accepted in public companies.

From January 2001 to January 2006, he served as an outside director of Blue Square Israel Ltd., and as chairman of its audit committee and its financial statements committee. Blue Square Israel Ltd. is a public company traded on the NYSE (in the form of ADRs). One of the first moves made by that company in 2001 was the dual listing of its shares for trading also on the Tel-Aviv Stock Exchange. As part of his duties as chairman of the audit committee at Blue Square, he closely followed the process, audit and implementation of risk management required for compliance with the Sarbanes-Oxley Act. Blue Square reported that he was a director having accounting and financial expertise.

From 1995 to October 2002 he served as Chairman of the Board of Dikla Insurance Company Ltd.

From October 2003 to December 2004, he was outside member of the rating committee of Midroog Ltd.

Since October 2002, in addition to his duties as CEO of Clalit Health Services, he has also been chairman of the boards of Clalit Health Services subsidiaries: Mor – Institute for Medical Data Ltd., Shila Medical Services Ltd. (which includes “Clalit Smile”, “Clalit Esthetics” and “Clalit Complementary Medicine”) as well as Clalit Medical Engineering Ltd.

From January 2005 to January 2006, he served on the board of directors and member of the audit committee of UBank where he was reported as a director having accounting and financial expertise.

From 1993 to 1994, he served as Vice President of Finance and Business Development of Shekem Ltd.

From 1989 to 1992, he served as Deputy CEO in charge of finances at Automotive Industries Ltd. of the Automotive Equipment Group.

Mr. Vurmbrand serves as chairman of the financial statements committee.

**Prof. Ben-Zion Zilberfarb** – Bachelor in Economics and Business Administration, Master in Economics, Ph.D. in Economics from the University of Pennsylvania. Serves as Professor of Economics at Bar-Ilan University and holds the Edmond de Rothschild Chair for Global Asset Management at the School of Banking and Capital Markets at the Netanya Academic College.

Serves as outside director and member of the audit committees of Brimag Digital Age Ltd. and Fundtech Ltd., Direct Capital Investments Ltd. and of Delek Group Ltd. Serves as an outside director of Perrigo Company (an American company). Served as outside director and member of the audit committee of Clal Provident Fund and Education Fund Financing Ltd.

Served as outside director in Partner Communications (including a tenure as chairman of the audit committee). Served as Chairman of the Board of Directors of Karnit (1998-2000) and of Eurotrade Bank Ltd. (2000-2001). In the years 1982-1985, he served as director of the Economic Planning Authority, and 1988-1989 as Director General of the Ministry of Finance.

Partner Communications Ltd. reported him as having financial expertise under the US Securities Regulations. As a member of the audit committees of Fundtech and of Partner Communications Ltd., accompanied the process implementing requirements under the Sarbanes-Oxley Act. Is proficient in accounting matters pertaining to GAAP and to the recognition of earnings and other subjects relating to the communications sector.

Prof. Zilberfarb serves as member of the financial statements committee.

**Joseph Singer** – Bachelor in Economics and Business Administration, Master in Business Administration.

Serves as director and managing partner of Giza Singer Even Ltd., an economics and business consulting company specializing in two central areas: one, analysis and valuation of companies and the other, company and project financing. In addition, is a member of the boards of directors of various companies, including Singer and Even Ltd., Midroog Ltd., a rating company, Midroog Holdings Ltd., Giza Singer Even Finance Ltd. and Singer, Even & Kreizberg Holdings Ltd. Served as outside director of Edmond de Rothschild Mutual Funds Management Ltd. and as Chairman of its investments committee. Served as outside director of Otzarit Mutual Funds Management Co. Ltd. For over a decade served as President and CEO of Singer and Even Ltd. – Economics and Business Consulting Company.

Mr. Singer is a member of the financial statements and audit committees.

**Tsippi Samet** – Bachelor in Economics and Mathematics, Masters in Economics from the Hebrew University, Jerusalem.

Serves as President of Adif College for Insurance, Pension and Finance Studies, and as outside director in Sinai Insurance Holdings (1993) Ltd., Menora Mivtachim Pensions Ltd., Menora Mivtachim Gemel Ltd. and Ophir Optronics Ltd., as well as Chairperson of the Investment Committee of Avner –Motor Vehicle Accident Victims Insurance Ltd.

She served as outside director of Hazera Genetics Ltd. (2003 – February 2007).

In the period 1998-2002, served as Commissioner of Capital Markets, Insurance and Savings and at the same time served as director of M.I. Holdings Ltd. Between 1996-1998, served as a member of the Israel Securities Authority. Between 1983-1995, held the office of senior economist in the research unit of the Supervisor of Banks.

Ms. Samet serves as member of the audit committee.

## CHANGES IN THE BOARD OF DIRECTORS AND MANAGEMENT

**Changes in the Board of Directors.** At the General Meeting of the shareholders convened on December 24, 2006, it was resolved to appoint Dr. Itzhak Sharir as a member of the Bank's Board of Directors

**Changes in Management.** On January 29, 2007, the Board of Directors appointed Mr. Ehud Arnon as Executive Vice President and Head of Corporate Division. Mr. Arnon will replace Mr. Rony Hizkiyahu, who filled this position until December 31, 2006. Mr. Arnon is expected to assume his duties in May 2007.

## MEETINGS OF THE BOARD AND ITS COMMITTEES

In 2006, the Board of Directors held 36 meetings. In addition, 66 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 Bank and the Group.

March 27, 2007

Shlomo Zohar  
Chairman of  
the Board of Directors

Giora Offer  
President and  
Chief Executive Officer

## MANAGEMENT REVIEW 2006

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**SCHEDULE A - CONSOLIDATED BALANCE SHEET - MULTI-PERIOD DATA**

	As at December 31				
	2006	2005	2004	2003	2002
	Reported amounts <sup>(1)</sup>			Adjusted amounts <sup>(1)</sup>	
	In NIS millions				
<b>Assets</b>					
Cash and deposits with banks	25,406	20,586	17,751	16,888	18,878
Securities	38,914	42,188	40,068	38,774	36,581
Credit granted to the public	90,175	<sup>(2)</sup> 87,816	<sup>(2)</sup> 81,285	<sup>(2)</sup> 79,671	<sup>(2)</sup> 77,499
Credit granted to the Government	18	92	271	367	552
Investments in affiliated companies	1,591	1,527	1,320	1,238	1,282
Buildings and equipment	2,614	2,268	1,978	2,102	1,955
Other assets	3,820	*4,243	3,604	3,442	*3,691
<b>Total assets</b>	<b>162,538</b>	<b>158,720</b>	<b>146,277</b>	<b>142,482</b>	<b>140,438</b>
<b>Liabilities and Shareholders' Equity</b>					
Deposits from the public	130,517	*130,285	*121,982	*120,104	119,734
Deposits from banks	8,099	6,518	4,806	4,948	4,051
Deposits from the Government	119	*136	*127	*140	166
Debentures and subordinated capital notes	6,302	5,342	4,809	4,223	3,787
Other liabilities	9,134	<sup>(2)</sup> 9,254	<sup>(2)</sup> 7,718	<sup>(2)</sup> 6,628	<sup>(2)</sup> 7,187
<b>Total liabilities</b>	<b>154,171</b>	<b>151,535</b>	<b>139,442</b>	<b>136,043</b>	<b>134,925</b>
Minority interest	402	467	449	484	449
Shareholders' equity	7,965	6,718	6,386	5,955	5,064
<b>Total liabilities and shareholders' equity</b>	<b>162,538</b>	<b>158,720</b>	<b>146,277</b>	<b>142,482</b>	<b>140,438</b>

\* Reclassified.

Footnotes:

(1) See Note 1 B to the financial statements.

(2) Restated - see Note 1 Z to the financial statements.

**SCHEDULE B - CONSOLIDATED STATEMENT OF INCOME - MULTI-PERIOD DATA**

	As at December 31				
	2006	2005	2004	2003	2002
	Reported amounts <sup>(1)</sup>			Adjusted amounts <sup>(1)</sup>	
	In NIS millions				
<b>Financing Income</b>					
Income from financing activities before provision for doubtful debts	3,790	3,697	3,473	2,970	2,857
Provision for doubtful debts	570	691	880	845	896
Income from financing activities after provision for doubtful debts	3,220	3,006	2,593	2,125	1,961
<b>Non-Financing Income</b>					
Operating commissions	1,911	*1,863	*1,776	*1,666	*1,533
Net income (loss) on investment in shares	65	3	103	9	(11)
Other income	383	540	352	434	243
Total non-financing income	2,359	2,406	2,231	2,109	1,765
<b>Non-Financing Expenses</b>					
Salaries and related expenses	3,201	*2,966	*2,564	*2,303	2,182
Maintenance and depreciation of buildings and equipment	679	*670	*634	*638	*599
Other expenses	1,140	*1,093	*830	*669	*786
Total non-financing expenses	5,020	4,729	4,028	3,610	3,567
Operating income before taxes in reported amounts	559	683	796	624	159
Erosions and adjustments <sup>(1)</sup>	-	-	-	30	-
Operating income before taxes	559	683	796	654	159
Provision for taxes on operating income	350	324	342	371	207
Operating income (loss) after taxes	209	359	454	283	(48)
Bank's share in operating income (loss) of affiliated companies, net of tax effect	188	174	135	117	(1)
Net operating income (loss) before minority interest	397	533	589	400	(49)
Minority interest, after taxes, in the operating income of consolidated subsidiaries	(82)	(75)	(56)	(60)	(25)
Net operating income (loss)	315	458	533	340	(74)
Net cumulative effect as of the beginning of the year of change in accounting	-	(4)	(1)	10	-
Net income (loss), before extraordinary income (loss) after taxes	315	454	532	350	(74)
Cancellation of provision (provision) for impairment in value of investment in affiliated companies	173	-	-	(173)	(8)
Net income (loss) from extraordinary items, net of taxes	348	4	24	(23)	44
Net income (loss)	836	458	556	154	(38)

For footnotes see next page.

**SCHEDULE B - CONSOLIDATED STATEMENT OF INCOME - MULTI-PERIOD DATA (CONTINUED)**

	As at December 31				
	2006	2005	2004	2003	2002
	Reported amounts <sup>(1)</sup>			Adjusted amounts <sup>(1)</sup>	
<b>Earnings (loss) per share of NIS 0.1 (in NIS)<sup>(1)</sup>:</b>					
Net operating income (loss)	0.32	<sup>(2)</sup> 0.47	<sup>(2)</sup> 0.54	<sup>(2)</sup> 0.35	<sup>(2)</sup> (0.08)
Net income (loss) from extraordinary items, net of taxes <sup>(3)</sup>	0.53	-	<sup>(2)</sup> 0.03	<sup>(2)</sup> (0.19)	<sup>(2)</sup> 0.04
Net income (loss)	0.85	0.47	0.57	0.16	(0.04)
Total number of shares used for the above computation (in thousands)	980,639	980,639	980,639	980,639	980,639

\* Reclassified.

Footnotes:

(1) See Note 1B of the financial statements.

(2) Restated - See Note 1S of the financial statements.

(3) December 31, 2006: Including a cancellation of provision for impairment in value of investment in an affiliated company.  
December 31, 2005 and 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<sup>(1)</sup>

### REPORTED AMOUNTS

	2006				2005			
	Average balance <sup>(2)</sup>	Financing income (expense)	Rate of income (expense)		Average balance <sup>(2)</sup>	Financing income (expense)	Rate of income (expense)	
			Excluding the effect of derivatives	Including the effect of derivatives <sup>(3)</sup>			Excluding the effect of derivatives	Including the effect of derivatives <sup>(3)</sup>
	In NIS millions		%	In NIS millions		%		
<b>Non-Linked Israeli Currency:</b>								
Assets <sup>(4)(5)</sup>	49,455	3,586	7.25	45,005	2,800	6.22		
Effect of derivatives: <sup>(3)</sup>								
Embedded derivatives and ALM	9,708	57		*7,463	224			
Total assets	59,163	3,643	6.16	52,468	3,024	5.76		
Liabilities <sup>(5)</sup>	(48,887)	(1,969)	(4.03)	(46,171)	(1,359)	(2.94)		
Effect of derivatives: <sup>(3)</sup>								
Embedded derivatives and ALM	(8,386)	18		*(5,087)	(157)			
Total liabilities	(57,273)	(1,951)	(3.41)	(51,258)	(1,516)	(2.96)		
Interest margin			3.22	2.75		3.28	2.80	
<b>Israeli Currency Linked to the CPI :</b>								
Assets <sup>(4)(5)</sup>	21,434	1,111	5.18	21,207	1,715	8.09		
Effect of derivatives: <sup>(3)</sup>								
Embedded derivatives and ALM	51	3		431	21			
Total assets	21,485	1,114	5.19	21,638	1,736	8.02		
Liabilities <sup>(5)</sup>	(18,841)	(742)	(3.94)	(19,219)	(1,280)	(6.66)		
Effect of derivatives: <sup>(3)</sup>								
Embedded derivatives and ALM	(964)	(25)		(395)	4			
Total liabilities	(19,805)	(767)	(3.87)	(19,614)	(1,276)	(6.51)		
Interest margin			1.24	1.32		1.43	1.51	
<b>Foreign Currency:<sup>(6)</sup></b>								
Assets <sup>(4)(5)</sup>	76,132	(832)	(1.09)	73,418	6,242	8.50		
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	4,103	(157)		4,858	359			
Embedded derivatives and ALM	28,287	(381)		*25,832	1,198			
Total assets	108,522	(1,370)	(1.26)	104,108	7,799	7.49		
Liabilities <sup>(5)</sup>	(75,471)	2,375	3.15	(70,344)	(4,993)	(7.10)		
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	(4,099)	219		(4,847)	(318)			
Embedded derivatives and ALM	(26,051)	232		*(28,488)	(1,110)			
Total liabilities	(105,621)	2,826	2.68	(103,679)	(6,421)	(6.19)		
Interest margin			2.06	1.42		1.40	1.30	

\* Reclassified.

For footnotes see page 244.

**SCHEDULE C - INCOME AND EXPENSE RATIOS OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES<sup>(1)</sup> (CONTINUED)**  
**REPORTED AMOUNTS**

	2006				2005			
	Average balance <sup>(2)</sup>	Financing income (expense)	Rate of income (expense)		Average balance <sup>(2)</sup>	Financing income (expense)	Rate of income (expense)	
			Excluding the effect of derivatives	Including the effect of derivatives <sup>(3)</sup>			Excluding the effect of derivatives	Including the effect of derivatives <sup>(3)</sup>
In NIS millions		%		In NIS millions		%		
<b>Total:</b>								
Monetary assets which generated financing income <sup>(4)(5)</sup>	147,021	3,865	2.63	139,630	10,757	7.70		
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	4,103	(157)		4,858	359			
Embedded derivatives and ALM	38,046	(321)		33,726	1,443			
Total assets	189,170	3,387	1.79	178,214	12,559	7.05		
Monetary liabilities which generated financing expenses <sup>(5)</sup>	(143,199)	(336)	(0.23)	(135,734)	(7,632)	(5.62)		
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	(4,099)	219		(4,847)	(318)			
Embedded derivatives and ALM	(35,401)	225		(33,970)	(1,263)			
Total liabilities	(182,699)	108	0.06	(174,551)	(9,213)	(5.28)		
Interest margin			2.40			2.08	1.77	
In respect of options		108			(16)			
In respect of other derivatives (excluding options, hedging derivatives, ALM and detached embedded derivatives) <sup>(3)</sup>		(4)			-			
Commissions on financing operations and other financing income <sup>(7)</sup>		305			437			
Other financing expenses		(114)			(70)			
Income from financing activities before provision for doubtful debts		3,790			3,697			
Provision for doubtful debts (including general and supplemental provisions)		(570)			(691)			
Income from financing activities after provision for doubtful debts		3,220			3,006			

For footnotes see next page.

## SCHEDULE C - INCOME AND EXPENSE RATIOS OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES<sup>(1)</sup> (CONTINUED)

### REPORTED AMOUNTS

	2006	2005
	Average balance <sup>(2)</sup>	Average balance <sup>(2)</sup>
In NIS millions		
<b>Total:</b>		
Monetary assets which generated financing income <sup>(4)(5)</sup>	147,021	139,630
Other monetary assets <sup>(5)</sup>	3,355	*3,073
General and supplemental provisions for doubtful debts	(721)	(701)
<b>Total monetary assets</b>	<b>149,655</b>	<b>142,002</b>
<b>Total:</b>		
Monetary liabilities which generated financing expenses <sup>(5)</sup>	(143,199)	(135,734)
Liabilities related to derivative instruments <sup>(8)</sup>	(200)	*(98)
Other monetary liabilities <sup>(5)</sup>	(3,420)	*(3,054)
<b>Total monetary liabilities</b>	<b>(146,819)</b>	<b>(138,886)</b>
Surplus of monetary assets over monetary liabilities	2,836	3,116
Non-monetary assets	4,827	4,092
Non-monetary liabilities	(61)	(55)
<b>Total capital resources</b>	<b>7,602</b>	<b>7,153</b>

\* Reclassified.

Footnotes:

- (1) The data in this table is presented before and after the effect of derivative instruments (including off-balance sheet effect of derivative instruments).
- (2) Based on monthly opening balances, 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), 2006 – NIS (73) million in the non-linked segment, NIS (2) million in the CPI linked segment and NIS 132 million in the foreign currency segment; 2005 – NIS (145) million in the non-linked segment, NIS (1) million in the CPI linked segment and NIS 29 million in the foreign currency segment.
- (5) Excluding derivative instruments.
- (6) Including Israeli currency linked to foreign currency.
- (7) Including gains/losses on sale of investments in bonds and adjustment to fair value of trading bonds.
- (8) Average balances of derivative instruments (excluding average off-balance sheet balances of derivative instruments).
- (9) Excluding the outstanding debts and liabilities in respect of open credit card transactions in the amount of NIS 1,976 million (December 31, 2005 – NIS 1,873 million).

### SCHEDULE C - INCOME AND EXPENSE RATIOS OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES<sup>(1)</sup> (CONTINUED)

	2006				2005			
	Average balance <sup>(2)</sup>	Financing income (expense)	Rate of income (expense)		Average balance <sup>(2)</sup>	Financing income (expense)	Rate of income (expense)	
			Excluding	Including			Excluding	Including
			the effect of derivatives	the effect of derivatives <sup>(3)</sup>			the effect of derivatives	the effect of derivatives <sup>(3)</sup>
In US\$ millions*		%		In US\$ millions*		%		
<b>Foreign Currency – Nominal in US\$<sup>(6)*</sup></b>								
Assets <sup>(4)(5)</sup>	16,974	931	5.48		16,327	719	4.40	
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	916	29			1,085	25		
Embedded derivatives and ALM	6,347	234			5,757	144		
<b>Total Assets</b>	<b>24,237</b>	<b>1,194</b>	<b>4.93</b>		<b>23,169</b>	<b>888</b>	<b>3.83</b>	
Liabilities <sup>(5)</sup>	(16,916)	(630)	(3.72)		(15,703)	(418)	(2.66)	
Effect of derivatives: <sup>(3)</sup>								
Hedging derivatives	(915)	(20)			(1,083)	(22)		
Embedded derivatives and ALM	(6,496)	(215)			(6,352)	(136)		
<b>Total liabilities</b>	<b>(24,327)</b>	<b>(865)</b>	<b>(3.56)</b>		<b>(23,138)</b>	<b>(576)</b>	<b>(2.49)</b>	
Interest margin		329	1.76	1.37		312	1.74	1.34

\* Nominal Israeli Shekel amounts translated to US\$ Dollars at the representative rate of exchange.

Footnotes:

- (1) The data in this table is presented before and after the effect of derivative instruments (including off-balance sheet effect of derivative instruments).
- (2) Based on monthly opening balances (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) 2006 - in amount of US\$ 29 million 2005 - in the amount of US\$ 6 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, 2006**  
**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
<b>Non-linked Israeli Currency</b>					
Total assets	35,865	5,515	5,703	3,389	811
Total liabilities	44,114	4,055	5,427	1,302	287
Difference	(8,249)	1,460	276	2,087	524
Effect of forward transactions and special commitments	(965)	509	2,548	429	13
Options	(247)	399	2	(112)	14
Exposure to changes in interest rates in the segment	(9,461)	2,368	2,826	2,404	551
Cumulative exposure in the segment	(9,461)	(7,093)	(4,267)	(1,863)	(1,312)
<b>Israeli Currency Linked to the CPI</b>					
Total assets	472	783	3,945	5,580	3,509
Total liabilities	647	1,471	2,772	4,679	3,211
Difference	(175)	(688)	1,173	901	298
Effect of forward transactions and special commitments	-	(8)	(318)	(117)	(48)
Options	-	-	16	41	-
Exposure to changes in interest rates in the segment	(175)	(696)	871	825	250
Cumulative exposure in the segment	(175)	(871)	-	825	1,075
<b>Foreign Currency**</b>					
Total assets	33,441	16,530	9,210	7,142	5,348
Total liabilities	35,412	19,564	12,416	4,577	1,883
Difference	(1,971)	(3,034)	(3,206)	2,565	3,465
Effect of forward transactions and special commitments	1,083	(273)	(2,229)	(335)	32
Options	247	(399)	(20)	71	(14)
Exposure to changes in interest rates in the segment	(641)	(3,706)	(5,455)	2,301	3,483
Cumulative exposure in the segment	(641)	(4,347)	(9,802)	(7,501)	(4,018)
<b>Overall Exposure to Changes in Interest Rates</b>					
Total assets***	69,778	22,828	18,858	16,111	9,668
Outstanding debt deriving from credit card transactions****					
Total balance sheet assets	69,778	22,828	18,858	16,111	9,668
Total liabilities***	80,173	25,090	20,615	10,558	5,381
Creditors in respect of credit card activity****					
Total balance sheet liabilities	80,173	25,090	20,615	10,558	5,381
Difference	(10,395)	(2,262)	(1,757)	5,553	4,287
Effect of forward transactions and special commitments	118	228	(1)	(23)	(3)
Exposure to changes in interest rates in the segment	(10,277)	(2,034)	(1,758)	5,530	4,284
Cumulative exposure in the segment	(10,277)	(12,311)	(14,069)	(8,539)	(4,255)

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.

Over 5 to 10 years	Over 10 to 20 years	Over 20 years	No fixed maturity *	Total	Rate of return %	Average duration in years	31.12.2005	
							Rate of return %	Average duration in years
1,879	171	40	1,339	54,712	5.20	0.62	5.41	0.61
180	213	121	41	55,740	2.23	0.30	2.06	0.32
1,699	(42)	(81)	1,298	(1,028)	2.97	0.32	3.35	0.29
10	5	-	-	2,549	-	-	-	-
(124)	531	40	-	503	-	-	-	-
1,585	494	(41)	1,298	2,024	-	-	-	-
273	767	726	2,024	-	-	-	-	-
4,587	1,855	79	208	21,018	5.32	4.16	5.44	4.08
4,792	1,434	1	75	19,082	4.39	4.03	4.31	3.64
(205)	421	78	133	1,936	0.93	0.13	1.13	0.44
(73)	(233)	-	-	(797)	-	-	-	-
2	-	-	-	59	-	-	-	-
(276)	188	78	133	1,198	-	-	-	-
799	987	1,065	1,198	-	-	-	-	-
3,156	1,283	395	395	76,900	4.62	1.26	4.20	1.49
960	15	1	28	74,856	3.63	0.51	2.90	0.79
2,196	1,268	394	367	2,044	0.99	0.75	1.30	0.70
(3)	(27)	-	-	(1,752)	-	-	-	-
122	(531)	(40)	-	(564)	-	-	-	-
2,315	710	354	367	(272)	-	-	-	-
(1,703)	(993)	(639)	(272)	-	-	-	-	-
9,622	3,309	514	7,621	158,309	-	1.43	-	1.57
				4,229	-	-	-	-
9,622	3,309	514	7,621	162,538	-	-	-	-
5,932	1,662	123	408	149,942	-	0.88	-	0.99
				4,229	-	-	-	-
5,932	1,662	123	408	154,171	-	-	-	-
3,690	1,647	391	7,213	8,367	-	0.55	-	0.58
(66)	(255)	-	2	-	-	-	-	-
3,624	1,392	391	7,215	8,367	-	-	-	-
(631)	761	1,152	8,367	-	-	-	-	-

\* 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.

\*\*\*\* Assets and liabilities deriving from the use of credit cards, to which customers are already committed.

## SCHEDULE E – CREDIT RISK CLASSIFIED BY ECONOMIC SECTORS ON A CONSOLIDATED BASIS

REPORTED AMOUNTS (IN NIS MILLIONS)

	December 31, 2006				
	Balance sheet Credit risk <sup>(1)</sup>	Off-balance Sheet credit risk <sup>(2)</sup>	Total credit risk	Annual expense on specific provision for doubtful debts	Balance of problematic debt <sup>(3)</sup>
<b>1. Lending Activity in Israel</b>					
Agriculture	718	395	1,113	8	41
Industry	11,499	11,172	22,671	122	876
Construction and real estate	11,210	10,292	21,502	153	3,036
Electricity and water	1,381	331	1,712	(2)	2
Commerce	7,942	5,321	13,263	42	447
Hotels, hotel services and food	2,128	554	2,682	6	1,053
Transportation and storage	2,917	1,097	4,014	16	100
Communications and computer services	2,431	1,269	3,700	9	635
Financial services	6,170	7,401	13,571	40	145
Other business services	5,040	2,815	7,855	48	266
Public and community services	1,560	859	2,419	5	187
Individuals - housing loans	9,623	601	10,224	19	469
Individuals - other loans	12,095	10,811	22,906	77	478
<b>Total</b>	<b>74,714</b>	<b>52,918</b>	<b>127,632</b>	<b>543</b>	<b>7,735</b>
Less a deposit abroad linked to the credit risk of the borrower	(63)	-	(63)	-	-
<b>Total</b>	<b>74,651</b>	<b>52,918</b>	<b>127,569</b>	<b>543</b>	<b>7,735</b>
<b>Credit Risk Included in the Various Economic Sectors:</b>					
Agricultural Settlement Movements <sup>(4)</sup>	347	3	350	8	38
Local authorities <sup>(5)</sup>	244	153	397	-	16
<b>2. Lending Activity Outside of Israel</b>					
Agriculture	25	-	25	-	-
Industry	3,609	2,677	6,286	58	99
Construction and real estate	4,911	1,648	6,559	-	42
Electricity and water	75	127	202	-	-
Commerce	4,214	3,623	7,837	42	111
Hotels, hotel services and food	490	31	521	-	-
Transportation and storage	67	62	129	-	-
Communications and computer services	118	11	129	-	-
Financial services	3,132	877	4,009	-	4
Other business services	1,406	1,303	2,709	-	-
Public and community services	60	3	63	-	-
Individuals - housing loans	11	-	11	-	-
Individuals - other loans	1,179	332	1,511	-	4
<b>Total</b>	<b>19,297</b>	<b>10,694</b>	<b>29,991</b>	<b>100</b>	<b>260</b>

Footnotes:

- (1) Credit to the public of NIS 90,769 million, investments in bonds of NIS 2,678 million, and assets relating to derivative instruments created with the public of NIS 501 million.
  - (2) Credit risk in off-balance sheet financial instruments as calculated for purposes of borrower liability limitation. Due to lack of data, only partial information regarding unutilized credit lines is included in respect of a consolidated subsidiary.
  - (3) The balance of problematic debts net of credit covered by collateral allowed for setoff for the purpose of a borrower or a group of borrowers liability limitation. Includes the components of off-balance sheet risk.
  - (4) Kibbutzim and moshavim, regional and national organizations and corporations controlled by the agricultural settlement movements.
  - (5) Including corporations under their control.
- 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, 2005*				
	Balance sheet Credit risk <sup>(1)</sup>	Off-balance Sheet credit risk <sup>(2)</sup>	Total credit risk	Annual expense on specific provision for doubtful debts	Balance of problematic debt <sup>(3)</sup>
<b>1. Lending Activity in Israel</b>					
Agriculture	681	337	1,018	10	105
Industry	11,977	8,199	20,176	89	1,072
Construction and real estate	10,784	7,790	18,574	226	2,992
Electricity and water	1,409	246	1,655	1	4
Commerce	7,808	3,985	11,793	105	595
Hotels, hotel services and food	2,274	403	2,677	15	1,053
Transportation and storage	2,832	1,021	3,853	8	111
Communications and computer services	2,735	1,606	4,341	36	820
Financial services	5,399	5,019	10,418	17	118
Other business services	4,788	2,848	7,636	23	219
Public and community services	1,593	914	2,507	-	163
Individuals - housing loans	9,782	147	9,929	31	522
Individuals - other loans	11,411	8,579	19,990	68	606
<b>Total</b>	<b>73,473</b>	<b>41,094</b>	<b>114,567</b>	<b>629</b>	<b>8,380</b>
Less a deposit abroad linked to the credit risk of the borrower	(69)	-	(69)	-	-
<b>Total</b>	<b>73,404</b>	<b>41,094</b>	<b>114,498</b>	<b>629</b>	<b>8,380</b>
<b>Credit Risk Included in the Various Economic Sectors:</b>					
Agricultural Settlement Movements <sup>(4)</sup>	257	3	260	14	38
Local authorities <sup>(5)</sup>	293	153	446	-	27
<b>2. Lending Activity Outside of Israel</b>					
Agriculture	23	-	23	-	-
Industry	3,422	3,553	6,975	-	86
Construction and real estate	4,369	1,316	5,685	-	26
Electricity and water	110	176	286	-	-
Commerce	4,116	3,613	7,729	17	78
Hotels, hotel services and food	337	34	371	-	-
Transportation and storage	168	1	169	-	-
Communications and computer services	153	7	160	-	-
Financial services	3,730	738	4,468	-	7
Other business services	1,274	1,287	2,561	-	43
Public and community services	55	1	56	(2)	1
Individuals - housing loans	18	-	18	-	-
Individuals - other loans	1,327	184	1,511	(2)	4
<b>Total</b>	<b>19,102</b>	<b>10,910</b>	<b>30,012</b>	<b>13</b>	<b>245</b>

\* Restated - See Note 1 Z.

Footnotes:

(1) Credit to the public of NIS 88,496 million, investments in bonds of NIS 1,240 million, and assets relating to derivative instruments created with the public of NIS 770 million.

(2) Credit risk in off-balance sheet financial instruments as calculated for purposes of borrower liability limitation. Due to lack of data, only partial information regarding unutilized credit lines is included in respect of a consolidated subsidiary.

(3) The balance of problematic debts net of credit covered by collateral allowed for 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)**  
**REPORTED AMOUNTS**

	December 31	
	2006	2005
Credit <sup>(1)(2)</sup>	1,033	661
Off - balance sheet credit risk <sup>(3)</sup>	59	72
<b>Total</b>	<b>1,092</b>	<b>733</b>

Footnotes:

(1) After deducting specific provisions for doubtful debts.

(2) The amount of expense (income) in respect of the specific provision for doubtful debts totals NIS 0.1 million (2005: NIS 0.1 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**  
**REPORTED AMOUNTS**

Quarter	2006				2005			
	4	3	2	1	4	3	2	1
In NIS millions								
<b>Assets</b>								
Cash and deposits with banks	25,406	23,181	22,084	21,134	20,586	18,057	19,643	16,607
Securities	38,914	38,970	40,648	42,885	42,188	42,890	41,896	41,223
Credit granted to the public	90,175	**89,772	**88,450	**87,956	**87,816	**87,284	**84,875	**82,221
Credit granted to the Government	18	22	81	101	92	179	227	276
Investments in affiliated companies	1,591	1,818	1,764	1,745	1,527	1,495	1,425	1,371
Buildings and equipment	2,614	2,567	2,412	2,369	2,268	2,221	2,043	1,998
Other assets	3,820	4,135	4,138	3,995	*4,243	*3,915	*3,852	*3,513
<b>Total assets</b>	<b>162,538</b>	<b>160,465</b>	<b>159,577</b>	<b>160,185</b>	<b>158,720</b>	<b>156,041</b>	<b>153,961</b>	<b>147,209</b>
<b>Liabilities and Shareholders' Equity</b>								
Deposits from the public	130,517	130,872	129,435	*131,882	*130,285	*127,425	*126,920	*121,096
Deposits from banks	8,099	6,817	7,732	6,428	6,518	6,888	6,840	6,431
Deposits from the Government	119	130	*120	*107	*136	*139	*119	*113
Subordinated capital notes	6,302	5,856	5,561	5,560	5,342	5,226	4,859	4,828
Other liabilities	9,134	**8,809	**9,118	**8,898	**9,254	**8,917	**8,047	**7,826
<b>Total liabilities</b>	<b>154,171</b>	<b>152,484</b>	<b>151,966</b>	<b>152,875</b>	<b>151,535</b>	<b>148,595</b>	<b>146,785</b>	<b>140,294</b>
Minority' interest	402	444	463	487	467	449	440	434
Shareholders' equity	7,965	7,537	7,148	6,823	6,718	6,997	6,736	6,481
<b>Total liabilities and shareholders' equity</b>	<b>162,538</b>	<b>160,465</b>	<b>159,577</b>	<b>160,185</b>	<b>158,720</b>	<b>156,041</b>	<b>153,961</b>	<b>147,209</b>

\* Reclassified.

\*\* Restated - see Note 1 Z to the financial statements.

## SCHEDULE H - CONDENSED CONSOLIDATED STATEMENT OF INCOME FOR EACH QUARTER - MULTI QUARTER DATA

### REPORTED AMOUNTS

Quarter	2006			
	4	3	2	1
In NIS millions				
<b>Financing Income</b>				
Income from financing activities before provision for doubtful debts	1,004	961	933	(1)892
Provision for doubtful debts	177	142	109	142
Profit from financing activities after provision for doubtful debts	827	819	824	750
<b>Non-Financing Income</b>				
Operating commissions	502	(1)471	(1)465	(1)473
Net income from investment in shares	14	1	42	8
Other income	113	66	95	(1)109
Total non-financing income	629	538	602	590
<b>Non-Financing Expenses</b>				
Salaries and related expenses	834	(1)622	(1)749	(1)996
Maintenance and depreciation of buildings and equipment	179	(1)175	159	(1)166
Other expenses	334	(1)246	(1)289	(1)271
Total non-financing expenses	1,347	1,043	1,197	1,433
Operating income (loss) before taxes	109	314	229	(93)
Provision for taxes on operating income	70	112	90	78
Operating income (loss) after taxes	39	202	139	(171)
Bank's share in operating income of affiliated companies net of tax effect	29	61	49	49
Net operating income (loss) before minority interest	68	263	188	(122)
Minority interest in the operating income after taxes of consolidated companies	(16)	(18)	(25)	(23)
Net operating income (loss)	52	245	163	(145)
Cancellation of provision for impairment in value of investment in affiliated company	-	-	-	173
Net income (loss) from extraordinary items, net of taxes	96	(1)	254	(1)
Net income	148	244	417	27
<b>Earnings (losses) per share of NIS 0.1 (in NIS):</b>				
Net operating income (loss)	0.05	0.25	0.17	(0.15)
Net income from extraordinary items, net of taxes <sup>(2)</sup>	0.10	-	0.26	0.18
Net income	0.15	0.25	0.43	0.03
Total number of shares used for the above computation (in thousands)	980,639	980,639	980,639	980,639

Footnotes:

(1) Reclassified.

(2) Including cancellation of provision for impairment in value of investment in an affiliated company.

**SCHEDULE H - CONDENSED CONSOLIDATED STATEMENT OF INCOME FOR EACH QUARTER - MULTI QUARTER DATA (CONTINUED)**  
**REPORTED AMOUNTS**

Quarter	2005			
	4	3	2	1
	In NIS millions			
<b>Financing Income</b>				
Income from financing activities before provision for doubtful debts	955	955	910	877
Provision for doubtful debts	188	201	173	129
Income from financing activities after provision for doubtful debts	767	754	737	748
<b>Non-Financing Income</b>				
Operating commissions	<sup>(1)</sup> 485	<sup>(1)</sup> 479	<sup>(1)</sup> 455	<sup>(1)</sup> 444
Net income (losses) on investment in shares	2	-	2	(1)
Other income	131	188	<sup>(1)</sup> 119	<sup>(1)</sup> 102
Total non-financing income	618	667	576	545
<b>Non-Financing Expenses</b>				
Salaries and related expenses	<sup>(1)</sup> 969	<sup>(1)</sup> 699	<sup>(1)</sup> 652	<sup>(1)</sup> 646
Maintenance and depreciation of buildings and equipment	<sup>(1)</sup> 171	<sup>(1)</sup> 170	<sup>(1)</sup> 159	<sup>(1)</sup> 170
Other expenses	<sup>(1)</sup> 363	<sup>(1)</sup> 261	<sup>(1)</sup> 243	<sup>(1)</sup> 226
Total non-financing expenses	1,503	1,130	1,054	1,042
Operating income (loss) before taxes	(118)	291	259	251
Provision for taxes on operating income	11	100	106	107
Operating income (loss) after taxes	(129)	191	153	144
Bank's share in operating income of affiliated companies, net of tax effect	45	46	43	40
Net operating income (loss) before minority interest	(84)	237	196	184
Minority interest, after taxes, in the operating income of consolidated subsidiaries	(19)	(21)	(18)	(17)
Net operating income (loss)	(103)	216	178	167
Cumulative effect of change in accounting	-	-	-	(4)
Net income (loss) from extraordinary items, net of taxes	(8)	1	11	-
Net income (loss)	(111)	217	189	163
<b>Earnings (losses) per share of NIS 0.1 (in NIS):</b>				
Net operating income (loss)	<sup>(2)</sup> (0.11)	<sup>(2)</sup> 0.22	<sup>(2)</sup> 0.18	<sup>(2)</sup> 0.17
Net income from extraordinary items, net of taxes <sup>(3)</sup>	<sup>(2)</sup> -	<sup>(2)</sup> -	<sup>(2)</sup> 0.01	<sup>(2)</sup> -
Net income (loss)	(0.11)	0.22	0.19	0.17
Total number of shares used for the above computation (in thousands)	980,639	980,639	980,639	980,639

Footnotes:

(1) Reclassified.

(2) Restated - see note 1S of the financial statements.

(3) Including the cumulative effect of change in accounting.

## CERTIFICATION

I, Giora Offer, certify that:

1. I have reviewed the quarterly report of Israel Discount Bank Ltd. (hereinafter: "the Bank") as of December 31, 2006 (hereinafter: "the Report");
2. Based on my knowledge, the Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made therein, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the Report;
3. Based on my knowledge, the financial statements, and other financial information included in the Report, fairly present in all material respects the financial condition, results of operations and changes in shareholders' equity of the Bank as of, and for, the periods presented in this report;
4. Other officers of the Bank providing this certification and I are responsible for establishing and maintaining controls and procedures for the disclosure required in the Report of the Bank and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Bank, including its consolidated subsidiaries, is made known to us by others within the Bank and those entities, particularly during the period of preparing this report;
  - (b) Evaluated the effectiveness of the Bank's disclosure controls and procedures and presented in the Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the Report based on such evaluation; and
  - (c) Disclosed in the Report any change in the Bank's internal control over financial reporting that occurred during this quarter that has materially affected, or is reasonably likely to materially affect, the Bank's internal control over financial reporting; and
5. The other officers of the Bank providing this certification and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Bank's Auditors, to the Board of Directors to the audit committee of the Board of Directors, and to the finance committee of the Board of Directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Bank's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Bank's internal control over financial reporting.

Nothing in that stated above derogates my responsibility or the responsibility of any other person under any law.

Giora Offer,  
President & Chief Executive Officer

March 28, 2007

## CERTIFICATION

I, Joseph Beressi, certify that:

1. I have reviewed the quarterly report of Israel Discount Bank Ltd. (hereinafter: "the Bank") as of December 31, 2006 (hereinafter: "the Report");
2. Based on my knowledge, the Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made therein, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the Report;
3. Based on my knowledge, the financial statements, and other financial information included in the Report, fairly present in all material respects the financial condition, results of operations and changes in shareholders' equity of the Bank as of, and for, the periods presented in this report;
4. Other officers of the Bank providing this certification and I are responsible for establishing and maintaining controls and procedures for the disclosure required in the Report of the Bank and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Bank, including its consolidated subsidiaries, is made known to us by others within the Bank and those entities, particularly during the period of preparing this report;
  - (b) Evaluated the effectiveness of the Bank's disclosure controls and procedures and presented in the Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the Report based on such evaluation; and
  - (c) Disclosed in the Report any change in the Bank's internal control over financial reporting that occurred during this quarter that has materially affected, or is reasonably likely to materially affect, the Bank's internal control over financial reporting; and
5. The other officers of the Bank providing this certification and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Bank's Auditors, to the Board of Directors to the audit committee of the Board of Directors, and to the finance committee of the Board of Directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Bank's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Bank's internal control over financial reporting.

Nothing in that stated above derogates my responsibility or the responsibility of any other person under any law.

Joseph Beressi, Executive Vice-President  
Chief Accountant

March 28, 2007

## 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.

	Shlomo Zohar	Giora Offer	Joseph Beressi
	Chairman of the	President and	Executive Vice President,
March 28, 2007	Board of Directors	Chief Executive Officer	Chief Accountant

## FINANCIAL STATEMENT 2006

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Somekh Chaikin



## **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, 2006 and December 31, 2005, 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, 2006. These financial statements are the responsibility of the Bank's Board of Directors and Management. Our responsibility is to express an opinion on these financial statements based on our audit.

We did not audit the financial statements of certain affiliated companies, the investment in which amounted to NIS 65 million and NIS 74 million at December 31, 2006 and 2005, respectively, and the share of the Bank in their net operating income is NIS 5 million, NIS 1 million and NIS 7 million, for the three years, the last of which ended December 31, 2006. 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, 2006 and 2005, 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, 2006. 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, these financial statements are presented in reported amounts, in accordance with accounting standards of the Israel Accounting Standard Board and Directives of the Supervisor of Banks.

Without qualifying our opinion, we draw attention to the following Notes to the financial statements:

- (a) Note 1 regarding the adjustment by way of a restatement of the comparative figures for prior years, following the initial implementation of the Directive of the Supervisor of Banks concerning the inclusion in the item "Credit to the public" of outstanding debts deriving from credit card transactions.
- (b) Note 6 D concerning the investigation that was conducted in the United States with respect to matters related to the Prohibition of Money Laundering Regulations and its impact upon IDB New York.
- (c) Concerning Notes 19 C, 15.1, 15.3, 15.5 and 15.7 as to class actions and pleas for the approval of certain actions as class actions.

Somekh Chaikin  
Certified Public Accountants (Isr.)

Ziv Haft  
Certified Public Accountants (Isr.)

March 28, 2007

## BALANCE SHEET AS AT DECEMBER 31

### REPORTED AMOUNTS

	Notes	Consolidated		The Bank	
		December 31		December 31	
		2006	2005	2006	2005
in NIS millions					
<b>Assets</b>					
Cash and deposits with banks	2	25,406	20,586	27,931	21,728
Securities	3	38,914	42,188	16,937	17,233
Credit granted to the public	4	90,175	**87,816	51,467	**49,175
Credit granted to Governments	5	18	92	7	89
Investment in investee companies (consolidated – affiliated companies)	6	1,591	1,527	6,618	6,433
Buildings and equipment	7	2,614	2,268	2,032	1,699
Other assets	8	3,820	*4,243	1,963	2,380
<b>Total assets</b>		<b>162,538</b>	<b>158,720</b>	<b>106,955</b>	<b>98,737</b>
<b>Liabilities and Shareholders' Equity</b>					
Deposits from the public	9	130,517	*130,285	84,710	*80,282
Deposits from banks	10	8,099	6,518	5,526	2,970
Deposits from the Government		119	*136	5	*10
Subordinated capital notes	11	6,302	5,342	3,880	3,519
Other liabilities	12	9,134	**9,254	4,869	**5,238
<b>Total liabilities</b>		<b>154,171</b>	<b>151,535</b>	<b>98,990</b>	<b>92,019</b>
Minority interest		402	467	-	-
Shareholders' equity	13	7,965	6,718	7,965	6,718
<b>Total liabilities and shareholders' equity</b>		<b>162,538</b>	<b>158,720</b>	<b>106,955</b>	<b>98,737</b>

\* Reclassified

\*\* Restated - see Note 1 Z.

The notes to the financial statements are an integral part thereof.

Shlomo Zohar  
Chairman of the Board  
of Directors

Giora Offer  
President &  
Chief Executive Officer

Joseph Beressi  
Executive Vice President  
Chief Accountant

March 27, 2007

## STATEMENT OF INCOME FOR THE YEAR ENDED DECEMBER 31

### REPORTED AMOUNTS

	Notes	Consolidated		
		2006	2005	2004
In NIS millions				
<b>Financing Income</b>				
Income from financing activities before provision for doubtful debts	23	3,790	3,697	3,473
Provision for doubtful debts	11,4C	570	691	880
Income from financing activities after provision for doubtful debts		3,220	3,006	2,593
<b>Non-Financing Income</b>				
Operating commissions	24	1,911	<sup>(1)</sup> 1,863	<sup>(1)</sup> 1,776
Net income on investment in shares	25	65	3	103
Other income	26	383	540	352
Total non-financing income		2,359	2,406	2,231
<b>Non-Financing Expenses</b>				
Salaries and related expenses	27	3,201	<sup>(1)</sup> 2,966	<sup>(1)</sup> 2,564
Maintenance and depreciation of buildings and equipment		679	<sup>(1)</sup> 670	<sup>(1)</sup> 634
Other expenses	28	1,140	<sup>(1)</sup> 1,093	<sup>(1)</sup> 830
Total non-financing expenses		5,020	4,729	4,028
Operating income before taxes		559	683	796
Provision for taxes on operating income	29	350	324	342
Operating income after taxes		209	359	454
Bank's share in operating income of affiliated companies, net of tax effect	6B1	188	174	135
Net operating income before minority interest		397	533	589
Minority interest, after taxes, in the operating income of consolidated subsidiaries		(82)	(75)	(56)
Net operating income		315	458	533
Net cumulative effect as of the beginning of the year of change in accounting	1Y	-	(4)	(1)
Net income, before extraordinary income after tax		315	454	532
Cancellation of provision for impairment in value of investment in affiliated company	6F	173	-	-
Net income from extraordinary items, net of taxes	30	348	4	24
Net income		836	458	556
<b>Earnings per share of NIS 0.1 (in NIS):</b>				
Net operating income	1S, 36	0.32	<sup>(2)</sup> 0.47	<sup>(2)</sup> 0.54
Net income from extraordinary items, net of taxes <sup>(3)</sup>		0.53	-	<sup>(2)</sup> 0.03
Net income		0.85	0.47	0.57
Total number of shares used for the above computation (in thousands)		980,639	980,639	980,639

**Footnotes:**

(1) Reclassified.

(2) Restated - See Note 1S.

 (3) December 31, 2006: Including a cancellation of provision for impairment in value of investment in an affiliated company.  
 December 31, 2005 and December 31, 2004: Including net cumulative effect as of the beginning of the year of change in accounting.

The notes to the financial statements are an integral part thereof.

## STATEMENT OF INCOME FOR THE YEAR ENDED DECEMBER 31

### REPORTED AMOUNTS

	Notes	2006	The Bank	
			2005	2004
In NIS millions				
<b>Financing Income</b>				
Income from financing activities before				
provision for doubtful debts	23	2,423	1,848	2,005
Provision for doubtful debts	11,4C	377	441	582
Income from financing activities after				
provision for doubtful debts		2,046	1,407	1,423
<b>Non-Financing Income</b>				
Operating commissions	24	903	922	890
Net income on investment in shares	25	44	-	75
Other income	26	279	378	241
Total non-financing income		1,226	1,300	1,206
<b>Non-Financing Expenses</b>				
Salaries and related expenses	27	2,082	<sup>(1)</sup> 2,032	<sup>(1)</sup> 1,725
Maintenance and depreciation of buildings and equipment		452	429	398
Other expenses	28	540	<sup>(1)</sup> 448	<sup>(1)</sup> 378
Total non-financing expenses		3,074	2,909	2,501
Operating income (loss) before taxes		198	(202)	128
Provision for taxes on operating income	29	103	26	24
Operating income (loss) after taxes		95	(228)	104
Bank's share in operating income of investee				
companies, net of tax effect	6B1	220	686	429
Operating income		315	458	533
Net cumulative effect as of the beginning				
of the year of change in accounting	1Y	-	(4)	(1)
Net income, before				
extraordinary income after tax		315	454	532
Cancellation of provision for impairment in value				
of investment in affiliated company	6F	173	-	-
Net income from extraordinary items, net of taxes	30	348	4	24
Net income		836	458	556

Footnote:

(1) Reclassified.

The notes to the financial statements are an integral part thereof.

## STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY REPORTED AMOUNTS

	Capital reserves			Total share capital and reserves
	Share capital	Share premium reserve	Other capital reserves	
	in NIS millions	in NIS millions		
Balance at December 31, 2003*	658	2,939	37	3,634
<b>Changes in 2004 :</b>				
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
<b>Changes in 2005 :</b>				
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 loss on the hedging of cash flows	-	-	-	-
Net loss on the hedging of cash flows reclassified to the income statement	-	-	-	-
Balance at December 31, 2005	658	2,939	37	3,634
<b>Changes in 2006:</b>				
Initial application of an accounting standard by an affiliated company <sup>(3)</sup>	-	-	-	-
Income for the year	-	-	-	-
The State's bonus to the employees (privatization) <sup>(4)</sup>	-	-	175	175
Benefit in respect of stock options granted to officers <sup>(5)</sup>	-	-	8	8
Net adjustments for the presentation of available-for-sale securities at fair value	-	-	-	-
Related tax effect	-	-	-	-
Financial statements translation adjustments	-	-	-	-
Balance at December 31, 2006	658	2,939	220	3,817

\* Adjusted amounts - see Note 1B.

Footnotes:

(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).

(2) Including an amount of NIS 2,704 million that is not available for distribution (See Note 32).

(3) The Bank's share in the balance of negative goodwill as of January 1, 2006, which an affiliated company credited to retained earnings, in accordance with the transitional provisions of Accounting Standard No. 20 (amended) - See Note 1 E.

(4) See Note 32.

(5) See Note 13 D.

The notes to the financial statements are an integral part thereof.

Other cumulative comprehensive income (loss)					
Adjustment for presentation of available for sale securities at fair value	Translation adjustments <sup>(1)</sup>	Net income (loss) on cash flow hedging	Retained earnings <sup>(2)</sup>	Total shareholders' equity	
278	(232)	(7)	2,282	5,955	
-	-	-	556	556	
(169)	-	-	-	(169)	
43	-	-	-	43	
-	-	2	-	2	
-	-	(1)	-	(1)	
152	(232)	(6)	2,838	6,386	
-	-	-	458	458	
(270)	-	-	-	(270)	
136	-	-	-	136	
-	3	-	-	3	
-	-	(3)	-	(3)	
-	-	8	-	8	
18	(229)	(1)	3,296	6,718	
-	-	-	1	1	
-	-	-	836	836	
-	-	-	-	175	
-	-	-	-	8	
426	-	-	-	426	
(195)	-	-	-	(195)	
-	(4)	-	-	(4)	
249	(233)	(1)	4,133	7,965	

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31

### REPORTED AMOUNTS

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	in NIS millions					
<b>Cash Flows from Operating Activities</b>						
Net income for the year	836	458	556	836	458	556
Adjustments necessary to present cash flows from operations:						
Bank's share in undistributed loss of investee companies (consolidated - affiliated companies)	(308)	(167)	(109)	(322)	(719)	(332)
Minority interest in income of consolidated subsidiaries	82	75	56	-	-	-
Depreciation of buildings and equipment	275	286	259	190	193	171
Provision for decline in value of securities held for investment	7	8	11	-	-	-
Provision for doubtful debts	642	763	961	447	510	663
Loss (gain) on sale of available-for-sale	-	(29)	(121)	(35)	(22)	(99)
Realized and non realized gain from adjustment to fair value of trading securities	(59)	(4)	(70)	(25)	(3)	(39)
Gain on realization of investments	(376)	-	(40)	(417)	-	(40)
Benefit with respect to the allotment of options	8	-	-	8	-	-
Provision for impairment in value of buildings	4	10	-	4	10	-
Loss (gain) on sale of buildings and equipment	(2)	(7)	41	(2)	(6)	39
Net deferred taxes	106	121	(67)	86	10	(37)
Severance pay – decrease (increase) in excess of deposits over the provision	43	(123)	(46)	9	(86)	(48)
Inflation adjustment component of investing and financing activities	1,361	(850)	1,624	254	330	(31)
<b>Changes in Balance Sheet Items:</b>						
Other assets, net	315	(612)	(39)	355	(21)	49
Other liabilities, net	(316)	**1,622	**1,105	(452)	**983	**496
Net Cash Flows from Operating Activities	2,618	1,551	4,121	936	1,637	1,348

\* Reclassified.

\*\* Restated - see Note 1 Z.

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31 (CONTINUED) REPORTED AMOUNTS

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	in NIS millions					
<b>Cash Flows from Asset Transactions:</b>						
Acquisition of held-to-maturity bonds	(2,134)	(2,289)	(2,171)	-	-	-
Proceeds from redemption of held-to-maturity bonds	2,722	2,370	2,205	-	-	-
Acquisition of available-for-sale securities	(17,288)	(18,009)	(21,272)	(4,679)	(7,067)	(9,121)
Proceeds from sale of available-for-sale securities	15,298	12,021	13,230	1,684	2,031	3,999
Proceeds from redemption of available-for-sale securities	4,334	4,786	5,874	4,093	4,504	5,789
Net deposits with banks	(805)	270	248	(36)	(584)	(26)
Trading securities, net	(336)	(297)	(627)	(541)	(370)	(539)
Net credit granted to the public	(3,157)	** (7,111)	** (2,481)	(2,871)	** (3,609)	** (489)
Net credit granted to the Government	74	180	95	82	179	54
Additional investment in investee companies	153	(34)	109	757	16	180
Decrease in cash due to initially consolidated companies (annex A)	-	(2)	-	-	-	-
Proceeds, net, from sale of investments in previously consolidated subsidiaries (annex B)	508	-	1	-	-	-
Acquisition of buildings and equipment	(644)	* (581)	* (373)	(548)	* (470)	* (295)
Proceeds from sale of buildings and equipment	14	31	220	10	28	219
<b>Net Cash Flows from Asset Transactions</b>	<b>(1,261)</b>	<b>(8,665)</b>	<b>(4,942)</b>	<b>(2,049)</b>	<b>(5,342)</b>	<b>(229)</b>
<b>Cash Flows From Liability and Capital Transactions:</b>						
Net deposits from the public	281	* 8,364	* 1,822	4,477	* 3,597	* (137)
Net deposits from banks	1,581	1,711	(141)	2,556	990	387
Net deposits from the Government	(17)	* 10	* (13)	(5)	* (9)	* (2)
Payment for fixed assets purchased on credit	(13)	* (4)	* (2)	(13)	* (4)	* (2)
Issuance of subordinated capital notes	1,485	644	742	807	100	65
Redemption of bonds and subordinated capital notes	(729)	(449)	(426)	(639)	(447)	(373)
The State's bonus to the employees (privatization)	128	-	-	98	-	-
Dividend paid to shareholders	(58)	(56)	(49)	-	-	-
<b>Net cash flows from liability and capital transactions</b>	<b>2,658</b>	<b>10,220</b>	<b>1,933</b>	<b>7,281</b>	<b>4,227</b>	<b>(62)</b>
Increase in cash	4,015	3,106	1,112	6,168	522	1,057
Cash balance at beginning of year (see Note 2)	18,099	14,993	13,881	13,153	12,631	11,574
Cash balance at end of year (see Note 2)	22,114	18,099	14,993	19,321	13,153	12,631

\* Reclassified.

\*\* Restated - see Note 1 Z.

The notes to the financial statements are an integral part thereof.

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31, 2006 (CONTINUED)

### REPORTED AMOUNTS

#### Annex A – Decrease in cash due to initially consolidated subsidiaries

	2006	2005	2004
	In NIS millions		
Assets and liabilities at acquisition date of consolidated subsidiaries:			
Long-term assets	-	(2)	-
Total decrease in cash due to initially consolidated companies	-	(2)	-

#### Annex B - Proceeds from sale of investments in previously consolidated subsidiaries

	2006	2005	2004
	In NIS millions		
Assets and liabilities of previously consolidated subsidiaries, at date of sale:			
Assets	14	-	2
Liabilities	19	-	(1)
Shares available-for-sale	231	-	-
Minority shareholder's interest	(23)	-	-
Goodwill	11	-	-
Debtors in respect of capital gains	-	-	(1)
Capital gain	256	-	1
Net cash flows on sale of investments in previously consolidated subsidiaries	508	-	1

#### Annex C - Non-cash asset and liability activity during the reported year

	2006	2005	2004
	In NIS millions		
<b>The Bank:</b>			
Purchase of fixed assets	15	41	21
Lending of securities	132	41	58
The State's bonus to the employees (privatization)	45	-	-
Additional purchase of shares in a consolidated subsidiary	21	-	-
<b>Consolidated:</b>			
Purchase of fixed assets	16	50	24
Lending of securities	156	184	92
The State's bonus to the employees (privatization)	47	-	-
The transfer of bonds from available for sale securities to held to maturity bonds	-	-	5,587

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 states that the note relates to the Bank only, or to the consolidated statements only.
- (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 Israel Accounting Standard Board, dealing with the discontinuation of the adjustment of financial statements ("Standard 12") came into effect in October 2001. According to Standard 12 and according to Standard No. 17 of December 2002, as from January 1, 2004, the adjustment of financial statements was discontinued and they are presented in reported amounts (namely, amounts adjusted on the basis of the CPI for the month of the transition, together with nominal amounts 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 No. 36 of the Institute of Certified Public Accountants in Israel. The adjusted amounts included in the financial statements for December 31, 2003, served as a starting point for the nominal financial reporting in accordance with the Standard as from January 1, 2004.

In these financial statements, "cost" – cost in reported amounts.

The data included in these financial statements is presented, in accordance with the Standards and the instructions of the Supervisor of Banks, in "reported amounts" as follows:

##### (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 their realizable value or updated economic value, but rather the reported amounts of such assets.

##### (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 Bank's share in the results of operations of investee companies and the minority shareholders' interest in the

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

results of consolidated companies, are determined on the basis of the financial statements of these companies.

### 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. Inter-company balances and transactions between the consolidated companies are eliminated in the consolidated financial statements. Financial statements of provident funds managed by the Bank or by a consolidated subsidiary have not been consolidated.

The Bank's financial statements only, 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 of 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%.

**Accounting Standard No. 20 (Amended).** In March 2006, the Israel Accounting Standards Board published Accounting Standard No.20 (Amended) – "Accounting Treatment of Goodwill and Intangible Assets on Acquisition of Investee companies." The standard determines the Accounting treatment with regard to goodwill and intangible assets on acquisition of a subsidiary or an investee company, which is not a subsidiary.

The main changes determined in the standard as compared with accounting standards applying until January 1, 2006: the allocation of the excess of the cost of the acquisition in an investee company to identifiable intangible assets of the acquired company; the distinguishing between intangible assets with defined use of life and intangible assets with undefined use of life; immediate recognition as of acquisition date, of a negative goodwill that was formed during the acquisition, as a gain in the financial statements after its deduction from intangible assets and from non-monitory assets of the investee company; the discontinuation of the amortization of positive goodwill and intangible assets with undefined use of life; the distinction between the goodwill of a subsidiary and an investee company which is not a subsidiary while evaluating the impairment in value of an investment.

The Supervisor of Banks notified that standard 20 will apply to financial statements of banking institutions except the sections relating to the cancellation of goodwill amortization and the recognition of negative goodwill in the income statement. The accounting treatment of goodwill will remain in its present form, thus the amortization of goodwill shall not exceed a period of 10 years, unless the Supervisor of Banks has approved otherwise, and negative goodwill will not be recognized immediately on the statements of income. In the future with the full embracing of the IFRS the Supervisor of Banks will reconsider his position.

Should the Supervisor fully embrace the standard, the future application of the standard will influence the goodwill recorded in the acquisition of Fishman's shares in ICC and the goodwill to be recorded in the acquisition of Harel's shares in ICC shares (see Note 34 hereunder).

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### 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 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					
	2006	2005	2004	2006	2005	2004
	CPI (in points):			%	%	%
Balance sheet month (December index)	102.9	103.0	100.6	(0.1)	2.4	1.2
Known at balance sheet month (November index)	102.9	103.2	100.5	(0.3)	2.7	0.9
Representative exchange rate	At the balance sheet date of the:					
U.S. Dollar (in NIS)	4.225	4.603	4.308	(8.2)	6.8	(1.6)
Currency basket (in NIS)	4.8253	5.089	5.006	(5.2)	1.7	0.8
Euro	5.564	5.446	5.877	2.2	(7.3)	6.2

### G. CONVERSION OF FINANCIAL STATEMENTS OF EXTENSIONS ABROAD

Up to the year 1994, foreign subsidiaries were considered autonomous units, and the conversion differences with respect to the investment therein were 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 Israel Accounting Standard Institute issued Standard No.13 dealing with the effect of changes in foreign currency exchange rates ("Standard 13"). The Bank implements that Standard as from January 1, 2004. Standard 13 deals with the conversion 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. Furthermore, the Standard determines rules for the classification of foreign operations as an "autonomous foreign entity" or as an "extension", based on the relevant characteristics stated therein. In the framework of the interim provisions for quarterly reporting in reported amounts in 2004, the Supervisor of Banks determined that foreign extensions of banking corporations should continue to be classified by the banking corporations as an "extension", and that classification of a new foreign banking extension as an autonomous unit would be subject to prior approval by the Supervisor.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### 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, not of a provision for impairment in value net of a temporary nature.
  - (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 reporting date. Gains or losses due to adjustments to fair value are recorded in the statement of income.
  - (c) "Available-for-sale securities" - securities not classified under the two previous categories. Securities available for sale are stated at their fair value on the balance sheet date, except for shares the fair value of which is not readily available, which are stated at cost. Unrealized gains or losses resulting from the adjustment to fair value, net of the related tax effect, are recorded as a separate line item in Shareholders' Equity, and forwarded to statement of income upon sale or redemption of the securities. 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 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 problematic debts in the same quarter in which a debt has been classified as problematic.

**1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

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, the Bank obtained the approval of the Supervisor of Banks to accrue it until the end of 2005.

- (4) The ratios of the general provision and the supplemental provision (including the provision for off-balance sheet items), to credit granted to the public for the Bank and its consolidated subsidiaries in Israel are:

	Consolidated		The Bank	
	December 31		December 31	
	2006	2005	2006	2005
General provision	0.20%	0.22%	0.20%	0.23%
Supplemental provision	0.20%	0.20%	0.15%	0.17%

The directives of the Supervisor of Banks stipulate that the balance of the general provision for doubtful debts, at adjusted values, accumulated under the previous directives, at a rate of 1% of total indebtedness as of December 31, 1991, should be maintained. The adjustment of the general provision was discontinued on January 1, 2005, according to directives of the Supervisor of Banks.

- (5) The supplemental provision and the general provision are not deductible for tax purposes, and in accordance with the directives of the Supervisor of Banks, a deferred tax asset has not been recorded.
- (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 the deduction of accumulated depreciation and impairment in value if such was made. Adjusted depreciation is calculated by the straight-line method based on the estimated useful life of the assets. The cost of buildings includes interest capitalized during the construction period. Buildings and realty designated for sale have been presented at their market price in those cases where it is lower than their adjusted cost. 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.

The core systems ("Ophek Project") development costs are being amortized over a period of seven years.

**K. AMORTIZATION OF DEFERRED EXPENSES**

Bond and subordinated capital notes issue costs are amortized proportionally to the outstanding principal amount of the bonds.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 financing income on non-performing loans and except for interest in arrears on housing loans of a mortgage bank which are recognized when collected.

With respect to securities – see (h) above; with respect to the provision for doubtful debts – see (i) above; with respect to derivative financial instruments – see (m) below.

Sale and leaseback transactions are presented in the financial statements in accordance with International Accounting Standard (IAS) 17.

### 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.

The fair value of derivatives as abovementioned is stated, net, in the items “Other assets” or “Other liabilities”.

Changes in the fair value of a derivative instrument shall be reflected in the statement of income, or shall be included in shareholders equity as an “other comprehensive income” component, in accordance with the designation of the derivative instrument.

The change in the fair value of derivatives hedging exposure to the change in the fair value of an asset, a liability or a firm commitment, shall be recognized in the statement of income on a current basis, as well as the change in value of the hedged item, which may be related to the hedged risk.

The accounting treatment of changes in the fair value of derivatives that hedge exposure to changes in the cash flow generated by an asset, a liability or an anticipated transaction, depends on the effectiveness of the hedging relationships.

- The effective part of the change in the fair value of a derivative designated to hedge a cash flow risk, is initially reported in shareholders equity (outside the statement of income) as a component of “other comprehensive income”, following which, when the anticipated transaction affects the income statement, it is reclassified to the statement of income.
- The non-effective part of the change in the fair value of a derivative designated as above is recognized immediately in the statement of income.

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. For further details see note 16 hereunder.

### 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.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Deferred taxes have been calculated according to the "liability" method, at tax rates expected to be applicable during the period in which the deferred taxes are realized, based on laws in force at the balance sheet date. The realization of deferred taxes receivable is contingent upon the future existence of taxable income. Management believes that such deferred tax assets will be realizable in the future.

- (2) A provision for deferred taxes is included in the financial statements for that part of the adjustment of depreciable non-monetary assets (excluding buildings - see Note 29 J) which will not be deductible for tax purposes.
- (3) Retained earnings of certain investee companies may be subject to additional taxes if and when distributed as cash dividends. With respect to consolidated subsidiaries - when a dividend distribution is not expected in the foreseeable future - no provision for taxes has been recorded. With respect to affiliated companies - a provision for taxes on income was recorded if an additional tax liability is likely to arise due to the distribution of dividend.
- (4) Profits from the future sale of investments in shares of investee companies may attract additional taxes. The provision for deferred taxes does not include taxes relating to the sale of investments in investee companies as long as the supposition of the ongoing holding of the investment exists. (See also Note 29 K).
- (5) The provision for taxes on income of the Bank and its consolidated subsidiaries which are financial institutions, for the purposes of Value Added Tax, includes profit tax levied on income as stipulated in the Value Added Tax Law. Value Added Tax levied on payroll of financial institutions is included in the statement of income under the item "Salaries and related expenses".
- (6) In July 2004, the Israel 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. (See Y hereunder).

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 to the Bank with regards to the said matters.

The Standard applies to financial statements for periods beginning January 1, 2005. The Standard determines that it is to be adopted by way of a cumulative effect of a change in accounting method.

## Q. CONTINGENT LIABILITIES

The accounting treatment of outstanding legal actions is in accordance with the provisions of the US Accounting Standard FAS-5 "Accounting for Contingencies" and its related guidelines, and in accordance with the guidelines and clarifications of the Supervisor of Banks, including public reporting directives in the matter of 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. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

- 1) Probable – probability of over 70%.
- 2) Reasonably possible – probability of over 20% and up to and including 70%.
- 3) Remote – probability of 20% or less.

According to the guidelines, only in rare cases may a banking corporation state in its financial statements that it is not possible to assess the prospects of a risk exposure materializing in respect of an ordinary legal action and an action approved as a class action, this in four financial statements (including one annual financial statements) to be published subsequently to the filing of an action together with a 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 shall be disclosed where the amount claimed exceeds 0.5% of the equity capital of the Bank and it is not possible to assess the prospects of the risk exposure materializing, 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 further be noted, that in cases where the Bank is one of the defendants in the action, and the claimants have not allocated the amount claimed to each of the defendants, the amount estimated as relevant to the Bank is computed to the best of ability, considering the fact that taking the full amount into account might be misleading and is not correct under the circumstances, and that the estimate made does not necessarily represent the allocation which at the end of the day would be decided by the Court.

Additional limitations to those included in Accounting Standard No.19, are included in directives of the Supervisor of Banks with respect to certain matters relating to the accounting treatment of taxes on income, including with respect to terms for recognition of a deferred tax asset with respect to tax losses carried forward and timing differences. In these matters the Bank is also subject to the additional limitations set by the directives of the Supervisor of Banks.

The financial statements include appropriate provisions in accordance with generally accepted accounting principles and the estimates of the Managements of the Bank and of its subsidiaries, based on opinions of their legal Counsels.

### 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.

### S. EARNINGS PER SHARE

In February 2006, the Israel Accounting Standard Board published Accounting Standard No.21 – “Income per share.” The Standard determines the principles for computing and presenting the basic and the diluted income per share. This Standard replaces the provisions of Opinion 55 of the Institute of Certified Public Accountants in Israel regarding income per share.

The standard applies to financial statements for periods beginning on January 1, 2006 onwards. The Standard determines that it should be adopted by way of a restatement of the income per share data for prior reporting periods. Following the application of the Standard, the Bank presents the earnings per share in relation to one share unit of NIS 0.1 par value each, while in the past the earnings per share were presented in relation to a unit of NIS 1 par value. The earnings per share data for prior reporting periods had been restated.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### 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 Israel Accounting Standard Board published in February 2003, Accounting Standard No. 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. FINANCIAL INSTRUMENTS - DISCLOSURE AND PRESENTATION

In August 2005, the Israel Accounting Standard Board published Accounting Standard No. 22 – “Financial instruments: disclosure and presentation”. This Standard determines rules for the presentation of financial instruments in financial statements and specifies the disclosure required in respect thereof. Furthermore, the Standard determines the mode by which financial instruments are to be classified as financial liabilities and as equity, the classification of interest, dividends, losses and profits related thereto and the circumstances in which financial assets and financial liabilities may be offset. The Standard applies to financial statements for periods beginning on or after January 1, 2006.

The Standard determines that it be applied by the “from this day forward” mode. Comparative data presented in financial statements for periods beginning on the date on which the Standard becomes effective, are not to be restated. There are some directives of the Supervisor of Banks with respect to certain issues to which the above Standard relates. In such cases, the directives of the Supervisor will apply to banking corporations. The standard had no effect on the financial statements of the Bank.

### W. EQUITY BASED COMPENSATION

The Israel Accounting Standards Board issued in September 2005 Accounting Standard No. 24 – “Equity based compensation”. This Standard requires that transactions involving compensation paid by way of shares should be recognized in the financial statements, including transactions with employees or other parties involving payment in capital instruments, cash or other assets. According to the Standard, transactions involving goods or services received in consideration for payment in shares are to be stated at their fair value.

The Standard requires, among other things, that as regards share based payment transactions that are settled by capital instruments, the goods or services received thereby and the parallel increase in the share capital, should be measured according to the fair value of the goods or services that had been received, unless it is not possible to assess the fair value in a reliable manner.

As to transactions with employees, it is required to measure the fair value of the capital instruments granted, as generally, it is not possible to reliably assess the fair value of the services that had been received from the employees. The fair value of the capital instruments granted is to be measured on the grant date.

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The payroll expenses in the case of options granted to employees, is to be recorded over the vesting period against a credit to a capital reserve.

Moreover, the Standard states the various disclosure requirements regarding the substance and scope of share-based payment arrangements that existed during the reported period and the manner in which the fair value of these arrangements has been determined.

The Standard applies to financial statements for periods beginning January 1, 2006.

The implications of applying the said Standard by the Bank depend on the future and present granting of share-based compensation by the Bank. (For details regarding a stock option plan for officers of the Bank see Note 13 hereunder).

## X. DISCLOSURE OF THE EFFECT OF NEW ACCOUNTING STANDARDS ON THE PERIOD PRIOR TO THEIR APPLICATION

In June 2000, the Israel Accounting Standard Board issued Accounting Standard No. 6, which requires "disclosure of the effect of new Accounting Standards on the period prior to their application."

**Accounting Standard No. 29.** The Israel Accounting Standards Board published in July 2006 Accounting Standard No. 29 "Adoption of International Financial Reporting Standards (IFRS)" (hereinafter: "the Standard"), this following the resolution of November 2005 of the Professional Committee of the Israel Accounting Standards Board.

In accordance with the provisions of the Standard, corporations to which the Securities Law, 1968 applies and which are obligated to report in accordance with the rules enacted under this Law, will prepare their financial statements in accordance with the international financial reporting standards, starting with the financial statements for the period beginning January 1, 2008 and thereafter.

The above is not applicable to corporations, whose financial statements are prepared according to the directives and guidelines of the Supervisor of Banks, in accordance with the Securities Regulations.

The IFRS standards initial adoption will be through IFRS 1, which deals with initial adoption of the IFRS standards.

The Israel Securities Authority has initiated amendments to the Securities Regulations, which would enable the application of the provisions of Accounting Standard No. 29. Concurrently, the Authority issued in September 2006, a draft guideline in the matter of the disclosure that will be required regarding the adoption of the International Financial Reporting Standards (IFRS) for public comments.

The Supervisor of Banks informed banking corporation as follows regarding the method of implementation of the Standard:

- The Supervisor will currently issue directives for implementation of Israel accounting standards published by the Israel Accounting Standards Board, based on the IFRS standards, and which do not relate to the core banking activity.
- In the second half of 2009, the Supervisor will determine the implementation date of IFRS standards that relate to core banking activity, taking into consideration the results of the adoption process of these standards in Israel on the one hand, and the progress in the convergence process between international reporting standards (IFRS) and United States standards, on the other hand.
- Regarding core banking activity, financial statements prepared according to the directives and guidelines of the Supervisor of Banks will continue to be prepared according to United States standards fixed in public reporting directives.

**Accounting Standard No. 27.** In September 2006, the Israel Accounting Standard Board published Accounting Standard No. 27 – "Fixed Assets." This Standard deals with the recognition of assets, the recording of depreciation in their respect, the treatment of compensation in respect of impairment in value of an asset, the disposal of assets and the treatment

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

of obligations in respect of the cost of dismantling and removal of an item and of the restoration of the site on which it is located.

The principal change in the new Standard is the addition of a remeasurement model as a possible model for the recognition of an asset. In accordance with the remeasurement model, a fixed asset item, whose fair value can be determined reliably, shall be recognized at the remeasured amount less accumulated depreciation and less impairment losses accumulated thereafter. Reassessments are to be made on a current basis in respect of each group of assets to which the remeasured item belongs.

The Standard applies to Financial Statements for periods beginning on January 1, 2007 and thereafter. The Standard is to be initially applied retroactively, except for two exceptions detailed in the Standard.

Up to the financial statements issuance date, no instructions have been published by the Supervisor of Banks regarding the manner in which the Standard should be adopted by banking corporations, if at all.

**Accounting Standard No. 23.** In December 2006, the Israel Accounting Standards Board published Accounting Standard No. 23 – “The accounting treatment of transactions between an entity and the controlling shareholder therein”. The Standard replaces the Securities (Presentation in the financial statements of transactions between an entity and the controlling shareholder therein) Regulations, 1996. The Standard states that the basis of valuation in transactions between a corporation and the controlling shareholder therein should be determined according to the fair value of the transaction. Differences between the consideration determined in transactions between a corporation and the controlling shareholder therein and the fair value of such transactions should be reflected in equity. The Standard presents details regarding accounting treatment with respect to prevalent kinds of transactions.

The Standard applies to transactions between an entity and the controlling shareholder therein subsequent to January 1, 2007, and is also applicable as from the said date to a loan extended to the controlling shareholder or received from the controlling shareholder prior to the said date.

As of date of publication of the financial statements, the Supervisor of Banks has not yet issued directives regarding the manner in which the Standard should be adopted by banking corporations, if at all.

**Accounting Standard No. 30.** In March 2007, the Israel Accounting Standard Board issued Accounting Standard No. 30 – “Intangible assets”. This standard determines the accounting treatment of intangible assets not dealt with by other Standards, and it cancels certain provisions of Accounting Standard No. 20. The Standard applies to financial statements for periods beginning January 1, 2007.

As of date of issue of the financial statements the Supervisor of Banks has not as yet issued directives as to the adoption of the Standard by banking corporation, if at all.

### Y. CUMULATIVE EFFECT – INITIAL APPLICATION OF ACCOUNTING STANDARD NO. 19 (2005)

#### Cumulative effect of a change in accounting – initial implementation of Accounting Standard No.19 (2005)

As from January 1, 2005, the Bank is applying the provisions of Standard No.19 (see above in Section O 6). The effect of the Standard in the amount of NIS 4 million is stated by way of a cumulative effect of a change in accounting method.

### Z. CREDIT CARD TRANSACTIONS

On February 21, 2007, the Supervisor of Banks published an amendment to the public reporting directives, following the publication of the reporting format for credit card companies. The directive amends the definition of “credit to the public” to include also “debit balances of the public resulting from credit card transactions”.

According to a legal opinion obtained by the Bank, outstanding debts resulting from credit card transactions made by

## 1. SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

customers of the Bank using credit cards issued to these customers by the Bank in conjunction with the credit card company, are deemed "credit" extended by the Bank to the customer.

In the past, such outstanding balances were presented as an off-balance sheet item. In accordance with the said amendment, these balances were reclassified in the financial statements as of December 31, 2006, and presented as a component of "credit to the public." Comparative amounts for previous periods were restated accordingly.

As a result of the restatement, credit to the public as of December 31, 2005 increased by NIS 3,926 million considered and NIS 1,813 million in the Bank, against an increase in the same amount in other commitments.

## 2. CASH AND DEPOSITS WITH BANKS<sup>(1)</sup>

	Consolidated		The Bank	
	December 31		December 31	
	2006	2005	2006	2005
	in NIS millions			
Cash and deposits with central banks	4,017	1,934	3,243	1,099
Deposits with commercial banks	20,138	17,235	17,049	12,777
Acceptances	1	1	1	1
Deposits with specialized banking institutions	1,250	1,416	7,638	7,851
<b>Total</b>	<b>25,406</b>	<b>20,586</b>	<b>27,931</b>	<b>21,728</b>
Includes cash, deposits with banks and deposits with central banks for an initial period of up to three months	22,114	18,099	19,321	13,153

Footnote:

(1) See Note 15 for pledges.

3. SECURITIES<sup>(1)</sup>

## A. CONSOLIDATED

December 31, 2006

	Book value	Net adjusted cost (for shares - cost)	Non-realized gains from adjustment to fair value	Non-realized losses from adjustment to fair value	Fair value <sup>(2)</sup>
In NIS millions					
<b>(1) Held-to-maturity bonds:</b>					
Bonds and bills:					
Government	4,783	4,783	37	70	4,750
Others	41	41	-	1	40
Total held-to-maturity bonds	4,824	4,824	37	71	4,790
<b>(2) Available for sale securities:</b>					
Bonds and bills:					
Government	25,516	25,488	260	232	25,516
Others	4,316	4,321	19	24	4,316
Total	29,832	<sup>(3)</sup> 29,809	279	256	29,832
Shares:					
Others	1,193	941	253	1	1,193
Total available-for-sale securities	31,025	30,750	<sup>(4)</sup> 532	<sup>(4)</sup> 257	<sup>(5)</sup> 31,025
<b>(3) Trading Securities:</b>					
Bonds and bills:					
Government	2,580	2,533	52	5	2,580
Others	471	384	95	8	471
Total	3,051	2,917	147	13	3,051
Shares:					
Others	14	13	2	1	14
Total trading securities	3,065	2,930	<sup>(6)</sup> 149	<sup>(6)</sup> 14	3,065
Total securities	38,914	38,504	718	342	38,880

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 2,074 million (US\$ 491 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 371 millions.

(6) Recorded in the statement of income.

**3. SECURITIES<sup>(1)</sup> (CONTINUED)**  
**A. CONSOLIDATED (CONTINUED)**

December 31, 2005					
	Book value	Net adjusted cost (for shares - cost)	Non-realized gains from adjustment to fair value	Non-realized losses from adjustment to fair value	Fair value <sup>(2)</sup>
In NIS millions					
<b>(1) Held-to-maturity bonds:</b>					
Bonds and bills:					
Government	5,810	5,810	60	109	5,761
Others	23	23	-	-	23
Total held-to-maturity bonds	5,833	5,833	60	109	5,784
<b>(2) Available for sale securities:</b>					
Bonds and bills:					
Government	27,856	27,873	184	201	27,856
Others <sup>(7)</sup>	4,761	4,784	69	92	4,761
Total	32,617	<sup>(3)</sup> 32,657	253	293	32,617
Shares:					
Others	1,060	994	66	-	1,060
Total available-for-sale securities	33,677	33,651	<sup>(4)</sup> 319	<sup>(4)</sup> 293	<sup>(5)</sup> 33,677
<b>(3) Trading Securities:</b>					
Bonds and bills:					
Government	2,166	2,159	11	4	2,166
Others	509	500	16	7	509
Total	2,675	2,659	27	11	2,675
Shares:					
Others	3	4	-	1	3
Total trading securities	2,678	2,663	<sup>(6)</sup> 27	<sup>(6)</sup> 12	2,678
Total securities	42,188	42,147	406	414	42,139

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 4,852 million (US\$ 1,054 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 815 millions.

(6) Recorded in the statement of income.

(7) For details as to shares of a subsidiary company acquired with the intention of sale, see Note 6 E.

3. SECURITIES<sup>(1)</sup> (CONTINUED)

## B. THE BANK

December 31, 2006

	Book value	Net adjusted cost (for shares - cost)	Non-realized gains from adjustment to fair value	Non-realized losses from adjustment to fair value	Fair value <sup>(2)</sup>
In NIS millions					
<b>(2) Available for sale securities:</b>					
Bonds and bills:					
Government	12,273	12,089	202	18	12,273
Others	1,397	1,399	3	5	1,397
Total	13,670	13,488	205	23	13,670
Shares:					
Others	719	503	216	-	719
Total available-for-sale securities	14,389	13,991	<sup>(3)</sup> 421	<sup>(3)</sup> 23	<sup>(4)</sup> 14,389
<b>(3) Trading Securities:</b>					
Bonds and bills:					
Government	2,410	2,404	11	5	2,410
Others	133	131	2	-	133
Total	2,543	2,535	13	5	2,543
Shares:					
Others	5	3	3	1	5
Total trading securities	2,548	2,538	<sup>(5)</sup> 16	<sup>(5)</sup> 6	2,548
Total securities	16,937	16,529	437	29	16,937

General footnote: See note 23E 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, the fair value of which is not readily available, stated at cost of NIS 46 million.
5. Recorded in the statement of income.

**3. SECURITIES<sup>(1)</sup> (CONTINUED)**
**B. THE BANK (CONTINUED)**

December 31, 2005					
	Book value	Net adjusted cost (for shares - cost)	Non-realized gains from adjustment to fair value	Non-realized losses from adjustment to fair value	Fair value <sup>(2)</sup>
In NIS millions					
<b>(2) Available for sale securities:</b>					
Bonds and bills:					
Government	13,163	13,061	124	22	13,163
Others	1,557	1,555	4	2	1,557
Total	14,720	14,616	128	24	14,720
Shares:					
Others <sup>(6)</sup>	532	484	48	-	532
Total available-for-sale securities	15,252	15,100	<sup>(3)</sup> 176	<sup>(3)</sup> 24	<sup>(4)</sup> 15,252
<b>(3) Trading Securities:</b>					
Bonds and bills:					
Government	1,900	1,899	5	4	1,900
Others	80	80	-	-	80
Total	1,980	1,979	5	4	1,980
Shares:					
Others	1	2	-	1	1
Total trading securities	1,981	1,981	<sup>(5)</sup> 5	<sup>(5)</sup> 5	1,981
Total securities	17,233	17,081	181	29	17,233

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 399 million.
5. Recorded in the statement of income.
6. For details as to shares of a subsidiary company acquired with the intention of sale, see Note 6 E.

### 3. SECURITIES (CONTINUED)

- C.** The item includes a balance of: consolidated – NIS 444 million million; the Bank – NIS 317 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.

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. As of December 31, 2006, the market value of the Bezeq shares exceeds their cost, as determined by guidelines of the Supervisor of Banks in the amount of NIS 91 million. Subsequent to balance sheet date, a dividend of NIS 52 million was received, and it will be recorded in the first quarter of 2007.

- D.** The item includes the shares of "HOT" that were received as part of the creditor arrangement of "TEVEL" upon completion of the transaction for the merger of the TV cable companies on December 31, 2006, the fair value of which was NIS 73 million.

According to a guideline of the Supervisor of Banks, the excess of fair value of the shares received over the net balance of the debt (net of provisions for doubtful debts), in the amount of NIS 33 million, is to be recognized upon the sale of the said shares.

- E.** For details regarding sale of holdings in Harel Insurance Investments Ltd., see Note 6 H below. The balance of the shares remaining in the Bank at this stage is included in the "Securities" item.
- F.** In the course of the fourth quarter of 2006, IDB New York reclassified securities amounting to market value of US\$182.5 million from the available for sale portfolio to the trading portfolio. As a result of this reclassification, IDB New York recognized as income unrealized gains in the amount of US\$5.8 million.

Pursuant to the guideline of the Supervisor of Banks, the Bank reversed the said reclassification and the net gains recognized.

**4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS)**
**A. CREDIT GRANTED TO THE PUBLIC**

	Consolidated		The Bank	
	December 31		December 31	
	2006	2005	2006	2005
	in NIS millions			
Credit	90,484	*88,184	51,604	*49,290
Customers' liabilities for acceptances	285	312	179	193
Total credit	90,769	88,496	51,783	49,483
General provision and supplemental provision for doubtful debts	(594)	(680)	(316)	(308)
Total	90,175	87,816	51,467	49,175

\* Restated - see Note 1 Z.

Footnote:

The specific provision for doubtful debts has been deducted from the relevant items (see Note 4 C).

## 4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS)

## B. CREDIT GRANTED TO THE PUBLIC INCLUDES:

## 1. Credit to problem borrowers excluding local authorities:

	Consolidated		The Bank	
	December 31		December 31	
	2006	2005	2006	2005

in NIS millions

**a) Non-Income Bearing Loans to Problem Borrowers**

Balance at balance sheet date:

In Israeli currency, non-linked	1,794	*1,957	1,193	*1,363
In Israeli currency, linked to CPI	318	*357	200	*161
In foreign currency (including linked to foreign currency)	417	396	343	*265

**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	3	-	3
Average repayment period, in years	6	-	-	-

Effective rate of income:

Included in the anticipated repayment flow	6.3%	-	-	-
Included in the repayment flow according to original contracts	8.5%	-	-	-

In Israeli currency, linked to CPI:

Balance at balance sheet date	-	7	-	-
Average repayment period, in years	-	9	-	-

Effective rate of income:

Included in the anticipated repayment flow	-	4.4%	-	-
Included in the repayment flow according to original contracts	-	6.4%	-	-

\* Reclassified.

**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 local authorities (continued):**

	Consolidated		The Bank	
	December 31		December 31	
	2006	2005	2006	2005
	in NIS millions			
2) Credit restructured in prior years, with waiver of income:				
Balance at balance sheet date:				
In Israeli currency, non-linked	1	*6	-	*3
In Israeli currency linked to CPI	7	*1	-	-
In foreign currency (including linked to foreign currency)	-	11	-	-
3) Credit restructured during the current year -				
without waiver of income:				
Balance at balance sheet date:				
In Israeli currency, non-linked	66	*100	19	39
In Israeli currency, linked to CPI	107	*52	33	*10
In foreign currency (including linked to foreign currency)	104	277	78	228
<b>c) Restructured Credit Not Yet Executed</b>				
Balance at balance sheet date	143	92	135	33
<b>d) Credit in Temporary Arrears</b>				
Balance at balance sheet date	187	*390	140	291
Interest in respect of such credit included in the statement of income	11	25	10	22
<b>e) Credit Under Special Supervision</b>				
Balance at balance sheet date	3,543	*3,804	2,714	*2,847

\* Reclassified.

## 4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

## B. CREDIT GRANTED TO THE PUBLIC INCLUDES (CONTINUED):

## 2. Credit to local authorities sector

	Consolidated		The Bank	
	December 31		December 31	
	2006	2005	2006	2005
	in NIS millions			
<b>a. Credit to local authorities</b>				
Balance at the balance sheet date	244	293	214	259
<b>b. The credit to local authorities included:</b>				
(1) Credit under special supervision:				
Balance at balance sheet date	16	27	15	25
(2) Credit that is not included in credit granted to problematic borrowers:				
Balance at balance sheet date	228	266	199	234
Interest in respect of such credit included in the statement of income	24	26	20	22
<b>Total</b>	<b>244</b>	<b>293</b>	<b>214</b>	<b>259</b>

4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)  
C. PROVISION FOR DOUBTFUL DEBTS

	2006			
	Specific provision <sup>(1)</sup>		Supplemental provision <sup>(2)</sup>	Total
	According to extent of delinquency	Other		
In NIS millions	In NIS millions	In NIS millions		
<b>Consolidated</b>				
Balance of provision at beginning of year	150	5,005	748	5,903
Provision for current year	68	735	46	849
Reduction of provision	(52)	(99)	(119)	(270)
Collection of debts written-off in previous years	-	(9)	-	(9)
Provision charged to statement of Income	16	627	(73)	570
Write-offs/transfers	(5)	(342)	-	(347)
Inflationary erosion and adjustment of balances	-	(12)	-	(12)
Balance of provision at end of year	161	5,278	675	6,114
Includes - Balance of provision that was not deducted from "credit granted to the public"	-	54	81	135
<b>The Bank</b>				
Balance of provision at beginning of year	-	4,167	352	4,519
Provision for current year	-	451	24	475
Reduction of provision	-	(81)	(16)	(97)
written-off in previous years	-	(1)	-	(1)
Provision charged to statement of Income	-	369	8	377
Write-offs	-	(265)	-	(265)
Inflationary erosion and adjustment of balances	-	-	-	-
Balance of provision at end of year	-	4,271	360	4,631
Includes - Balance of provision that was not deducted from "credit granted to the public"	-	51	44	95

\* Reclassified.

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 423 million; 2005 - NIS 509 million; 2004 - NIS 478 million; The bank: - NIS 197 million; 2005 - NIS 197 million; 2004 - NIS 197 million (see Note 11).

2005				2004			
Specific provision <sup>(1)</sup>		Supplemental provision <sup>(2)</sup>	Total	Specific provision <sup>(1)</sup>		Supplemental provision <sup>(2)</sup>	Total
According to extent of delinquency	Other			According to extent of delinquency	Other		
*130	*4,838	*695	5,663	*112	*4,405	*660	5,177
63	742	72	877	62	993	59	1,114
(41)	(105)	(23)	(169)	(41)	(160)	(24)	(225)
-	(17)	-	(17)	-	(9)	-	(9)
22	620	49	691	21	824	35	880
(2)	(457)	4	(455)	(3)	(396)	-	(399)
-	4	-	4	-	5	-	5
*150	*5,005	*748	5,903	*130	4,838	695	5,663
-	65	68	133	-	53	70	123
-	4,093	340	4,433	-	3,794	344	4,138
-	506	30	536	-	711	20	731
-	(76)	(18)	(94)	-	(124)	(24)	(148)
-	(1)	-	(1)	-	(1)	-	(1)
-	429	12	441	-	586	(4)	582
-	(359)	-	(359)	-	(290)	-	(290)
-	4	-	4	-	3	-	3
-	4,167	352	4,519	-	4,093	340	4,433
-	63	44	107	-	51	42	93

## 4. CREDIT GRANTED TO THE PUBLIC (CONTINUED):

## D. HOUSING LOANS AND THE PROVISION FOR DOUBTFUL DEBTS IN RESPECT THERE OF BASED ON THE DURATION OF DELINQUENCY

## Consolidated

	December 31, 2006					December 31, 2005				
	Duration of delinquency									
	Over 3 and up to 6 months	Over 6 and up to 15 months	Over 15 and up to 33 months	Over 33 months	Total	Over 3 and up to 6 months	Over 6 and up to 15 months	Over 15 and up to 33 months	Over 33 months	Total
In NIS millions										
Amount in arrears	7	16	19	62	104	*7	*17	*21	*48	93
Of which: Interest on the amount in arrears	-	-	1	15	16	-	-	*1	*11	12
Balance of provision for doubtful debts based on delinquency period <sup>(1)</sup>	1	23	46	91	161	-	*25	*47	*78	150
Balance of loans net of provision for doubtful debts	140	137	51	24	352	*166	*158	*54	*20	398

\* Reclassified

Footnote:

(1) Not including a provision for interest in respect of the amount in arrears.

## 4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)

E. COMPOSITION OF CREDIT TO THE PUBLIC<sup>(1)</sup> AND OFF-BALANCE-SHEET CREDIT RISK<sup>(2)</sup>, BY SIZE OF CREDIT TO INDIVIDUAL BORROWERS

## Consolidated

		December 31							
		2006			2005				
		Number of borrowers <sup>(2)</sup>	Credit	Credit risk <sup>(3)</sup>	Number of borrowers <sup>*(2)</sup>	Credit <sup>*</sup>	Credit risk <sup>*(3)</sup>		
in NIS millions									
Credit limit (in NIS thousand):									
	Up to	10	399,025	1,551	1,861	374,949	1,563	1,511	
Over	10	Up to	20	99,019	1,174	768	88,553	954	592
Over	20	Up to	40	118,129	2,046	2,280	112,066	1,689	2,051
Over	40	Up to	80	110,218	2,964	3,961	110,487	2,579	3,908
Over	80	Up to	150	51,463	3,303	2,413	51,336	2,977	2,169
Over	150	Up to	300	27,128	4,644	1,554	29,049	4,613	1,163
Over	300	Up to	600	16,677	5,840	1,625	17,750	5,899	1,069
Over	600	Up to	1,200	7,624	4,530	1,775	7,810	4,433	1,461
Over	1,200	Up to	2,000	2,672	2,648	1,130	2,655	2,770	1,030
Over	2,000	Up to	4,000	2,151	4,248	1,637	2,172	4,146	1,533
Over	4,000	Up to	8,000	1,172	4,419	2,231	1,350	5,091	2,021
Over	8,000	Up to	20,000 <sup>(4)</sup>	1,114	8,819	4,675	1,036	7,717	4,614
Over	20,000	Up to	40,000 <sup>(4)</sup>	582	8,796	5,069	494	8,108	4,537
Over	40,000	Up to	200,000 <sup>(4)</sup>	547	25,018	18,373	580	26,396	16,845
Over	200,000	Up to	400,000 <sup>(4)</sup>	49	6,763	5,668	38	5,638	4,578
Over	400,000	Up to	800,000 <sup>(4)</sup>	16	3,581	4,190	13	5,219	1,941
Over	800,000	Up to	1,200,000 <sup>(4)(5)</sup>	6	1,628	4,402	2	841	981
Total			837,592	91,972	63,612	800,340	90,633	52,004	
Income receivable and other debtors <sup>(6)</sup>				1,976			1,873		
Total				93,948	63,612		92,506	52,004	

\* Restated - see Note 1z.

Footnotes:

(1) Including investments in bonds of the public and assets related to derivative financial instruments created with the public, net of a specific provision for doubtful debts.

(2) Number of borrowers based on total credit and credit risk.

(3) Credit risk of off-balance sheet financial instruments, as computed for the purpose of limitations on a borrower.

(4) Consolidated - by combining specific balances.

(5) Upper credit limit 2006: NIS 1,163 million .

(6) The outstanding balance of ICC customers with respect to credit cards issued by it. The Supervisor of Banks exempted credit card companies, at this stage, from presenting these balances according to size of borrower.

**4. CREDIT GRANTED TO THE PUBLIC (NET OF PROVISION FOR DOUBTFUL DEBTS) (CONTINUED)**
**E. COMPOSITION OF CREDIT TO THE PUBLIC<sup>(1)</sup> AND OFF-BALANCE-SHEET CREDIT RISK<sup>(2)</sup>, BY SIZE OF CREDIT TO INDIVIDUAL BORROWERS (CONTINUED)**
**The Bank**

			December 31					
			2006			2005		
			Number of borrowers <sup>(2)</sup>	Credit	Credit risk <sup>(3)</sup>	Number of borrowers <sup>(2)</sup>	Credit*	Credit risk <sup>(3)</sup>
in NIS millions								
Credit limit (in NIS thousand):								
	Up to	10	199,589	284	1,688	209,975	345	1,452
Over	10	Up to	20	56,768	559	532	56,011	494
Over	20	Up to	40	88,119	1,247	2,184	84,688	982
Over	40	Up to	80	92,019	1,986	3,887	91,594	1,590
Over	80	Up to	150	38,432	1,921	2,308	38,182	1,616
Over	150	Up to	300	12,112	1,528	1,391	13,467	1,406
Over	300	Up to	600	5,075	1,305	1,335	5,808	1,222
Over	600	Up to	1,200	3,419	1,690	1,117	3,723	1,507
Over	1,200	Up to	2,000	1,311	1,271	695	1,503	1,307
Over	2,000	Up to	4,000	1,155	2,124	999	1,272	2,060
Over	4,000	Up to	8,000	746	2,590	1,479	922	2,996
Over	8,000	Up to	20,000	604	4,516	2,932	581	3,486
Over	20,000	Up to	40,000	293	5,094	3,039	276	3,610
Over	40,000	Up to	200,000	340	16,125	12,128	342	17,370
Over	200,000	Up to	400,000	36	5,136	4,895	36	5,044
Over	400,000	Up to	800,000	16	3,973	4,505	12	4,571
Over	800,000	Up to	1,200,000	5	1,146	3,807	2	841
Over	1,200,000	Up to	1,600,000	1	-	1,305	1	44
<b>Total</b>			<b>500,040</b>	<b>52,495</b>	<b>50,226</b>	<b>508,395</b>	<b>50,491</b>	<b>39,431</b>

\* Restated - see Note 1z.

Footnotes:

(1) Including investments in the public bonds and assets related to derivative financial instruments created with the public, 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. 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, 2006

	Balance of credit	Balance of debt	Balance in arrears	Specific provision		
				According to extent of delinquency	Other	Total
in NIS millions						
Housing loans <sup>(1)</sup>	6,391	302	88	141	-	141
"Large loans" <sup>(2)</sup>	1,355	79	28	5	25	30
Other loans	846	82	26	15	19	34
<b>Total</b>	<b>8,592</b>	<b>463</b>	<b>142</b>	<b>161</b>	<b>44</b>	<b>205</b>

December 31, 2005

	Balance of credit	Balance of debt	Balance in arrears	Specific provision		
				According to extent of delinquency	Other	Total
in NIS millions						
Housing loans <sup>(1)</sup>	6,622	329	78	127	-	127
"Large loans" <sup>(2)</sup>	1,139	104	33	6	26	32
Other loans	874	90	25	17	17	34
<b>Total</b>	<b>8,635</b>	<b>523</b>	<b>136</b>	<b>150</b>	<b>43</b>	<b>193</b>

Footnotes:

(1) Loans, which according to the Directive of The Bank of Israel, the provision in respect thereof is to be computed based on the extent of delinquency.

(2) Housing loans, the outstanding balance of each exceeds NIS 783 thousand (2005: NIS 785 thousand).

**5. CREDIT GRANTED TO GOVERNMENTS**

	Consolidated		The Bank	
	December 31		December 31	
	2006	2005	2006	2005
	in NIS millions			
Credit from proceeds of debenture issues	-	-	-	-
Credit for supplementing the interest for				
qualified housing loans	-	50	-	-
Less - advance interest supplement from the Government	-	(50)	-	-
Other credit <sup>(1)</sup>	18	92	7	89
<b>Total credit granted to Governments</b>	<b>18</b>	<b>92</b>	<b>7</b>	<b>89</b>

Footnote:

(1) Including credit to foreign governments: Consolidated - NIS 6 million (2005: NIS 26 million), the Bank - NIS 4 million (2005: NIS 23 million).

## 6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES

## A. CONSOLIDATED

	December 31, 2006			December 31, 2005		
	Affiliated companies	Consolidated subsidiaries	Total	Affiliated companies	Consolidated subsidiaries	Total
In NIS millions						
<b>Investments</b>						
Shares stated on equity basis <sup>(1)</sup>	1,353	224	1,577	1,471	49	1,520
Other investments:						
Capital notes	2	-	2	2	-	2
Shareholders' loans	12	-	12	5	-	5
Total other investments	14	-	14	7	-	7
Total investments	1,367	224	1,591	1,478	49	1,527
<b>Includes:</b>						
Earnings accumulated since January 1, 1992	678	(21)	657	*520	(36)	484
Items accumulated in shareholders' equity since January 1, 1992:						
Adjustments in respect of presentation of securities available for sale at fair value, net	31	-	31	15	-	15
Adjustment for translation of foreign currency financial statements	(2)	-	(2)	(1)	-	(1)
<b>Details Regarding Goodwill:</b>						
Period of amortization	10 years			10 years		
Original amount	10	246	256	6	82	88
Unamortized balance	7	224	231	5	49	54
<b>Details Regarding the Allocated Excess of Cost:</b>						
Period of amortization	20 years					
Original amount	-	-	-	114	-	114
Unamortized balance	-	-	-	91	-	91
<b>Book and Market Values of Marketable Investments:</b>						
Book value	1,254	-	1,254	1,360	-	1,360
Market value	1,477	-	1,477	1,928	-	1,928

\*Reclassified.

Footnote:

(1) 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, 2006			December 31, 2005		
	Affiliated companies	Consolidated subsidiaries	Total	Affiliated companies	Consolidated subsidiaries	Total
In NIS millions						
<b>Investments:</b>						
Shares stated on equity basis <sup>(1)</sup>	1,322	5,083	6,405	1,434	4,779	6,213
Other investments:						
Subordinated debt notes and Capital notes	2	140	142	2	146	148
Shareholders' loans	3	68	71	-	72	72
Total other investments	5	208	213	2	218	220
Total investments	1,327	5,291	6,618	1,436	4,997	6,433
<b>Includes:</b>						
Retained earnings since January 1, 1992	684	2,353	3,037	*536	2,328	2,864
Items accumulated in shareholders' equity since January 1, 1992:						
Adjustments in respect of presentation of securities available for sale at fair value, net						
	31	(53)	(22)	15	(133)	(118)
Adjustment for translation of foreign currency financial statements						
	(2)	35	33	(1)	37	36
The State's bonus to the employees (privatization)						
	-	32	32	-	-	-
<b>Details Regarding Goodwill:</b>						
Period of amortization						
	10 years			10 years		
Original amount	8	242	250	4	80	84
Unamortized balance	7	223	230	4	49	53
<b>Details Regarding the Allocated Excess of Cost:</b>						
Period of amortization						
	20 years					
Original amount	-	-	-	114	-	114
Unamortized balance	-	-	-	91	-	91
<b>Book and Market Values of Marketable Investments:</b>						
Book value	1,254	550	1,804	1,360	527	1,887
Market value	1,477	408	1,885	1,928	488	2,416

\* Reclassified.

Footnote:

(1) 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)**  
**THE BANK'S SHARE OF INCOME OR LOSS OF INVESTEE COMPANIES**

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	In NIS millions					
The Bank's share of operating income of investee companies (consolidated - affiliated companies)	190	196	135	248	770	475
<b>Provision for taxes:</b>						
Current taxes	-	-	-	25	58	44
Deferred taxes	2	22	-	3	26	2
Total provision for taxes	2	22	-	28	84	46
The Bank's share of operating income of investee companies (consolidated - affiliated companies), after tax	188	174	135	220	686	429

**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		Share in voting rights	
		2006	2005	2006	2005
		As a percentage		As a percentage	
<b>1. Consolidated Subsidiaries:</b>					
Discount Bancorp, Inc. <sup>(1)</sup>	Holding company, U.S.A.	100.00	100.00	100.00	100.00
Israel Discount Bank of New York <sup>(2)</sup>	Commercial bank, U.S.A	100.00	100.00	100.00	100.00
Mercantile Discount Bank Ltd.	Commercial bank	100.00	100.00	100.00	100.00
Discount Mortgage Bank Ltd. <sup>(3)</sup>	Mortgage bank	65.07	65.07	65.07	65.07
Israel Credit Cards Ltd.	Credit card service	68.24	51.00	76.00	63.00
Discount Leasing Ltd.	Equipment leasing	100.00	100.00	100.00	100.00
Discount Israel Capital Markets and Investments Ltd.	Underwriting and investments	100.00	100.00	100.00	100.00
Discount Manpikim Ltd.	Securities issue	100.00	100.00	100.00	100.00
Ilanot-Discount Ltd. <sup>(4)</sup>	Mutual fund management	-	55.00	-	55.00
Israel Discount Bank (Switzerland) SA	Commercial bank, Switzerland	100.00	100.00	100.00	100.00
<b>Companies held by Israel Discount Bank of New York:</b>					
Discount Bank (Latin America) <sup>(5)</sup>	Commercial bank, Uruguay	100.00	100.00	100.00	100.00
IDBNY Realty (Delaware), Inc. <sup>(5)</sup>	Holding company, USA	100.00	100.00	100.00	100.00
IDBNY Realty Inc. <sup>(6)</sup>	REIT, USA	100.00	100.00	100.00	100.00
<b>Company held by Discount Israel Capital Markets and Investments Ltd.:</b>					
Freenet A.K. Communications Ltd.	Holding company	100.00	100.00	100.00	100.00
<b>2. Affiliated Companies:</b>					
First International Bank of Israel Ltd. <sup>(7)</sup>	Commercial bank	26.45	26.45	11.09	11.09
Harel Insurance Investments Ltd. <sup>(8)</sup>	Holding company	-	15.89	-	15.89

\* Reclassified.

Footnotes:

- (1) A holding company, wholly-owned by the Bank, which fully owns and controls Israel Discount Bank of New York. For details as to an investigation with respect to matters related to the Prohibition of Money Laundering Law, see section D. hereunder.
- (2) The company is owned by Discount Bancorp, Inc.
- (3) For details regarding a full purchase offer for the shares of Discount Mortgage Bank, see section I hereunder.
- (4) For details regarding the sale of all the holdings in Ilanot Discount, see section E 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 details regarding the provision for impairment in value and its reversal, see section F hereunder.
- (8) For details regarding the sale of holdings in Harel, see section H hereunder.
- (9) Including adjustments from translation of financial statements of foreign autonomous units and adjustments concerning the presentation of certain securities of investee companies at fair value.
- (10) Goodwill.
- (11) Allocated excess of cost.

Value of investment in shares on equity		Of which excess of cost balance		Contribution to net operating income		Other investments		Dividend		Other items recorded in shareholders' equity <sup>(9)</sup>		Guarantees issued for consolidated subsidiaries in favor of entities outside the Group			
Equity basis	Market value	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005	2006	2005		
In NIS millions															
27	29	-	-	-	-	-	-	(1)	3	-	-	2	2	-	-
2,461	2,512	-	-	-	-	-	-	(139)	308	-	-	(312)	(377)	-	-
1,160	1,055	-	-	-	-	63	69	60	114	-	-	55	11	-	-
550	527	408	488	-	-	-	-	23	17	-	-	-	-	7	7
451	200	-	-	<sup>(10)</sup> 223	<sup>(10)</sup> 36	47	47	54	42	56	26	-	-	-	-
97	96	-	-	-	-	-	-	1	3	-	-	-	-	-	4
162	*152	-	-	-	-	92	96	10	*14	-	-	-	-	-	-
54	54	-	-	-	-	-	-	-	1	-	-	-	-	-	-
-	37	-	-	-	<sup>(10)</sup> 12	-	-	7	11	5	39	-	-	-	-
72	69	-	-	-	-	-	-	3	(7)	-	-	-	-	-	-
151	124	-	-	-	-	-	-	24	18	-	-	-	(3)	-	-
1,748	1,678	-	-	-	-	-	-	(68)	87	-	-	(5)	-	-	-
6,738	7,158	-	-	-	-	-	-	(234)	507	154	296	(42)	(42)	-	-
(25)	* (29)	-	-	-	-	148	124	7	* (15)	-	-	(2)	-	-	-
1,254	930	1,477	1,230	-	-	-	-	133	122	-	-	31	15	-	-
-	430	-	698	-	<sup>(11)</sup> 91	-	-	37	50	14	16	-	-	-	-

## 6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

### D. AN INVESTIGATION REGARDING MATTERS RELATING TO THE PROHIBITION OF MONEY LAUNDERING LAWS

The New York County District Attorney's Office conducted in 2005 an investigation with respect to several banks and financial institutions, regarding matters pertaining to the transfer of funds from a third country and in matters relating to duties imposed by anti money laundering laws and regulations, including the conduct of IDB New York in these matters. Concurrently, a mutual examination performed by the New York State Banking Department ("NYSBD") and the FDIC discovered many deficiencies in the efficiency in the systems of control and reporting of matters regarding the prohibition of money laundering and prevention of financing of terror at IDB New York. Following these findings, the NYSBD and the FDIC, impose a Cease and Desist order on IDB NY. These orders require IDB NY to, among other things, refrain from operating with its deficient procedures, correct these deficiencies, reinforce control and supervision processes, establish an enforcement plan and correct the procedures related to these matters, all in the manner and dates determined by the said authorities.

On December 15, 2005, IDB New York consented to the entry of these orders. The Cease and Desist orders required, among other things, that the Board of Directors of IDB New York would appoint an independent entity that would examine the actions adopted by the senior management for the correction of the deficiencies found by prior inspections; that an overall plan be formed, adopted and implemented to assure compliance with the provisions of law and the principles governing matters of prohibition of money laundering and the financing of terror, which would relate, inter-alia, to control systems, training programs, audit program and the appointment of an executive in charge of compliance with the said laws and principles; that a compliance committee be appointed of members of the Board of IDB New York, which would monitor the implementation of the requirements stated in the Cease and Desist orders. In addition, IDB New York is to be charged with the payment of an amount not exceeding US\$16.5 million, which is to be paid to the Superintendent of Banks of the State of New York, to the FDIC and to the FinCEN. In 2005, a provision was recorded in the full amount. In October 2006, the final amount that IDB New York will have to pay was determined at US\$12 million. Accordingly, the provision for payments to the supervisory authorities in the U.S. was decreased in 2006 by US\$4.5 million.

Discount Bank, as the parent company of IDB New York, has declared that it is aware of the said arrangements and that it has taken upon itself to act to the best of its ability to assure the fulfillment of the above commitments.

Concurrently and in addition, IDB New York reached an agreement on December 15, 2005, with the District Attorney of the County of New York for the termination of the inquiry by way of settlement. In the agreement IDB New York has undertaken to cooperate with the District Attorney of the County of New York. Furthermore, IDB New York has recognized the facts relating to certain accounts, and to the fact that the internal controls and the procedures of the bank as well as its treatment of the matters relating to the prohibition of money laundering contributed to the findings of the District Attorney of the County of New York. According to the terms of the agreement, IDB New York has undertaken to pay an amount of US\$8.5 million, as well as to report to the District Attorney of the County of New York within one year, as to all the actions taken to improve the procedures of the bank and to correct the deficiencies found both by the District Attorney of the County of New York and by the bank regulatory authorities, as detailed in the abovementioned Cease and Desist orders. In 2005, a provision was recorded in the full amount. The District Attorney of the County of New York has agreed not to sue IDB New York and its related companies with respect to the investigation.

The Management of IDB New York has begun implementing the requirements included in the Cease and Desist orders and in the cooperation agreement with the District Attorney of the County of New York, and these are being implemented in accordance with the schedule, as required. IDB New York was required to act in three dimensions: the

## 6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

first one – the preparation of a comprehensive enforcement plan for performing the Cease and Desist orders. For this purpose, IDB New York engaged the services of KPMG. The second one – examination of the activities of senior management with regard to the implementation of prior inspection findings. For this purpose, the services of Promontory were engaged. The third layer, examination of all transactions conducted by IDB New York during the years 2002-2005 (“look back”) in order to identify operations deemed to be suspicious, and as such requiring report.

On April 5, 2006, Promontory presented IDB New York with a report summarizing the findings of the Cease and Desist examination conducted by it.

The report describes the circumstances and the deficiencies that led, in the authors’ opinion, to the issuance of the Cease and Desist orders and to the examination by the District Attorney. In addition, the report includes a series of recommendations for improvements and changes, which in the opinion of the authors of the report are vital for the prevention of similar failures in the future. According to the report, the major part of the recommendations had already been implemented by IDB New York. The failures and deficiencies indicated in the report are mostly reporting and supervisory failures, some of which derive from deficient internal organization communication and deficient communication with the regulatory authorities, some of which due to an organizational structure in need of change (which has already been carried out, and certain of which, as stated, due to weakness in the supervisory and control tools.

In consequence of this report, the Board of Directors of IDB New York decided to appoint a sub-committee to discuss the recommendation of the report concerning the performance of the Board of Directors. The committee of the Board of Directors has discussed the recommendations of the report in as far as they relate to the activities of the Board, and has prepared an analysis of the measures that had been and will be taken. Management of IDB New York was also required by the Board of Directors to present to the Board a detailed program for the implementation of the recommendations of the report.

On February 6, 2006, The Board of Directors of the Bank decided to recommend to the Board of Directors of IDB New York to appoint Mr. Reuven Spiegel as President and CEO of IDB New York in place of Mr. Arie Sheer. On February 23, 2006, the Board of Directors of IDB New York decided to terminate the office of Mr. Arie Sheer and to appoint Mr. Reuven Spiegel as President and CEO of IDB New York. (For details regarding a lawsuit filed by Mr. Sheer, see below “Further legal proceedings to which the Bank is a party” under “Legal proceedings”).

IDB New York continues with its timely filing of quarterly AML/BSA progress reports to the Superintendent of Banks of the State of New York and to the FDIC. In October 2006, the Superintendent of Banks of the State of New York and the FDIC informed IDB New York that the Look Back Methodology Report appears reasonable.

The Internal Audit Department of IDB New York continues its role to oversee and monitor the status of all the corrective actions implemented following the Promontory Report. As on the date of the publication of the financial statements, 90% of the Report’s items have been completed.

During the first months of 2006, IDB New York continued to reinforce the controls and procedures, as required by the Cease and Desist orders of the FDIC and of the NYSBD and by the cooperation agreement with the District Attorney of New York. The financial statements as of December 31, 2005, include a provision of NIS 120 million in respect of fines and consulting fees.

The cost of implementing the improvements and of the examinations during 2006 amounted to US\$16.1 million. It is estimated by IDB New York that the additional cost of improvements and examinations will amount to an amount of approximately US\$9 million in 2007. At the meeting of the Board of Directors of IDB New York convened in February

## 6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

2007, the outside Counsel advising IDB New York on regulatory matters, drew the attention of the Directors to their responsibility to supervise the relations between the shareholders and their representatives on the Board of Directors of IDB New York in order to ensure that the progress made by the bank in the implementation of the Cease and Desist orders are not impaired.

**The examination at Discount Bank Latin America (“DBLA”).** Following the above examination procedures, performed by the Authorities at IDB New York, an examination was performed in December 2005 at DBLA by the Central Bank of Uruguay.

Following this examination, a fine of US\$41,000 was imposed on DBLA and recommendations for regularizing its operations were issued: namely, procedures for reporting suspicious transactions, installation of electronic systems for identification and the alert of suspicious transactions, improvement of the manner of documentation and keeping customer data and the closing down DBLA's representative offices in Peru, Brazil, Argentina and Mexico.

Following the examination, DBLA hired the services of KPMG, which formed a plan for improving its preparations for the implementation of money laundering prohibition rules. Most of the recommendations have already been implemented. The process of closing down the representative offices and/or reorganizing them under Bancorp is not complete yet.

**Material deficiencies in the internal control.** As reported to the Bank, the Management of IDB New York reported to the audit committee in the meeting approving the financial statements of IDB New York as of December 31, 2005, that no material weaknesses had been identified in the internal control, except for controls regarding the compliance with the Bank Secrecy Act (BSA) and the Anti-Money Laundering Act (AML).

In order to properly relate to control issues regarding BSA and AML, IDB New York established a compliance committee (hereinafter – “the committee”), composed of three external directors and also appointed a new officer in charge of BSA/AML. The committee reports to the board of directors on a monthly basis and a set of rules was established for the compliance committee as well as definition of duties for the officer in charge of BSA/AML. The board of directors also approved on February 7, 2006, the compliance plan for BSA/AML and distributed it on February 23, 2006 to all employees of IDB New York. The new officer in charge of BSA/AML took office on January 16, 2006, and he also serves as a member of the compliance committee and reports to the board of directors, to the audit committee and to the president and CEO. According to what has been stated at the meeting of the Audit Committee approving the financial statements of IDB New York as of December 31, 2006, Management of IDB New York reported that no material weaknesses in the internal control had been identified, and that all material weaknesses identified in 2005 had been corrected.

**Material weaknesses in the internal control over financial reporting.** Within the framework of the report of IDB New York in accordance with the rules of the Federal Insurance Corporation Improvement Act (FDICIA) (which IDB New York was granted an extension for its submission until June 30, 2006), the new Management of IDB New York, appointed following the change in control of the Bank, reported that it had identified material weaknesses in the internal control over the financial reporting as of December 31, 2005. The Bank has been informed that these weaknesses are on the background of and following the letters of instruction issued by the regulatory authorities in the United States in December 2005.

The independent auditors of IDB New York informed that the identified material weaknesses have no effect on their unqualified opinion on the financial statements as of December 31, 2005, which was issued on March 20, 2006, and that they had been taken into consideration in determining the scope of the audit of the financial statement for 2005.

The identified weaknesses, in respect of which the new Management of IDB New York has already undertaken

## 6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

corrective measures, relate to the following matters: proper controls as defined by COSO; insufficient expertise of the accounting staff in application of Accepted Accounting Principles in the United States; ineffective policies and procedures for the preparation, review and analysis of accounts reconciliation; policies and procedures and manpower ensuring the due preparation of accurate and reliable financial statements.

### E. THE SALE OF SHARES OF ILANOT DISCOUNT LTD. AND THE OPERATIONS OF THE PROVIDENT FUNDS

#### 1. Agreement in Principle for the sale of shares of Ilanot Discount Ltd. and the operations of provident funds

On November 9, 2005, an agreement in principle was signed between the Bank and Clal Insurance Enterprises Holdings Ltd., whether itself or by way of a company under its control (hereinafter – “the Purchaser”) for the sale of all shares of Ilanot Discount Ltd. and for the sale of the provident funds operations as one package, in consideration for NIS 1,310 million, subject to adjustments.

The consideration for the sale of the shares of Ilanot Discount Ltd. was set in the Agreement in Principle at NIS 600 million, subject to adjustments, and the consideration for the sale of the operations of the Provident Funds was set at NIS 710 million, subject to adjustments.

The Agreement in Principle determined, among other things, that following the consummation of the transaction, the Bank shall provide Ilanot Discount and the Provident Funds with distribution services in consideration for a distribution fee equal to the rate of fees stated in the draft regulations known at the time regarding distribution commissions payable by mutual funds and provident funds, respectively, as well as operating services and additional services.

#### 2. AN AGREEMENT FOR THE SALE OF THE SHARES OF ILANOT DISCOUNT.

On April 11, 2006, the Bank, Clal Finance Batucha Management and Investments Ltd. (hereinafter – “the Purchaser”) and Clal Insurance Enterprises Holdings Ltd. (both of the IDB Group), signed an agreement for the sale by the Bank to the Purchaser of all the shares of Ilanot Discount (hereinafter – “the Sales Agreement”). In addition the Bank is to assign to the Purchaser the right to receive management fees from Ilanot Discount and will also sell to the Purchaser the goodwill it acquired in the field of mutual fund management. In consideration for the above, the Purchaser will pay the Bank NIS 580 million, subject to adjustments that may arise from the difference between the expenses of Ilanot Discount and the actual payments made to the Bank in the period from January 1, 2006 until date of closing of the transaction, in comparison to the amount of expenses determined in the Sale Agreement.

The Sale Agreement includes, inter-alia, provisions as to additional services that the Bank may provide to Ilanot Discount. The Sales Agreement also stipulates indemnification arrangements between the Bank and the Purchaser under certain circumstances.

The sale agreement came into effect on June 18, 2006, after the completion of all conditional terms for its execution. As part of the completion of the sale, the following agreements were signed between the Bank and Ilanot Discount: an operational agreement, according to which the mutual funds managed by Ilanot Discount would gradually be transferred for operation by the Bank, and a distribution agreement (replacing a previous agreement) according to which the Bank would distribute the mutual funds managed by Ilanot Discount.

45% of the shares of Ilanot Discount that were sold to the Prchaser were acquired by the Bank on September 29, 2005, from IDB Development Ltd. (hereinafter: “IDB”) and Discount Investment Company Ltd. (hereinafter: “DIC”) in consideration for NIS 229.7 million, after the Bank claimed the right of first refusal, replacing a third party, with whom IDB and DIC signed an agreement for the sale of these shares.

## 6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

The said shares were acquired and held from the start with the intention of selling them. Accordingly, as of December 31, 2005 the said shares were presented, until that sale, in the financial statements as available-for-sale securities, and the rights of the outside shareholders have been computed at 45%.

Correspondingly with the completion of the sale, the Bank paid IDB and DIC a sum of NIS 12.5 million, as additional consideration for the shares that it acquired from them.

The profit from the sale transaction amounted approximately NIS 256 million, net after tax, and had been recorded in the financial statements as net gain from extraordinary items.

## 3. THE EXCLUSION OF ILANOT DISCOUNT FROM THE CONSOLIDATION

The consolidated financial statements no longer include the balance sheet data of Ilanot Discount Ltd., which were consolidated in the past. The income statement data was consolidated until the date of termination of the consolidation (June 30, 2006).

Following is the data for Ilanot Discount Ltd. as formerly included in the consolidated financial statements.

	At date of termination of the consolidation	At December 31, 2005
In NIS millions		
<b>Balance sheet</b>		
-----		
Assets (excluding cash and cash equivalents)	73	77
Liabilities	21	31
Goodwill at realization date	11	12
Minority interest at realization date	23	20
-----		
	For the year ended December 31, 2006	December 31, 2005
In NIS millions		
<b>Statement of income</b>		
-----		
Revenues	57	105
Net income	16	26
Group's share in net income	7	11
-----		

4. On January 29, 2007, the Bank and its subsidiary Discount Management of Provident Fund Ltd. (hereinafter: "Discount Provident") signed an agreement with Clal Insurance Company Ltd. (hereinafter: "Clal Insurance") according to which Clal Insurance would acquire from the Bank and from Discount Provident their provident fund management activity (hereinafter: "the sold provident funds") including, inter alia, the goodwill acquired in respect of provident fund management, the rights to ownership of the trade names of the sold provident funds, as well as the information, data base, lists of members and actual portfolios; rights and liabilities with respect to the management of all the sold provident funds as well as the assets of the sold provident funds, including the right to receive management fees and other income related to the management of the sold provident funds and all remaining rights and liabilities of the management company with respect to the sold provident funds (hereinafter together: "the assigned rights and liabilities").

The consideration for the assigned rights and liabilities was fixed at NIS 621 million, subject to adjustments in the event of a positive difference between the income of Discount Provident from management fees in respect of the sold provident funds as from January 1, 2007 until the closing of the transaction, and the expenses of Discount Provident as

## 6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

fixed in the sale agreement in respect of the said period, as long as.

Concurrently, the parties formulated agreements regarding the terms of distribution, operating and member services to be signed by the parties at the closing of the transaction. Pursuant to these agreements, the Bank will distribute the sold provident funds for a period of ten years, and will also distribute other provident funds managed by subsidiaries of Clal Insurance, and will provide Clal Insurance with operating services with respect to the sold provident funds for a period of five years. In consideration for the distribution services, the Bank will receive a distribution commission according to the maximum tariff stated in relevant legislation. The annual consideration for operating services will be calculated at the rate of 0.1% of the assets of the sold provident funds. As part of the member services agreement, the Bank will provide services to members of the sold provident funds in the period from the closing of the transaction until the date of signing consulting agreements with the members, but not later than December 31, 2007 (hereinafter: "the transition period"), all as stated in the memorandum issued by the Commissioner of Capital Markets. The member services agreement includes adjustment mechanisms in the event of changes in the provisions of the legislative arrangement with respect to the transition period.

The agreement includes provisions with respect to the transfer the ownership of the data base of the sold provident funds and with respect to limited utilization rights of the said data base for the Bank and for Discount Provident. Compensatory arrangements subject to fulfillment of certain conditions were also included in the agreement.

As from the date of closing of the transaction, the Bank will be released from its obligation and guarantee regarding certain payments to members of the sold provident funds relating to their deposit component in nominal terms (hereinafter: "the Bank's guarantee") and, insofar as required, Clal Insurance will accept an alternative obligation towards the members (subject to the approval of the Commissioner of Capital Markets).

Closing of the transaction is subject to receipt of relevant approvals required by law or agreement, including: approval by the Commissioner of Restrictive Trade Practices regarding corporate merger, a permit from the Commissioner of Capital Markets for transfer of management of the sold provident funds to Clal Insurance, all matters relating to replacement of the Bank's guarantee, and any other approval or permit (insofar as required) under and according to any relevant legislation.

The sold provident funds are: Tamar, Gefen, General Severance Pay Fund, Shikma, Eshkolot, Toar, Hadas Central Severance Pay Fund and Edmond de Rothschild Discount Overseas.

The Bank estimates that the net gain (after tax) from this transaction will amount to NIS 380 million, subject to adjustments as stated above. The gain will be recorded in the quarter in which the transaction is consummated.

### F. PROVISION FOR THE IMPAIRMENT IN VALUE OF THE BANK'S INVESTMENT IN THE FIRST INTERNATIONAL BANK OF ISRAEL LTD. ("FIBI")

#### 1. Provision for impairment in value

Towards the publication of the financial statements of the Bank as of March 31, 2003, the Supervisor of Banks instructed the Bank to include a provision for impairment in value of FIBI of 20% of the equity value of the investment as of March 31, 2003. Accordingly, the Bank included in the financial statements for March 31, 2003, a provision of NIS 173 million.

#### 2. AN OPINION IN THE MATTER OF THE PROVISION FOR IMPAIRMENT IN VALUE

**(a) The original opinion.** Towards the publication of the financial statements as of December 31, 2002, the Bank received an opinion rendered by Prof. Yoram Eden, CPA (Isr.), in which he examined the question whether the Bank should be required, in accordance with generally accepted accounting principles, to include a provision for the

## 6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

impairment in value of its investment in FIBI (hereinafter – “the original opinion”).

In his conclusion, Prof. Eden reached the conclusion that the recoverable value of the investment of Discount Bank in FIBI, does not fall below the stated value of the investment in its books. Therefore, no provision for impairment in value is required in respect of this investment. The Bank deliberated the original opinion and decided to adopt it.

- (b) **Updates to the original opinion.** Since the original opinion, the Bank has received from Prof. Eden, at the end of every reporting period, updates to the original opinion and an updated opinion and updates to the updated opinion, in each of which Prof. Eden has concluded that the recoverable value of the investment of Discount Bank in FIBI has not been less than the value at which the investment in FIBI is stated in its financial statements, and therefore he is of the opinion that in accordance to generally accepted accounting principles, no provision for impairment in value was initially required in respect of this investment, neither is it required in any one of the updates. The Bank deliberated these opinions and decided to adopt them.

## 3. REVERSAL OF THE PROVISION FOR IMPAIRMENT IN VALUE

- (a) The Bank applied to the Supervisor of Banks for permission to reverse the said provision. This, among other things in view of the fact that since the issue of the Supervisor’s directive in this respect, a significant improvement has taken place in the results of FIBI, as reflected in its published financial statements, as well as a significant increase in the market price of its shares. Furthermore, the Bank has independent opinions according to which the recoverable value of the Bank’s investment in FIBI does not fall below its share in the equity of the First International Bank.
- (b) On May 22, 2006, the Supervisor of Banks informed the Bank that he had reached the conclusion that his involvement in the matter of the provision for impairment in value of the investment in FIBI is no longer required, and accordingly, starting with the financial statements of the Bank as of March 31, 2006 onwards, the Bank will decide in accordance with generally accepted accounting principles in Israel, the accounting treatment and the provision for impairment in value, if required, in respect of the investment of the Bank in FIBI.

In accordance with the above, the Bank reversed the said provision in its financial statements as of March 31, 2006.

## G. PUBLIC ISSUANCE BY FIBI

In an immediate report dated March 13, 2007, the First International Bank announced that its Board of Directors decided to act towards the possibility of increasing its share capital through issuance of rights to shares and/or issuance of rights to other securities, which would improve its capital structure, to be offered to all its shareholders, including a possible benefit component relative to the market price of its shares.

It should be noted that in view of its share capital structure and the provisions of the Securities Law, FIBI may issue and list for trading on the Stock Exchange only shares and/or rights to shares of NIS 0.01 par value each, which are the class of shares with preferred voting rights thereby may change.

Management of FIBI recommends preparations for the raising of capital in the amount of NIS 500 million to NIS 700 million. FIBI noted that no certainty exists that the offering and/or offerings will, in fact, materialize and, if materialized, that the structure of the offerings and/or the amount to be raised thereby may change.

The bank is considering its position and actions as regards the said public issue. At this stage, as no details are available as to the planned public issue, if at all executed, it is not possible to assess its impact on the Bank.

## H. THE SALE OF THE HOLDINGS IN HAREL INSURANCE INVESTMENTS LTD. (HEREINAFTER - “HAREL”)

The Board of Directors resolved on May 28, 2006, to authorize the President and CEO of the Bank to sign a Memorandum of Understanding for the sale of 10.1% of the share capital of Harel and for an option to sell all the

## 6. INVESTMENTS IN INVESTEE COMPANIES AND DETAILS OF THESE COMPANIES (CONTINUED)

remaining shares that the Bank holds in Harel, comprising 5.79% of the share capital of Harel. On August 13, 2006, the parties signed a detailed agreement in accordance with the principles set in the Memorandum of Understanding.

On November 1, 2006, the transaction for the sale of 10.1% of the share capital of Harel to Samporena Capital Pte Ltd. (hereinafter: "Samporena Group"), in consideration for an amount of NIS 414 million, came into effect.

Following the sale, the Bank holds 5.79% of the share capital of Harel, which are stated in the item "Securities"). Samporena Group and G.I.N. Economic Consulting and Management Ltd. (a company fully controlled by the Hamburger Group) have granted the Bank an option to sell to them on May 28, 2007, all of the remaining shares (5.79% of Harel's share capital) the Bank holds in Harel.

The consideration to be paid if the Bank exercises this option will be the higher of (1) 5.79% of NIS 4,087.8 million, subject to adjustments; or (2) the weighted average market price of the Harel shares during a period of 60 days ending five business days prior to the exercise date.

The option is a non-recurring and is exercisable by a notice given on May 28, 2007. The option will expire if it is not exercised on that date.

Upon closure of the transaction, the shareholders agreement signed on December 28, 2000, between the Hamburger Group and the Bank, was terminated.

The profit from the sale of shares amounted approximately NIS 104 million, net after tax, and had been recorded in the financial statements as net gain from extraordinary items.

### I. PURCHASE OFFER FOR ALL SHARES OF DISCOUNT MORTGAGE BANK HELD BY THE PUBLIC

On March 14, 2007, the Bank issued a purchase offer for all the shares of Discount Mortgage Bank held by the public, i.e., 460,735 ordinary shares of NIS 1 par value each, comprising 34.93% of the issued and paid share capital and voting rights of Discount Mortgage Bank.

According to the offer, holders of the shares are invited to sell them to the Bank, until April 30, 2007 (hereinafter – "the last date of acceptance"), at a price of NIS 575 per share, under the terms detailed in the purchase offer issued by the Bank.

The total consideration that is expected for the shares is approximately NIS 256 million.

The Bank's commitment to purchase the shares under the purchase offer is subject to receipt of the following approvals:

(a) Permit from the Governor of the Bank of Israel, in accordance with the conditions of Section 34 of the Banking Law (Licensing), according to which the Bank is permitted to hold the total means of control in Discount Mortgage Bank; (b)

Approval from the Commissioner of Restrictive Trade Practices, insofar as required.

In the event that the said approvals are not obtained until three business days prior to the last date of acceptance, the purchase offer will not become effective and the Bank will not purchase any shares in accordance therewith.

The Bank's commitment to purchase the shares is also subject to receipt of acceptance notices for at least 394,777 shares (hereinafter – "the minimum acceptance rate"). If the acceptance rate for the purchase offer does not reach the minimum acceptance rate, the purchase offer will not become effective.

If the acceptance rate for the purchase offer is equal to, or higher than, the minimum acceptance rate, the Bank will purchase all the shares in respect of which acceptance notices were received and will act in accordance with the provisions of Section 337(a) of the Companies Law, and will purchase, by way of a forced sale, the balance of the shares held by the public, at the price determined in the purchase offer and under the same conditions, and thereafter will act to remove the Discount Mortgage Bank shares from trading on the Stock Exchange.

## 7. BUILDINGS AND EQUIPMENT

### A. COMPOSITION

	Consolidated			The Bank		
	Buildings and land*	Equipment, furniture and vehicles	Total	Buildings and land*	Equipment, furniture and vehicles	Total
	in NIS millions					
<b>Cost</b>						
Balance at beginning of the year	1,893	2,990	4,883	1,355	1,947	3,302
Additions	210	428	638	188	347	535
Disposals**	(30)	(222)	(252)	(22)	(176)	(198)
Balance as at December 31, 2006	2,073	3,196	5,269	1,521	2,118	3,639
<b>Depreciation</b>						
Balance at beginning of the year	832	1,783	2,615	582	1,021	1,603
Depreciation for the year	39	236	275	24	166	190
Accumulated depreciation on disposals**	(17)	(218)	(235)	(10)	(176)	(186)
Balance as at December 31, 2006	854	1,801	2,655	596	1,011	1,607
Depreciated balance as at December 31, 2006	1,219	1,395	2,614	925	1,107	2,032
Depreciated balance as at December 31, 2005	1,061	1,207	2,268	773	926	1,699
The average depreciation rate in 2006	2.9%	14.1%	9.2%	2.6%	15.9%	9.6%
The average depreciation rate in 2005	3.0%	15.1%	9.9%	2.6%	16.2%	10.2%

\* Includes:

- Installations and leasehold improvements, the depreciated balance of which amounted to NIS 100 million - consolidated and to NIS 52 million in the Bank. (2005: NIS 93 million - consolidated; and NIS 48 million - in the Bank).
- Interest capitalized in prior years net of amortization, in the amount of NIS 3 millions (2005: NIS 3 millions).
- Including a provision for decline in value in the amount of NIS 29 million (2005: NIS 25 million).

\*\* December 31, 2006 – Including deduction in respect of a company no longer consolidated at a cost of NIS 3 million and accumulated depreciation of NIS 2 million.

- b. The Bank and a consolidated subsidiary own leasehold rights for various periods ending in the years 2008 to 2044. The Bank and a consolidated subsidiary are the owners of non-capitalized leasehold rights: Consolidated NIS 31 million (2005: NIS 33 million). The Bank, stand alone: NIS 29 million (2005: NIS 31 million). The Bank and a consolidated subsidiary are the owners of capitalized leasehold rights: Consolidated – NIS 120 million (2005: NIS 123 million). The Bank, stand alone – NIS 90 million (2005: NIS 93 million).
- c. The depreciated cost of buildings not yet registered in the names of the Bank or of its subsidiaries at the Land Registry Office, amounts to NIS 179 million (2005: NIS 183 million) on a consolidated basis, and NIS 128 million (2005: NIS 131 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 29 million (2005: NIS 33 million) on a consolidated basis, and NIS 24 million (2005: NIS 27 million) for the Bank.

## 7. BUILDINGS AND EQUIPMENT (CONTINUED)

## E. THE COST OF IN-HOUSE DEVELOPMENT OF COMPUTER SOFTWARE :

	Consolidated		The Bank	
	2006	2005	2006	2005
	in NIS millions			
The cost of software put into operation	863	505	809	452
Accumulated depreciation	(288)	* (209)	(249)	* (175)
Undepreciated balance	575	296	560	277
Cost of software not yet in operation	165	319	151	315
Total	740	615	711	592

\* Reclassified.

See Notes 19 C 18 hereunder, for details regarding the renovation of the central computer infrastructure of the Bank.

## 8. OTHER ASSETS

	Consolidated		The Bank	
	December 31			
	2006	2005	2006	2005
	in NIS millions			
Net deferred tax assets (see Note 29 J)	602	* 716	318	416
Advance tax payments in excess of current provisions	62	* 126	-	-
Deposits for severance pay and pensions in excess of provision (see Note 16 F, I)	482	522	470	479
Issue costs and discount expenses of debentures and subordinated capital notes	11	7	9	5
Income receivable	190	150	52	76
Debit balances of derivative financial instruments	874	* 1,503	727	1,129
Surrender value of life insurance policies owned by the Bank and corporate	650	678	-	-
Other debtors and debit balances	949	* 541	387	275
Total other assets	3,820	4,243	1,963	2,380

\* Reclassified.

## 9. DEPOSITS FROM THE PUBLIC

	Consolidated		The Bank	
	December 31			
	2006	2005	2006	2005
	in NIS millions			
Deposits on demand	11,836	11,691	8,601	8,217
Schedule and other deposits	<sup>(1)</sup> 112,042	<sup>*(1)</sup> 110,977	70,246	<sup>*</sup> 65,341
Acceptances	1	1	1	1
Savings plan deposits	6,638	7,616	5,862	6,723
Total deposits from the public	130,517	130,285	84,710	80,282

\* Reclassified.

Footnote:

(1) 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 3 A), are secured by designated deposits, the balance of which at December 31, 2006 was NIS 2,074 million (December 31, 2005: NIS 4,852 million).

## 10. DEPOSITS FROM BANKS

	Consolidated		The Bank	
	December 31			
	2006	2005	2006	2005
	in NIS millions			
<b>Commercial banks:</b>				
Deposits on demand	715	603	435	1,015
Schedule deposits	2,507	2,565	2,235	1,581
Acceptances	285	312	179	193
<b>Central banks:</b>				
Schedule deposits	2,300	-	2,300	-
<b>Specialized banking institutions:</b>				
Deposits on demand	19	72	107	96
Schedule deposits	2,273	2,966	270	85
Total deposits from banks	8,099	6,518	5,526	2,970

## 11. DEBENTURES AND SUBORDINATED CAPITAL NOTES

	Average maturity years <sup>(1)</sup>	Internal rate of return <sup>(1)</sup> %	Consolidated		The Bank	
			December 31		December 31	
			2006	2005	2006	2005
in NIS millions						
Subordinated capital notes in Israeli currency, linked to the CPI <sup>(2)</sup>	5.27	5.43	6,174	5,191	3,667	3,292
Subordinated capital notes in non-inked Israeli currency	0.08	5.61	128	151	213	227
<b>Total debentures and subordinated capital notes</b>			<b>6,302</b>	<b>5,342</b>	<b>3,880</b>	<b>3,519</b>

Footnotes:

(1) Internal rate of return is the rate which discounts the projected payment flow of amounts presented in the balance sheet. Period to maturity is the average of the repayments periods weighted by the cash flows discounted at the internal rate of return. Data regarding the internal rate of return and the period to maturity relates to the consolidated statements as of December 31, 2006.

(2) 2006 - Including NIS 750 million subordinated capital notes regarded as "hybrid tier I capital" (see note 14 5 below).

## 12. OTHER LIABILITIES

	Consolidated		The Bank	
	December 31			
	2006	2005	2006	2005
in NIS millions				
Current tax provisions in excess of advance payments	72	99	31	41
Net provision for deferred taxes (see Note 29 k)	24	45	24	44
Income in advance	197	141	88	59
Provision for doubtful debts in respect of guarantees	128	128	88	101
Expenses payable	732	1,009	395	708
Provisions for vacation pay, seniority bonus and retirement benefits	1,007	917	831	777
Provision for severance and retirement benefits in excess of amounts deposited (See Note 16 F)	15	12	-	-
Credit balances of derivative financial instruments excluding embedded derivatives	1,038	*1,520	825	1,286
Credit cards activity creditors	4,847	**4,389	2,001	**1,813
Other creditors and credit balances	1,074	*994	586	*409
<b>Total other liabilities</b>	<b>9,134</b>	<b>9,254</b>	<b>4,869</b>	<b>5,238</b>

\* Reclassified

\*\* Restated - see Note 1 Z.

### 13. SHAREHOLDERS' EQUITY

#### A. THE AUTHORIZED, ISSUED AND PAID-UP NOMINAL SHARE CAPITAL (IN NEW ISRAEL SHEKELS):

	December 31, 2006		December 31, 2005	
	Authorized	Issued and Fully Paid-Up	Authorized	Issued and Fully Paid-Up
Ordinary "A" Shares of NIS 0.1 par value each	140,000,000	98,063,921	100,000,000	98,063,921
6% Cumulative Preferred Shares, of NIS 0.00504 par value each (equivalent to 10 pounds sterling each)	202	202	202	202
<b>Total</b>	<b>140,000,202</b>	<b>98,064,123</b>	<b>100,000,202</b>	<b>98,064,123</b>

Ordinary "A" Shares are registered and are listed for trade on the Tel Aviv Stock Exchange.

#### B. 6% CUMULATIVE PREFERRED REGISTERED SHARES:

The dividend and the rights of these shareholders are linked to the representative rate of exchange of the New Israel shekel to the pound sterling at the date of each payment. At the balance sheet date, every holder of a preferred share, the par value of which is equivalent to 10 pounds sterling, is entitled to an annual dividend in an amount of NIS 4.97, and at the time of liquidation to a distribution in an amount of NIS 82.88. According to an Opinion issued by the Institute of Certified Public Accountants in Israel, non-participating preferred shares are not to be included as part of shareholders' equity, and accordingly they are presented under the item "other liabilities".

#### C. INCREASE IN THE REGISTERED SHARE CAPITAL

The special meeting of shareholders convened on December 26, 2006 resolved to increase the registered share capital of the Bank by 400 million ordinary A shares of NIS 0.1 par value each, and to amend the Memorandum and Articles accordingly.

The shares derived from the said increase are intended to be issued to investors in subordinate capital notes (series "A") in a total amount of NIS 1 billion, in the event of a compulsory conversion of the principal amount and/or interest, in certain circumstances that have been determined by the Supervisor of Banks (hereinafter: "compulsory conversion events"; for additional details see Note 14 below).

The Bank is committed towards the State of Israel, which holds 25% of the share capital of the Bank, that the shares constituting part of the registered share capital of the Bank, which were created as a result of the said increase in capital, will be utilized for the above purpose, only upon occurrence of a compulsory conversion event, and will not be used for any other purposes.

As of December 31, 2006, subordinate capital notes in the amount of NIS 750 million were issued. Accordingly, the balance of the shares derived from the said increase in the registered share capital (100 million ordinary "A" shares of NIS 0.1 par value each) will be utilized for additional future issues of subordinate capital notes (series "A") in a total amount of NIS 250 million.

#### D. OPTION PLAN - AN OPTION PLAN FOR OFFICERS OF THE BANK

##### (1) The original plan

The Board of Directors of the Bank resolved, on March 26, 2006, to approve a stock option plan for officers of the Bank, including the Chairman of the Board and the President and CEO of the Bank.

The purpose of this plan is to enhance the interests and goals of the Bank, by way of increasing the material interest of Bank officers in its success and results of operations. The plan is designed to add a layer of long-term remuneration that

### 13. SHAREHOLDERS' EQUITY (CONTINUED):

#### D. OPTION PLAN - AN OPTION PLAN FOR OFFICERS OF THE BANK (CONTINUED):

would induce officers to reach long-term growth targets, and would act towards the long-term preservation of the senior and qualitative management team of the Bank.

According to this plan, 9,806,392 stock option warrants would have been allotted to the Chairman of the Board, and 9,806,392 stock option warrants would be allotted to the President & CEO, as well as 10,787,031 stock option warrants would be allotted to ten other officers of the Bank, including the Internal Auditor (hereinafter – “the other officers”). The allotment of the stock option warrants to the Chairman of the Board as part of the plan, was to be brought for approval at a special general meeting of shareholders of the Bank, which had been summoned for April 26, 2006. (For details regarding the removal from the agenda of the general meeting of shareholders of the matters relating to the offer of option warrants to the Chairman of the Board and to the President and CEO, at their own request, and for details as to the ratification of the decisions made the offer of option warrants to the other officers, see sub-sections (2) and (3) hereunder, respectively).

Each stock option warrant is exercisable into one “A” ordinary share of NIS 0.1 par value each of the Bank (hereinafter – “the share”), subject to adjustments as detailed in the plan.

The exercise price of each option warrant offered to the Chairman or to the President & CEO according to the plan, would have been NIS 5.5 (subject to adjustments in terms of the plan), with the addition of linkage increments to the CPI, from the CPI last published prior to February 1, 2005, and up to the known CPI on the exercise date, with the addition of annual interest at the rate of 5%. The said exercise price had been determined according to a formula based principally on the price in the agreement for the acquisition of a controlling interest in the Bank.

The exercise price of each of the option warrants offered according to the plan to eight of the other officers, would have been NIS 6.379 (subject to adjustments in terms of the plan), with the addition of linkage increments to the CPI, from the CPI last published prior to February 1, 2005, and up to the known CPI on the exercise date. The said exercise price had been determined on the basis of the closing market price of the Bank's shares on February 1, 2005.

The exercise price of each of the option warrants offered according to the plan to one of the other officers, who took office at the Bank on March 1, 2006, as well as to one other officer who took office at the Bank on April 2, 2006, is closing market price of the Bank's shares on the last trading day prior to the day on which such officer started his employment with the Bank, as the case may be (subject to adjustments in terms of the plan), with the addition of linkage increments to the CPI, from the CPI last published prior to the said trading date and up to the known CPI on the exercise date.

The said exercise prices are subject to adjustments derived from the cash distribution of dividends and/or the distribution of bonus shares as well as rights issues by the Bank.

The exercise period of two thirds (2/3) of the warrants allotted under the plan will begin on January 5, 2009 and end on January 4, 2011, and the exercise period of the remaining one third (1/3) will begin on January 1, 2011 and end on December 31, 2012, all subject to the provisions specified in the plan as regards the termination of employment of the offerees with the Bank.

The theoretical value of the approved 30,399,815 option warrants, based on the provisions of Accounting Standard No. 24, is estimated at approximately NIS 112 million (of which an amount of NIS 68 million in respect of the Chairman of the Board and the President and CEO).

The value of the benefit to the officers, including payroll tax, as should have been recorded in the books of the Bank, is estimated, on March 23, 2006, at approximately NIS 122 million (of which an amount of NIS 74 million in respect of the

### 13. SHAREHOLDERS' EQUITY (CONTINUED):

#### D. OPTION PLAN - AN OPTION PLAN FOR OFFICERS OF THE BANK (CONTINUED):

Chairman of the Board and the President and CEO). The value of this benefit is to be recognized in the Bank's books from the first quarter in which the award has been made until the beginning of the exercise period of each part.

The estimated benefit to the officers is based on the Black & Scholes formula, considering known parameters and assessments or such that are assessable at the relevant date.

The fair value of each option warrant to be allotted to the Chairman of the Board and to the President and CEO as part of the plan is assessed at NIS 3.49. The fair value of each option warrant to be allotted as part of the plan to the eight other officers already employed by the Bank is assessed at NIS 4.29. The fair value of each option warrant to be allotted as part of the plan to the other officer who took office on March 1, 2006, is NIS 2.81. The fair value of each option warrant to be allotted as part of the plan to the other officer who took office on April 2, 2006, is NIS 2.53.

All data regarding the theoretical value of the benefit and its impact on the financial statements of the Bank as well as the fair value data as regards to each option warrant, have been computed based on the data available on March 23, 2006. It should be noted that the determining date for the fair value computation of the option warrants is the date on which such warrants are actually being allotted.

The actual date of the grant to the officers of the Bank (excluding the Chairman of the Board and the President & CEO) was the date of approval by the Board of Directors (with the exception of one officer in respect of whom the actual date of the grant was the date on which he took office at the Bank).

The parameters of the model for the computation of the theoretical value of the warrants are:

- Cost of the share on March 23, 2006 – NIS 9.5, higher than the average price in the month preceding this date by 5%;
- Exercise prices – as stated above;
- Period of expiration of the options – two thirds to expire after 4.8 years from date of allotment and one third to expire after 6.8 years from date of allotment;
- Non-risk interest rate – 3.7%;
- Dividend yield rate – "0", as the exercise price of the options is adjusted for the distribution of dividends;
- Standard deviation of the share yield – 19%.

In accordance with section 102 of the Income tax ordinance, all the option warrants under the plan are to be allotted in the name of a Trustee for and on behalf of the offerees, in accordance with the terms of the capital gains alternative by means of the Trustee.

Procedure for the exercise of the options – At each exercise date, the amount of the benefit to the offeree will be computed and the Bank would issue to the Trustee for the offeree a number of ordinary shares, the total market value of which, based on the closing market price of the shares of the Bank on the trading date preceding the exercise date, equals the amount of the monetary benefit.

The Bank will convert into share capital, that part of its earnings, within the meaning of section 302(b) of the Companies Law, 1999, ("the Companies law"), from premium on shares or from any other source included in its shareholders' equity, as stated in Section 304(a) of the Companies Law, equal to the par value amount of the exercised shares to be allotted as stated.

Each option warrant not exercised in accordance with the terms of the plan until the end of the period determined for its exercise, shall become null and void and would not entitle to any rights whatever.

On March 26, 2006, the State notified its consent to the terms of the stock option plan to officers of the Bank and of its

### 13. SHAREHOLDERS' EQUITY (CONTINUED):

#### D. OPTION PLAN - AN OPTION PLAN FOR OFFICERS OF THE BANK (CONTINUED):

consent to vote together with the controlling shareholders of the Bank, by power of the option shares held by it. (For details regarding the notice of revocation of the said consent, delivered on June 20, 2006, see sub-section (2) hereunder) The remuneration and terms of office of the Chairman of the Board were removed from the agenda of the said general meeting of shareholders at the request of the Chairman, and the matter will be brought for a renewed discussion by the authorized organs of the Bank (for further details see sub-section (2) hereunder).

#### (2) Further developments

On March 26, 2006, the Bank issued a notice for a special meeting of the Ordinary "A" shareholders of the Bank to be convened on April 26, 2006. The agenda for the meeting included, inter-alia, the following items:

- Approval of a proposed allotment of option warrants to the Chairman of the Board of the Bank, in a stock option plan to officers of the Bank;
- Increase of the registered share capital of the Bank by NIS 4,000,000 par value, and a respective amendment to the Memorandum and Articles of Association of the Bank;
- Approval of the terms of office of the Chairman of the Board of the Bank.

On April 20, 2006, the Israel Securities Authority (ISA) requested the Bank to provide explanations and documents with regards to the general meeting of shareholders that was to be held in order to approve the matters stated above. The requested details related to the manner in which the remuneration plan for senior management had been formulated and to the procedure for its approval.

Requests for details and information were also made to members of the Board of Directors.

The said letter was received on the background of a public uproar with respect to the remuneration of senior bank executives in general and at the Bank in particular.

In view of the situation that has arisen, the Chairman of the Board and the President & CEO were of the opinion that the preoccupation at this time with the stock option plan that had been approved with respect to them, might divert attention from promoting the issues that are on the agenda of the Bank. Therefore, out of concern for the Bank, and wishing not to delay the approval of the remaining issues that were to be discussed at the general meeting, and in order to avoid any possible damage to the Bank – the Chairman and the President & CEO requested the removal of the items dealing with the granting of stock option warrants to them (including the increase of the registered share capital of the Bank) from the agenda of the general meeting. A notice to this respect was issued to the public on April 23, 2006.

The said notice did not create any change in the plan for the granting of stock options to the officers of the Bank (not including the Chairman and the President & CEO; hereinafter "the other Officers"), and which can be carried out within the existing registered share capital of the Bank (without requiring its increase), in accordance with the terms of the option plan determined in their respect.

At the same time, the Bank responded to the said request of the ISA, however, on April 25, 2006, an additional letter from the ISA was received by the Bank, which among other things, requested additional information and clarifications as well as further questions, which in the opinion of the ISA required further deliberations. In view of these requests and questions the ISA was of the opinion that it was not proper to hold the general meeting convened for April 26, 2006, as planned. Under these circumstances, the Bank advised of the postponement of the general meeting.

At the request of the Chairman of the Board and to the President and CEO, their remuneration plan is being brought for reconsideration by the authorized organs of the Bank. For additional details see Not 22 hereunder.

### 13. SHAREHOLDERS' EQUITY (CONTINUED):

#### D. OPTION PLAN - AN OPTION PLAN FOR OFFICERS OF THE BANK (CONTINUED):

The Bank has provided the ISA with a legal opinion with respect to the procedure for the approval of the remuneration of the Chairman of the Board and has replied the questions asked.

In a letter dated June 20, 2006, the Accountant General at the Ministry of Finance informed that if and to the extent that the Bank would decide to renew the procedure for approval of a stock option plan and terms of remuneration for senior executives of the Bank or an alternative plan for options or remuneration that requires the State's consent, the controlling shareholders of the Bank would have to apply again for the prior consent of the State for the matter, in accordance with the provisions of the agreement dated February 1, 2005, and the State would reconsider its position on the matter, and any consent given in the past by the State in such matter is null and void.

On June 25, 2006, the Bank responded to the Accountant General at the Ministry of Finance, stating among other things that the remuneration plan for the other officers would be brought for renewed examination, discussion and ratification before the Audit Committee and to the Board of Directors of the Bank, and that the ratification procedure does not require by law the consent of any shareholder or the approval of the general meeting of shareholders.

On June 26, 2006, the representative of the controlling shareholders of the Bank replied to the Accountant General stating among other things that he rejects the contents of the letter of the Accountant General and that the ratification of the option plan to the other officers of the Bank is entrusted by law to the discretion of the Audit Committee and the Board of Directors of the Bank.

#### (3) Ratification of the remuneration plan to other officers

In view of the questions referred by the ISA, the Audit Committee and Board of Directors of the Bank reexamined the plan for the allotment of options to the other officers, including the Internal Auditor, as described in sub-section (1) above, and the award plan for members of management, including the Internal Auditor, as described in Note 16H

In discussions held on July 6 and 25, 2006, the Audit Committee and Board of Directors of the Bank ratified their decisions from March 26, 2006 regarding the approval of the award plan and the option plan.

The resolutions of the Audit Committee and Board of Directors clarified that the offer of option warrants to the other officers in accordance with the option plan remains in effect, separately and disengaged from the offer of option warrants to the Chairman of the Board and to the President and CEO. The said resolutions also clarified that they remain in effect without any reliance or dependence on the standpoints of the Government or the controlling shareholders of the Bank.

On the Audit Committee and the Board of Directors meetings it was noted with deep sorrow that Mr. Nissim Alagem, an Executive Vice President at the Bank, who was one of the offerees under the option plan had passed away. According to the terms of the plan the option warrants that were designated for him would not now be allotted.

The main arguments of the Audit Committee and the Board of Directors in favor of ratifying their said decisions, taking into consideration the best interests of the Bank, were as follows:

- (a) The remuneration plan in general balances three components: salary, options and bonus, and is intended to promote the interests of the Bank and its goals by way of the long-term preservation of the senior and qualitative executive team, which has proven its ability, so that it would continue to lead the Bank in the coming years. This especially on the background of the competitive environment in the banking industry, in which the Bank operates, and in view of the competition of recruitment of qualitative and highly skilled personnel, such as the class of officers belonging to the senior management rank of the Bank, and the remuneration offered to such officers by large financial and other companies in general, and in the banking industry in particular.

### 13. SHAREHOLDERS' EQUITY (CONTINUED):

#### D. OPTION PLAN - AN OPTION PLAN FOR OFFICERS OF THE BANK (CONTINUED):

- (b) The remuneration plan does not change the basic salary terms (including retirement benefits) of members of management, but adds further layers of remuneration, dependent on performance and conditional upon the success of the Bank. The one: short term remuneration – the award plan – conditional upon the annual performance of the Bank and tightens the bond between the remuneration of members of management and the annual return on equity and also depends on the personal performance of each particular member of Management. The other layer comprises long-term remuneration – the option plan – which is intended to create a long-term economic incentive and an obligation of the senior management team to continue and act in the coming years towards increasing the Bank's profits and its value.
- (c) Furthermore, the option plan also tries to create an identity of interests between members of management and the shareholders of the Bank at large, regarding the increase in value of the Bank.
- (d) As a part of the award plan, rates of return on equity have been determined with a view of forming both a challenging though realistic plan, taking into consideration the rates of return on equity reached by the Bank in recent years and the goals for the future.
- (e) The award plan grants the Board of Directors of the Bank the authority to decide, at its sole discretion, that for the purpose of computing the annual rate of return on equity, exceptional gains or losses or those that are not derived from current operations and which affect the rate of return on equity, would be eliminated. The plan also authorizes the Board of Directors to change or cancel at any time and at its sole discretion, the award plan, in part or in whole, provided that such change or cancellation would come into effect in the calendar year beginning at the end of the calendar year in which such a decision is taken.
- (f) In accordance with the option plan, the exercise price of the option warrants offered to some of the other offerees, who acted as officers of the Bank on February 1, 2005 (date on which the agreement for the sale of the Bank was signed between the State of Israel and the controlling shareholders of the Bank), and who have contributed significantly to the business management of the Bank in the period prior to the transfer of control of the Bank, would allow the said offerees to benefit from the rise in the market price of the Bank's shares, starting with the said date and until the date of allotment of the option warrants, as well as from that date and until the exercise date of the option warrants, on condition that they would not resign from office at the Bank prior to the beginning of the exercise period determined in the option plan. The exercise price of the option warrants offered to two of the said other offerees, who took office at the Bank in March and April 2006, was determined on the basis of the closing market quotation on the trading date, one day prior to the date on which they took office at the Bank, as the case may be.

#### (4) Allotment of option warrants

On August 4, 2006, the Bank allotted to a Trustee on behalf of nine other officers 9,806,391 non-marketable option warrants, exercisable into ordinary "A" shares of the Bank of NIS 0.1 par value each, under terms and on dates determined in the plan (see sub-section (1) above).

The theoretical value of the benefit in respect of the option warrants, allotted as above, in accordance with the provisions of Accounting Standard No. 24, is estimated at NIS 39 million. The value of the benefit in respect of the option warrants, allotted as above, which includes payroll tax, considering the change that has taken place in the payroll tax rates and the actual profit component (in contrast to that estimated at the time), is assessed at NIS 40 million.

The value of the benefit on behalf of the said nine other officers will be allocated in the books of the Bank as from the

### 13. SHAREHOLDERS' EQUITY (CONTINUED):

#### D. OPTION PLAN - AN OPTION PLAN FOR OFFICERS OF THE BANK (CONTINUED):

date of grant of the options (March 26, 2006), and until the beginning of the exercise period of each portion (two thirds over a period of 2.8 years and the additional one third over a period of 4.8 years). One of the other Officers retired from the Bank at the end of 2006, and the options that had been allotted to him expired. In the year ended on December 31, 2006, an amount of NIS 8 million were charged in respect of eight officers, as salary expenses as against a capital reserve.

#### E. DIVIDEND

The distribution of dividends by the Bank is subject to the provisions of the law, including limitation deriving from Directives of the Supervisor of Banks.

For details as to a limitation on the distribution of dividends from funds from a future sale of control over IDB New York, if at all, see "Employee agreement" in Note 32 C hereunder. For details as to a limitation determined by the Governor of the Bank of Israel, included in the permit granted to the Bronfman-Schron Group for the acquisition and holding of means of control in the Bank, see Note 32 B hereunder.

### 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS

**General** - Proper Banking Management Directives 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 two main components: Tier I capital and Tier II capital 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.

For details regarding issuance of hybrid tier I capital and the conditions thereof, see Section 5 below.

14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS  
(CONTINUED)

1. CAPITAL FOR CALCULATING RATIO OF CAPITAL

	December 31	
	2006	2005
in NIS millions		
Tier I capital:		
Original tier I capital	7,887	7,092
Hybrid tier I capital	750	-
Tier II capital:		
Upper Tier II capital <sup>(1)</sup>	257	*257
Other Tier II capital	3,779	*3,539
Tier III capital <sup>(2)</sup>	10	37
Deductions <sup>(3)</sup>	(1,271)	(947)
Total capital	11,412	9,978

\* Reclassified.

**14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS  
(CONTINUED)**
**2. WEIGHTED RISK BALANCE**

	December 31			
	2006		2005	
	Balances <sup>(4)</sup>	Weighted credit risk	Balances <sup>(4)</sup>	Weighted credit risk
in NIS millions				
<b>Credit risk assets</b>				
Cash and deposits with banks	25,406	4,386	20,586	3,810
Securities	38,914	7,872	42,188	8,161
Credit granted to the public <sup>(1)(5)</sup>	90,401	76,711	**88,034	**75,738
Credit granted to the government	18	2	92	3
Investment in affiliated companies <sup>(3)(5)</sup>	1,577	77	**1,520	519
Buildings and equipment	2,614	2,615	2,268	2,268
Other assets	3,820	3,365	4,243	3,601
<b>Total assets</b>	<b>162,750</b>	<b>95,028</b>	<b>158,931</b>	<b>94,100</b>
<b>Off-Balance Sheet Instruments</b>				
Transactions whose balance represents credit risk	10,344	9,336	**8,942	**6,936
Derivative financial instruments <sup>(6)</sup>	6,484	2,835	6,490	3,395
Other	316	316	399	399
<b>Total off-balance sheet instruments</b>	<b>17,144</b>	<b>12,487</b>	<b>15,831</b>	<b>10,730</b>
<b>Total credit risk assets</b>	<b>179,894</b>	<b>107,514</b>	<b>174,762</b>	<b>104,830</b>
Market risk		1,649		1,521
<b>Total risk assets</b>	<b>179,894</b>	<b>109,163</b>	<b>174,762</b>	<b>106,351</b>

\*\* Reclassified see note 1 Z.

Footnotes:

(1) The balance of the general provision for doubtful debts in the amount of NIS 211 million (2005: NIS 211 million) constitutes a part of the upper Tier II and is not deducted from credit to the public.

(2) Held against market risk only.

(3) The balance of investments in shares and in subordinated capital 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.

(4) 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.

(5) Loans and capital notes presented in the balance sheet under investments in affiliated companies in the amount of NIS 14 million (2005: NIS 7 million) are included in credit to the public.

(6) Including a NIS 25 million (2005: NIS 16 million) liability towards the Ma'of Clearing House.

14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)  
3. RATIO OF CAPITAL TO RISK ASSETS

	December 31	
	2006	2005
	Percent	
<b>A. The bank</b>		
Ratio of original tier I capital to risk assets		
Ratio of tier I capital to risk assets	7.9	6.7
Ratio of total capital to risk assets	10.5	9.4
Ratio of total minimal capital required by the Supervisor of Banks	9.0	9.0
<b>B. Significant subsidiaries</b>		
<b>1. Mercantile Discount Bank LTD. and its subsidiaries</b>		
Ratio of tier I capital to risk assets	8.6	7.9
Ratio of total capital to risk assets	12.7	12.2
Ratio of total minimal capital required by the Supervisor of Banks	9.0	9.0
<b>2. Discount Mortgage Bank LTD. and its subsidiaries</b>		
Ratio of tier I capital to risk assets	9.5	9.1
Ratio of total capital to risk assets	12.2	11.3
Ratio of total minimal capital required by the Supervisor of Banks	9.0	9.0
<b>3. Discount Bankcorp Inc.<sup>(1)</sup></b>		
Ratio of tier I capital to risk assets	10.9	10.8
Ratio of total capital to risk assets	11.9	11.8
Ratio of total minimal capital required by the Supervisor of Banks	8.0 <sup>(2)</sup>	8.0 <sup>(2)</sup>
<b>4. Israel Credit Cards LTD.</b>		
Ratio of tier I capital to risk assets	10.2	11.3
Ratio of total capital to risk assets	11.3	12.7
Ratio of total minimal capital required by the Supervisor of Banks	9.0	9.0

## Footnotes:

(1) The data in this item was computed in accordance with the rules applicable in the U.S.A.

(2) IDB New York, a subsidiary of Discount Bankcorp 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%.

## 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

### 4. ISSUE OF SUBORDINATED CAPITAL NOTES

**Issue of subordinated capital notes - March 2004.** On March 18, 2004, Manpikim – Discount Bank Issues Corporation Ltd. (“Manpikim”), completed an issue of NIS 236 million of subordinated 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. 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. The Supervisor of Banks approved the inclusion of the said subordinated capital notes as second tier capital 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 are being gradually sold by it, in accordance with the needs of the Bank.

The proceeds of the issue of the deferred capital notes series “A” and “B” 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.

The Supervisor of Banks approved the inclusion of the said subordinated capital notes as second tier capital of the Bank. The balance of deferred capital notes not yet sold by the subsidiary of Manpikim amounted, at December 31, 2006, to a par value of NIS 3 million.

**The publication of a shelf prospectus.** On September 28 2006, Manpikim published a shelf prospectus for the issuance of up to NIS 4 billion par value, subordinated capital notes (series “C” – “F”), and for the listing for trade of NIS 300 million par value, capital notes (series “B”), which were issued shortly prior to the publication of the prospectus.

At this stage, an issue of notes has been approved within the framework of the said shelf prospectus, in an amount not to exceed NIS 1.2 billion. At the beginning of March 2007, Manpikim issued NIS 350 million par value subordinate capital notes (Series “E”) in accordance with a shelf offer report dated March 5, 2007.

**Issue of deferred capital notes – Mercantile Hanpakot Ltd.** On August 23, 2005, Mercantile Hanpakot Ltd., a subsidiary of Mercantile Discount Bank, completed issuing NIS 200 million of deferred capital notes (series A), out of a series of a total of NIS 300 million. which were listed for trading on the Tel-Aviv Stock Exchange.

Mercantile Discount Bank received the approval of the Supervisor of Banks to have the said capital notes included as Mercantile discount Bank’s second tier capital. (Accordingly, the said capital notes are considered second tier capital for the purpose of calculating the Bank’s capital ratio).

Up to December 31, 2006, Mercantile Discount Bank raised additional secondary capital out of the same series of NIS 4 million.

**Issue of deferred capital notes – Discount Mortgage Issues Ltd.** On November 23, 2005, Discount Mortgage Issues

#### 14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)

Ltd., a subsidiary of Discount Mortgage Bank, published a prospectus for issuing of NIS 125 million deferred capital notes (Series "A"), out of a total series of NIS 300 million. Discount Mortgage Bank requested the approval of the Supervisor of Banks for inclusion of the said capital notes as part of Discount Mortgage Bank's secondary capital (once this approval is obtained, the Bank will also be able to include these capital notes as part of its secondary capital in computing its capital ratio).

Up to December 31, 2006, Discount Mortgage Bank raised additional secondary capital out of the same series of NIS 59 million.

#### 5. THE ISSUE OF HYBRID TIER I CAPITAL

In accordance with a resolution of the Board of Directors of December 10, 2006, the Bank issued, on December 31, 2006 through a private placement to institutional investors, NIS 750 million par value of subordinate capital notes (Series "A").

The Bank intends to list the said subordinate capital notes for trading on the Tel Aviv Stock Exchange in a prospectus, which the bank is preparing for publication, insofar as possible by the end of May 2007. The subordinate capital notes will bear interest at the rate of 6.35% per annum until such notes are listed for trading, and at an interest rate of 5.1% thereafter.

The subordinate capital notes were issued for a period of 99 years and the principal will be repayable on January 1, 2106. The principal and interest on the notes are linked to the CPI and will bear annual interest as stated. The interest on the subordinate capital notes is payable quarterly.

The Bank is entitled, at its own discretion, to redeem the subordinate capital notes prematurely, after a minimum of 15 years from the issuance date, subject to the conditions stated in the notes and to approval from the Supervisor of Banks. In the event that the notes are not redeemed prematurely after 15 years, the capital notes will bear step-up interest at the rate of 1% over the original margin determined for the first 15 years.

The subordinate capital notes include special provisions, as detailed below, mainly compulsory conversion of the principal amount and/or interest into ordinary "A" shares of NIS 0.1 par value each of the Bank, under certain circumstances determined by the Supervisor of Banks. In the event of conversion of the total principal amount of the capital notes and the allocation of shares in exchange for interest in respect of the full number of shares designated for such purpose in the authorized share capital of the Bank, 300 million ordinary "A" shares of the Bank, comprising 23.4% of the issued share capital of 1,280,639,209 ordinary "A" shares of the Bank, will be allocated in respect of the issued capital notes, as stated.

The subordinate capital notes are not secured by any pledge on the assets of the Bank or by any other collateral. The liability of the Bank for payment of the principal and interest on the capital notes is subordinate to all other liabilities of the Bank to creditors of any class, including to holders of subordinate capital notes that were issued or will be issued in the future by the Bank and/or its subsidiaries, and will be superior only to rights of the shareholders to the distribution of the balance of the Bank's assets upon liquidation. The liability of the Bank for payment of the principal amount of the capital notes and the interest thereon will be equivalent, *pari passu*, to other liability notes and/or securities that will be issued by the Bank or by its subsidiaries, and which are approved by the Supervisor of Banks as primary capital instruments.

The Governor of the Bank of Israel approved the Bank's inclusion of the capital notes as preferred primary capital. Following are the basic conditions for recognition of the capital notes as preferred primary capital:

**14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)**

1. The ratio of capital to risk assets of the Bank should not fall below 10% as of the date of issuance of a compound capital instrument.
2. Hybrid tier I capital is required to comply with the designated conditions for compound capital instruments, as defined in Proper Banking Management Directive No. 311, included in secondary capital.
3. Structure of the issuance – The issuance should be implemented directly only by the Bank itself.
4. Quantity restriction – The ratio of the hybrid tier I capital should not exceed 15% of the total tier I capital as defined in Proper Banking Management Directive No. 311, including the hybrid tier I capital (hereinafter: “overall tier I capital”).
5. Repayments – Only capital notes fully paid up in cash will be deemed hybrid tier I capital.
6. Non-accrual interest – In “special circumstances”, as defined below, on the due date for payment of interest, such interest will not be payable and the entitlement of holders of the capital notes to interest will expire. Interest not paid as a result of existence of the special circumstances will not accumulate and will be erased after the payment date. Following are the special circumstances:
  - (a) The Board of Directors of the Bank has determined that the Bank is unable to honor its obligations, which rank higher than the subordinate capital notes (series “A”) or are equivalent thereto, or the independent auditors of the Bank drew attention in their audit report or review report attached to the Bank’s annual or interim financial statements, respectively, to notes to the financial statements regarding the Bank’s inability to fulfill its obligations, as stated above;
  - (b) The Board of Directors of the Bank has determined that probability exists that payment of the interest would create a situation in which the Bank will be unable to settle its existing and/or expected liabilities, or the independent auditors of the Bank drew attention in their audit report or review report attached to the Bank’s annual or interim financial statements, respectively, to notes to the financial statements regarding the probability of such situation;
  - (c) During six consecutive quarters, the financial statements for the last of which were published prior to the date for payment of the interest, the Bank did not report on accrued net income (i.e. if the simple addition of the quarterly amounts of the net earning or losses reported in the Bank’s financial statements, for six consecutive quarters, constituted a negative amount);
  - (d) The last financial statements of the Bank published prior to the date of the interest payment indicate that the Bank has no distributable profits.
7. Allotment of shares in respect of interest – In the case of erasure of interest, as described in 6 above, the Bank is empowered to issue shares to holders of the capital notes against the erased interest. Such shares may be issued only in respect of interest not paid in the same year, and shares may not be issued in respect of interest erased in prior years.
8. Sustaining of losses – The Bank is required to convert all outstanding balances of principal and interest in respect of the subordinate capital notes into ordinary “A” shares of the Bank, of the circumstances described below occur:
  - (a) If the ratio of the overall tier I capital to risk assets of the Bank, as stated in the annual financial statements or in the quarterly interim financial statements of the Bank for the reporting period, falls in a particular quarter below 6%, and does not recover within 90 days from the date of issue of the said financial statements, to a rate of at least 6% - conversion will be implemented immediately;
  - (b) If the ratio of the tier I capital to risk assets of the Bank, excluding the hybrid tier I capital (hereinafter – “the original

**14. CAPITAL ADEQUACY IN ACCORDANCE WITH INSTRUCTIONS OF THE SUPERVISOR OF BANKS (CONTINUED)**

tier I capital”), as stated in the annual financial statements or in the quarterly interim financial statements of the Bank for the reporting period, falls in a certain quarter below 5.5%, and does not recover until the date of publication of the financial statements for the following quarter to a rate of at least 5.5% (even if the ratio of the overall tier I capital exceeds 6% at that time) – conversion will be implemented immediately:

- (c) If the ratio of the original tier I capital to risk assets of the Bank, as stated in the annual financial statements or in the quarterly interim financial statements of the Bank for the reporting period, falls in a certain quarter below 6% but not lower than 5.5%, and does not recover to a rate of at least 6% until the end of the two quarters following that quarter, as stated in the interim financial statements of the Bank – conversion will be implemented immediately (even if the ratio of the overall tier I capital exceeds 6% at that time), unless the Supervisor of Banks directs otherwise;
- (d) If the ratio of the original tier I capital, as stated in the annual financial statements or in the quarterly interim financial statements of the Bank for the reporting period, falls in a certain quarter below 5%, immediate partial conversion will be implemented in an amount that would recover the original primary capital ratio of the Bank published for that quarter to at least 5%;
- (e) If the Bank’s retained earnings become negative;
- (f) If the independent auditors of the Bank drew attention in their audit report or review report attached to the annual financial statements or to the interim financial statements of the Bank, respectively, to notes to the financial statements which express significant uncertainties regarding the continued existence of the Bank as a “going concern”.

9. Change in terms, premature redemption, and/or increase in interest rate – the subordinate capital notes will be issued for a period of 99 years and may be redeemed at the discretion of the issuer, subject to advance written approval from the Supervisor of Banks, after a minimum period of 15 years. Additionally, other terms of the subordinate capital notes may not be changed without advance written approval from the Supervisor of Banks.

Without detracting from this condition, one step-up of interest by up to 100 base points over the original margin determined for the first period of 15 years is enabled, after at least 15 years from the issuance date.

10. Subordination – Except for the rights of creditors in accordance with similar capital instruments, the capital notes are subordinate to claims of all other creditors, including holders of capital notes issued as secondary capital.
11. Collateral – The liabilities according to the capital notes are not secured by any collateral.
12. Issuance to related entities – The Bank will not issue subordinate capital notes to provident funds and/or mutual funds controlled and/or managed by the bank (insofar as this condition is at the Bank’s discretion in the primary allocation).
13. Transparency – The terms of the issuance will be clear and disclosed, including full disclosure in the Bank’s published annual financial statements of all conditions of the hybrid tier I capital, inter alia, the following details regarding the compound primary capital: amount, components, share in the total overall primary capital and principal characteristics.

Regarding recognition of the capital notes as preferred tier I capital, the Board of Directors adopted a capital adequacy policy according to which the Bank will maintain an original primary capital adequacy ratio (excluding the compound primary capital) of at least 6.5%, at all times.

## 15. PLEDGES

- A.** 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 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, 2006, of the pledged securities amounts to US\$ 23 million (NIS 97 million) [December 31, 2005 – US\$ 23 million (NIS 106 million)].
- In addition, Discount New York pledged securities and loans in favor of the Federal Home Loan Bank, in the amount of US\$309 million (NIS 1,305 million) as of December 31, 2006 as a collateral for deposits received from it [as at December 31, 2005: US\$382 million (NIS 1,758 million)].
- B.** Discount New York has sold securities, under buyback terms, in the amount of US\$807 million (NIS 3,408 million) as of December 31, 2006 [as at December 31, 2005: US\$ 1,428 million (NIS 6,573 million)].
- C.** 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.
- D.** The Bank is a member of the Euroclear Clearing House, which serves as a clearing system for transactions in securities traded on international markets, made through this clearing house. For this purpose, the Bank has pledged cash and securities in the amount of US\$ 20 million.
- E.** Discount Leasing Ltd. registered in favor of the State of Israel, a first floating charge on its assets, unlimited in amount, in respect of investment grants received.
- F.** Note 19 C 6 describes 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, 2006, amounted to NIS 18 million (December 31, 2005: NIS 24 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, 2006, was NIS 70 million (2005: NIS 24 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 provided the Ma'of Clearing House with a first degree pledge on all monies that had been deposited by the Bank in an account in the name of the Ma'of Clearing House at the Stock Exchange Clearing House and at an account in the name of the Ma'of Clearing House in another bank, all as collateral for amounts that the Bank will be liable for in respect of Ma'of transactions to which it is responsible towards the Ma'of Clearing House. The obligation is subject to conditions, and the Bank is entitled, under certain conditions, to demand the repayment of certain amounts. Within the framework of these accounts the Bank has pledged bonds in favor of the Ma'of Clearing House, the amount of which at December 31, 2006, totaled NIS 434 million (December 31, 2005: NIS 307 million).
- G.** 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

## 15. PLEDGES (CONTINUED)

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, 2006, to NIS 59 million (December 31, 2005: NIS 35 million).

- H.** As collateral for the obligations of Yatzil Finance and its subsidiaries towards the banks, the said companies registered an assignment by way of a pledge and a fixed and floating pledges on all their rights according to agreements with business houses for the discount of IsraCard, VISA, American Express and Diners Club Israel vouchers, and all the rights to receive monies and payments from IsraCard, ICC, American Express and Diners, under power of assignment of rights and under the business house agreement. As of balance sheet date there was no obligation towards the banks.
- I.** Israel Discount Bank (Switzerland) has pledged assets in the amount of SFR 11.5 million (December 31, 2005: SFR 7.5 million), as collateral for credit facilities in the amount of US\$2 million.
- J.** As detailed in Note 19 C 7 hereunder, since May 2005 the Bank amended its arrangement with the Tel-Aviv Stock Exchange Clearinghouse, in accordance with the requirements of the Articles of the Stock Exchange Articles and the bylaws of the Clearinghouse, and pledged as security for its obligations towards the Clearinghouse all the Bank's rights in the security deposit managed by the Clearinghouse (in which the Bank deposits securities) and all its rights in an account opened with another bank. The value of the collateral amounted on December 31, 2006, to NIS 24 million, similar to December 31, 2005 .
- K.** According to an agreement signed between Mercantile Discount Bank and the Tel-Aviv Stock Exchange Clearinghouse Ltd. (hereinafter – "the Clearinghouse"), this bank deposited a security – Government bonds – in favor of the Clearinghouse, in respect of the responsibility of the bank towards the Clearinghouse for transactions made by the bank or by its customers by means of the Clearinghouse. The value of the collateral as of December 31, 2006, amounted to NIS 5 million (December 31, 2005: NIS 3 million).  
As security for this agreement Mercantile Discount Bank registered on April 13, 2005, a first degree fixed charge on the said security and the rights therein, in favor of the Clearinghouse
- L.** In order to secure credit which the Bank receives from time to time from the Bank of Israel, the Bank pledged, in May 2005, in favor of the Bank of Israel, a portfolio of bonds held by it. The said pledge does not preclude the sale by the Bank of the portfolio of bonds or a part thereof, provided that the sale is made in the ordinary course of business of the Bank with regards to the securities of the type pledged by it.  
The value of the collateral amounted on December 31, 2006 to NIS 3.5 million. (As of December 31, 2005, no assets were pledged within the framework of the said arrangement).
- M.** As part of a general agreement for a credit facility from the Bank of Israel and for securing all sums that are or will be due to the Bank of Israel in respect of credit received or to be received by Mercantile Discount Bank from the Bank of Israel, Mercantile Discount Bank registered, on May 30, 2005, in favor of Bank of Israel, a first floating charge on two types of Israel Government bonds included in its securities portfolio (excluding bonds loaned to the public).

### 15. PLEDGES (CONTINUED)

Following are details relating to this pledge arrangement:

	Balance as of December 31, 2006	Highest balance during the year	Average balance in 2006
In NIS millions			
Pledged securities(market value)	810	971	830
Deposits with the Bank of Israel	187	1,322	328
Deposits by Bank of Israel	-	51	-

### 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, and in respect of which adequate provisions have been included. 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 six to twelve months' salaries, and in respect of which adequate provisions have been included.

**B.** The Bank's employees and those of its consolidated subsidiaries in Israel are entitled to long-service bonuses equal to a certain number of monthly salaries, and to a certain number of additional vacation days, upon completing 20, 30 and 40 years of employment in the Bank. In accordance with instructions of the Supervisor of Banks the provision in respect of this liability is computed on an actuarial basis and stated at its present value. The capitalization rate, set by the Supervisor of Banks, on an actuarial computation is 4%, and considering the future payroll increases, the amount of the liabilities for employee rights, in respect of the Bank employees, is capitalized at a payroll increase rate of 2.5% (December 31, 2005 – 2%). The financial statements include provisions for long-service bonuses totaling: Consolidated – NIS 447 million (2005: NIS 412 million); the Bank - NIS 386 million (2005: NIS 353 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 128 million (2005 - NIS 125 million); and for the Bank - NIS 101 million (2005 - NIS 98 million).

**C.** 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%. The amount of the provision at balance sheet date: Consolidated – NIS 432 million (2005: NIS 380 million); the Bank - NIS 344 million (2005: NIS 326 million).

## 16. EMPLOYEE BENEFITS (CONTINUED)

**D.** On October 10, 2005, the Chief Actuary at the Capital Markets, Insurance and Savings Department of the Ministry of Finance informed the managements of insurance companies that the determination of pension coefficients and evaluation of the reserves in respect of pension life assurance policies shall be made in accordance with the recommendations relating to the mortality base, presented in the paper published by the Supervisor of Insurance in April 2005, to be updated from time to time, this beginning with the financial statements in respect of the first quarter of 2006.

The Supervisor of Banks informed the Bank that it is his intention to apply the said mortality basis also to banking corporations.

The Bank elected to apply the Supervisor's notice at an earlier stage and included in the financial statements in the financial statements as of December 31, 2005 a provision of NIS 12 million, based on the actuary's evaluation of the effect of the change in the said mortality basis.

### E. THE PROVISION AND DEPOSITS FOR EMPLOYEES' SEVERANCE PAY ARE AS FOLLOWS:

	Consolidated		The Bank	
	December 31			
	2006	2005	2006	2005
	in NIS millions			
Deposits	2,181	2,181	1,917	1,911
Provision	1,702	1,661	1,447	1,432
Excess of deposit over provision	479	520	470	479
The excess (shortage) of amounts deposited over the provision is included in the item:				
Other assets (Note 8)	482	522	470	479
Other liabilities (Note 12)	(3)	(2)	-	-
Total, Net	479	520	470	479

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 2004-2006, 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 is entitled 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. An award plan for members of the Bank's management.** In March 26, 2006, the board of directors of the Bank resolved to approve an award plan to members of the Bank's management, including the Internal Auditor. In terms of the plan the Bank is to grant to every member of management an annual award in respect of each year in which he served as member of management in the period from 2006 to 2010.

The annual award would be derived in part from the rate of the annual return on equity and in part by the decision of the President and CEO (within the framework of an additional budget, the volume of which will also be derived from the annual rate of return on equity), in a differential manner according to his judgment, and in accordance with the extent of achievement of the specific targets set by him for each management member. The said distribution requires the approval of the board of directors of the Bank.

The minimum annual rate of return required for a distribution of an award to members of management in a particular year, is 8.5%.

The board of directors of the Bank is entitled to eliminate exceptional profits or losses, that do not stem from current operations, for the purpose of computing the rate of annual return on equity. The board of directors of the Bank is entitled to change or cancel the award plan, in whole or in part, provided that the change or cancellation would take effect in the calendar year following the year in which the decision for cancellation or change was taken.

The award plan to members of management of the Bank, including the Internal Auditor, was ratified by the Audit Committee and by the Board of Directors at the meetings held on July 15 and 26, 2006.

For details regarding a stock option plan for officers of the Bank, see Note 13 D.

**16. EMPLOYEE BENEFITS (CONTINUED)**

- I. IDB New York has a liability for the payment of pensions to its employees, in respect of which it has established a pension fund, in which contributions by the employer and by the employees are deposited. The annual deposits with the fund are based on calculations made by an independent actuary. Following are the principal details concerning the said liability:

	As at December 31	
	2006	2005
	In US\$ millions	
The actuarial liability for pension payments	32	37
Fair value of the pension fund assets	24	31
The actuarial liability for pension payments, net of market value of the Fund's assets	(10)	(6)
Balance of the deferred actuarial loss	8	4
The outstanding net liability of the pension fund, as reflected in the financial statements (Note 13)	2	2
Pension payment expenses recognized in the income statement	3	3
The assumptions used for the measurement of the components of the pension plan:		
	%	%
The annual discount rate	5.88	5.75
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	4.25

- J. For details as to an agreement signed in February 2005, 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 32 hereunder.

**17. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS  
CONSOLIDATED**

	DECEMBER 31, 2006						
	Israeli currency		Foreign currency <sup>(1)</sup>			Non-monetary items	Total
	Non-linked	Linked to the CPI	In US\$	In Euro	In other currencies		
in NIS millions							
<b>Assets</b>							
Cash and deposits with banks	3,003	1,250	14,525	4,712	1,916	-	25,406
Securities	13,669	1,946	20,368	1,308	416	1,207	38,914
Credit granted to the public	40,520	17,793	25,273	2,907	3,682	-	90,175
Credit granted to the Government	8	3	7	-	-	-	18
Investments in affiliated companies	6	7	1	-	-	1,577	1,591
Buildings and equipment	-	-	-	-	-	2,614	2,614
Other assets	1,735	19	1,672	37	76	281	3,820
<b>Total assets</b>	<b>58,941</b>	<b>21,018</b>	<b>61,846</b>	<b>8,964</b>	<b>6,090</b>	<b>5,679</b>	<b>162,538</b>
<b>Liabilities</b>							
Deposits from the public	49,722	12,095	57,465	8,437	2,798	-	130,517
Deposits from banks	2,785	681	4,341	264	28	-	8,099
Deposits from the Government	49	6	64	-	-	-	119
Subordinated capital notes	128	6,174	-	-	-	-	6,302
Other liabilities	7,285	126	1,288	53	118	264	9,134
<b>Total liabilities</b>	<b>59,969</b>	<b>19,082</b>	<b>63,158</b>	<b>8,754</b>	<b>2,944</b>	<b>264</b>	<b>154,171</b>
Difference	(1,028)	1,936	(1,312)	210	3,146	5,415	8,367
<b>Effect of hedging derivative instruments:</b>							
Derivative instruments (except for options)	-	-	157	38	(195)	-	-
<b>Effect of non hedging derivative instruments:</b>							
Derivative instruments (except for options)	2,549	(797)	1,320	(381)	(2,691)	-	-
Options in the money, net (in terms of base asset)	28	-	(90)	66	(5)	1	-
Options out of the money, net (in terms of base asset)	475	59	(536)	-	1	1	-
<b>Total</b>	<b>2,024</b>	<b>1,198</b>	<b>(461)</b>	<b>(67)</b>	<b>256</b>	<b>5,417</b>	<b>8,367</b>
Options in the money, net (discounted nominal value)	1,253	-	(1,151)	66	(169)	1	-
Options out of the money, net (discounted nominal value)	1,031	206	(1,285)	46	1	1	-

Footnote:

(1) Includes those linked to foreign currency.

**17. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS  
CONSOLIDATED (CONTINUED)**

	DECEMBER 31, 2005						
	Israeli currency		Foreign currency <sup>(1)</sup>			Non-monetary items	Total
	Non-linked	Linked to the CPI	In US\$	In Euro	In other currencies		
in NIS millions							
<b>Assets</b>							
Cash and deposits with banks	1,095	1,417	10,929	5,439	1,706	-	20,586
Securities	15,089	708	24,076	925	327	1,063	42,188
Credit granted to the public	**35,712	19,196	27,638	2,169	3,101	-	87,816
Credit granted to the Government	-	5	87	-	-	-	92
Investments in affiliated companies	4	2	1	-	-	1,520	1,527
Buildings and equipment	-	-	-	-	-	2,268	2,268
Other assets	1,457	17	2,591	14	56	108	4,243
<b>Total assets</b>	<b>53,357</b>	<b>21,345</b>	<b>65,322</b>	<b>8,547</b>	<b>5,190</b>	<b>4,959</b>	<b>158,720</b>
<b>Liabilities</b>							
Deposits from the public	*46,221	12,947	60,287	8,193	2,637	-	130,285
Deposits from banks	1,396	752	4,122	210	38	-	6,518
Deposits from the Government	*54	12	70	-	-	-	136
Subordinated capital notes	151	5,191	-	-	-	-	5,342
Other liabilities	**6,773	119	2,097	94	44	127	9,254
<b>Total liabilities</b>	<b>54,595</b>	<b>19,021</b>	<b>66,576</b>	<b>8,497</b>	<b>2,719</b>	<b>127</b>	<b>151,535</b>
Difference	(1,238)	2,324	(1,254)	50	2,471	4,832	7,185
<b>Effect of hedging derivative instruments:</b>							
Derivative instruments (except for options)	-	-	27	126	(153)	-	-
<b>Effect of non hedging derivative instruments:</b>							
Derivative instruments (except for options)	2,231	(733)	931	(222)	(2,207)	-	-
Options in the money, net (in terms of base asset)	285	56	(456)	110	3	2	-
Options out of the money, net (in terms of base asset)	(201)	35	203	(73)	36	-	-
<b>Total</b>	<b>1,077</b>	<b>1,682</b>	<b>(549)</b>	<b>(9)</b>	<b>150</b>	<b>4,834</b>	<b>7,185</b>
Options in the money, net (discounted nominal value)	598	61	(828)	167	-	2	-
Options out of the money, net (discounted nominal value)	(750)	209	653	(89)	(23)	-	-

\* Reclassified.

\*\* Restated - see Note 1z.

Footnote:

(1) Includes those linked to foreign currency.

**17. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS (CONTINUED)**  
**BANK**

	DECEMBER 31, 2006						
	Israeli currency		Foreign currency <sup>(1)</sup>			Non-monetary items	Total
	Non-linked	Linked to the CPI	In US\$	In Euro	In other currencies		
	in NIS millions						
<b>Assets</b>							
Cash and deposits with banks	3,118	6,525	11,878	4,629	1,781	-	27,931
Securities	12,703	1,136	1,181	1,159	34	724	16,937
Credit granted to the public	28,784	6,782	9,972	2,586	3,343	-	51,467
Credit granted to Governments	-	3	4	-	-	-	7
Investments in affiliated companies	4	146	63	-	-	6,405	6,618
Buildings and equipment	-	-	-	-	-	2,032	2,032
Other assets	1,346	12	290	32	61	222	1,963
<b>Total assets</b>	<b>45,955</b>	<b>14,604</b>	<b>23,388</b>	<b>8,406</b>	<b>5,219</b>	<b>9,383</b>	<b>106,955</b>
<b>Liabilities</b>							
Deposits from the public	40,463	9,749	24,683	7,549	2,266	-	84,710
Deposits from banks	3,192	176	1,857	246	55	-	5,526
Deposits from the Government	-	5	-	-	-	-	5
Subordinated capital notes	213	3,667	-	-	-	-	3,880
Other liabilities	4,079	84	381	48	99	178	4,869
<b>Total liabilities</b>	<b>47,947</b>	<b>13,681</b>	<b>26,921</b>	<b>7,843</b>	<b>2,420</b>	<b>178</b>	<b>98,990</b>
Difference	(1,992)	923	(3,533)	563	2,799	9,205	7,965
<b>Effect of non hedging derivative instruments:</b>							
Derivative instruments (except for options)	2,374	(407)	1,474	(639)	(2,802)	-	-
Options in the money, net, (in terms of base asset)	126	-	(198)	77	(5)	-	-
Options out of the money, net, (in terms of base asset)	460	60	(520)	(1)	1	-	-
<b>Total</b>	<b>968</b>	<b>576</b>	<b>(2,777)</b>	<b>-</b>	<b>(7)</b>	<b>9,205</b>	<b>7,965</b>
Options in the money, net, (discounted nominal value)	1,007	-	(928)	90	(169)	-	-
Options out of the money, net, (discounted nominal value)	943	206	(1,209)	59	1	-	-

Footnote:

(1) Includes those linked to foreign currency.

17. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS (CONTINUED)  
BANK (CONTINUED)

	DECEMBER 31, 2005						
	Israeli currency		Foreign currency <sup>(1)</sup>			Non-monetary items	Total
	Non-linked	Linked to the CPI	In US\$	In Euro	In other currencies		
in NIS millions							
<b>Assets</b>							
Cash and deposits with banks	941	6,328	7,575	5,370	1,514	-	21,728
Securities	14,299	138	1,399	831	33	533	17,233
Credit granted to the public	**24,706	7,886	11,999	1,869	2,715	-	49,175
Credit granted to Governments	-	5	84	-	-	-	89
Investments in affiliated companies	6	144	70	-	-	6,213	6,433
Buildings and equipment	-	-	-	-	-	1,699	1,699
Other assets	1,112	7	1,135	12	46	68	2,380
<b>Total assets</b>	<b>41,064</b>	<b>14,508</b>	<b>22,262</b>	<b>8,082</b>	<b>4,308</b>	<b>8,513</b>	<b>98,737</b>
<b>Liabilities</b>							
Deposits from the public <sup>(3)</sup>	*37,429	9,682	23,644	7,404	2,123	-	80,282
Deposits from banks	1,441	183	1,067	236	43	-	2,970
Deposits from the Government	*-	10	-	-	-	-	10
Subordinated capital notes	227	3,292	-	-	-	-	3,519
Other liabilities	**3,819	92	1,130	93	31	73	5,238
<b>Total liabilities</b>	<b>42,916</b>	<b>13,259</b>	<b>25,841</b>	<b>7,733</b>	<b>2,197</b>	<b>73</b>	<b>92,019</b>
Difference	(1,852)	1,249	(3,579)	349	2,111	8,440	6,718
<b>Effect of non hedging derivative instruments:</b>							
Derivative instruments (except for options)	2,180	(728)	1,110	(423)	(2,139)	-	-
Options in the money, net, (in terms of basic asset)	352	56	(525)	114	3	-	-
Options out of the money, net, (in terms of basic asset)	(193)	35	169	(47)	36	-	-
<b>Grand total</b>	<b>487</b>	<b>612</b>	<b>(2,825)</b>	<b>(7)</b>	<b>11</b>	<b>8,440</b>	<b>6,718</b>
Options in the money, net, (discounted nominal value)	475	61	(705)	169	-	-	-
Options out of the money, net, (discounted nominal value)	(926)	209	830	(90)	(23)	-	-

\* Reclassified

\*\* Restated - see Note 1z.

Footnote:

(1) Includes those linked to foreign currency.

**18. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS AND MATURITY PERIODS<sup>(1)</sup>**  
**CONSOLIDATED (IN NIS MILLIONS)**
**A. Anticipated Future Contractual Cash Flows as of December 31, 2006**

	On demand or within 1 month	Over 1 month and up to 3 months	Over 3 months and up to 1 year	Over 1 year and up to 2 years	Over 2 years and up to 3 years
<b>Israeli currency, non-linked:</b>					
Assets	23,182	5,378	10,671	4,568	3,959
Liabilities	31,102	6,252	17,577	4,096	385
Difference	(7,920)	(874)	(6,906)	472	3,574
Derivative instruments (excluding options)	(890)	480	2,649	411	36
Options (in terms of base assets)	(246)	398	1	(78)	(35)
<b>Israeli currency, CPI-linked:</b>					
Assets	375	644	3,667	3,184	2,679
Liabilities	576	755	2,084	3,102	1,717
Difference	(201)	(111)	1,583	82	962
Derivative instruments (excluding options)	(50)	(10)	(366)	(107)	(25)
Options (in terms of base assets)	-	-	16	41	-
<b>Foreign currency-local activity<sup>(3)</sup>:</b>					
Assets	15,568	7,124	4,035	2,341	1,638
Liabilities	18,599	11,503	6,114	372	274
Difference	(3,031)	(4,379)	(2,079)	1,969	1,364
Derivative instruments (excluding options)	929	(541)	(2,185)	(334)	(27)
Options (in terms of base assets)	246	(398)	(18)	37	34
<b>Foreign currency-foreign activity of extensions:</b>					
Assets	11,051	5,635	6,316	3,780	3,153
Liabilities	16,560	7,475	6,531	2,516	2,120
Difference	(5,509)	(1,840)	(215)	1,264	1,033
<b>Non-monetary items:</b>					
Assets	-	-	-	-	-
Liabilities	-	-	-	-	-
Difference	-	-	-	-	-
Options (in terms of base assets)	-	-	1	-	1
<b>Total:</b>					
Assets	50,176	18,781	24,689	13,873	11,429
Liabilities	66,837	25,985	32,306	10,086	4,496
Difference	(16,661)	(7,204)	(7,617)	3,787	6,933
Derivative instruments (excluding options)	(11)	(71)	98	(30)	(16)
<b>B. Balance Sheet Amount at Decemver 31, 2005</b>					
<b>Total:</b>					
Assets	40,254	13,468	26,671	14,441	9,009
Liabilities	62,194	24,717	29,267	9,740	5,551
Difference	(21,940)	(11,249)	(2,596)	4,701	3,458
Derivative instruments (excluding options)	6	27	(23)	(7)	(11)
Options (in terms of base assets)	-	-	-	-	-

\* Restated - see Note 1z to the financial statements.

Footnotes:

(1) This Note presents the anticipated future contractual cash flows in respect of assets and liabilities according to linkage base and according to the remaining period to the contractual maturity date of each cash flow. The data is shown net of the provision for doubtful debts.

Over 3 years and up to 4 years	Over 4 years and up to 5 years	Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	Total cash flows	Balance sheet amount <sup>(4)</sup>	
						No fixed maturity date <sup>(2)</sup>	Total
2,986	4,287	3,568	649	70	59,318	2,697	58,941
205	177	171	269	121	60,355	41	59,969
2,781	4,110	3,397	380	(51)	(1,037)	2,656	(1,028)
16	3	3	8	-	2,716	-	2,549
1	14	(124)	532	40	503	-	503
2,418	1,939	7,318	4,488	362	27,074	253	21,018
1,964	2,484	8,267	2,578	2	23,529	74	19,082
454	(545)	(949)	1,910	360	3,545	179	1,936
(22)	(19)	(95)	(479)	-	(1,173)	-	(797)
-	-	2	-	-	59	-	59
1,981	951	2,881	732	7	37,258	816	35,459
129	101	297	41	4	37,434	27	37,400
1,852	850	2,584	691	3	(176)	789	(1,941)
4	23	115	468	-	(1,548)	-	(1,752)
(1)	(14)	122	(532)	(40)	(564)	-	(564)
1,969	1,687	4,347	5,940	17,546	61,424	29	41,441
1,219	815	1,338	-	-	38,574	-	37,456
750	872	3,009	5,940	17,546	22,850	29	3,985
-	-	-	-	-	-	5,679	5,679
-	-	-	-	-	-	264	264
-	-	-	-	-	-	5,415	5,415
-	-	-	-	-	2	-	2
9,354	8,864	18,114	11,809	17,985	185,074	9,474	162,538
3,517	3,577	10,073	2,888	127	159,892	406	154,171
5,837	5,287	8,041	8,921	17,858	25,182	9,068	8,367
(2)	7	23	(3)	-	(5)	-	-
8,273	8,473	19,284	17,056	24,963	181,892	9,791	158,720
4,781	3,871	13,458	2,198	130	155,907	289	151,535
3,492	4,602	5,826	14,858	24,833	25,985	9,502	7,185
(20)	(9)	6	-	-	(31)	-	-
-	-	-	-	-	-	-	-

(2) Includes past-due receivables totaling NIS 1,897 million (2005: NIS 1,565 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.

**18. ASSETS AND LIABILITIES - ACCORDING TO LINKAGE TERMS AND MATURITY PERIODS<sup>(1)</sup>(CONTINUED)**  
**THE BANK (IN NIS MILLIONS)**
**A. Anticipated Future Contractual Cash Flows as of December 31, 2006**

	On demand or within 1 month	Over 1 month and up to 3 months	Over 3 months and up to 1 year	Over 1 year and up to 2 years	Over 2 years and up to 3 years
<b>Israeli currency, non-linked:</b>					
Assets	16,846	3,780	8,502	3,368	3,376
Liabilities	23,278	5,701	14,686	3,613	206
Difference	(6,432)	(1,921)	(6,184)	(245)	3,170
Derivative instruments (excluding options)	(1,003)	458	2,625	410	36
Options (in terms of base assets)	(207)	390	54	125	84
<b>Israeli currency, CPI-linked:</b>					
Assets	244	477	2,636	2,396	1,906
Liabilities	194	459	1,131	2,160	1,215
Difference	50	18	1,505	236	691
Derivative instruments (excluding options)	(50)	(2)	(366)	(88)	(6)
Options (in terms of base assets)	-	-	17	41	-
<b>Foreign currency-local activity<sup>(2)</sup>:</b>					
Assets	14,374	7,043	3,732	2,353	1,520
Liabilities	16,717	10,764	5,676	191	120
Difference	(2,343)	(3,721)	(1,944)	2,162	1,400
Derivative instruments (excluding options)	1,039	(530)	(2,172)	(354)	(48)
Options (in terms of base assets)	207	(390)	(71)	(166)	(84)
<b>Foreign currency - foreign activity of extensions:</b>					
Assets	1,010	324	836	842	579
Liabilities	1,614	1,277	246	6	1
Difference	(604)	(953)	590	836	578
<b>Non-monetary items:</b>					
Assets	-	-	-	-	-
Liabilities	-	-	-	-	-
Difference	-	-	-	-	-
<b>Total:</b>					
Assets	32,474	11,624	15,706	8,959	7,381
Liabilities	41,803	18,201	21,739	5,970	1,542
Difference	(9,329)	(6,577)	(6,033)	2,989	5,839
Derivative instruments (excluding options)	(14)	(74)	87	(32)	(18)
Options (in terms of base assets)	-	-	-	-	-
<b>B. Balance Sheet Amount at Decemver 31, 2005</b>					
<b>Total:</b>					
Assets	26,317	9,131	17,306	9,706	6,097
Liabilities	38,292	16,539	19,244	6,032	1,746
Difference	(11,975)	(7,408)	(1,938)	3,674	4,351
Derivative instruments (excluding options)	5	23	(23)	(7)	(11)
Options (in terms of base assets)	-	-	-	-	-

\* Restated - see Note 1z to the financial statements.

Footnotes:

(1) This Note presents the anticipated future contractual cash flows in respect of assets and liabilities according to linkage base and according to the remaining period to the contractual maturity date of each cash flow. The data is shown net of the provision for doubtful debts, the allocation of which over periods is made in accordance with an estimate based on the credit periods in respect of which they were made.

Over 3 years and up to 4 years	Over 4 years and up to 5 years	Over 5 years and up to 10 years	Over 10 years and up to 20 years	Over 20 years	Total cash flows	Balance sheet amount <sup>(4)</sup>	
						No fixed maturity date <sup>(2)</sup>	Total
2,557	4,078	3,315	474	55	46,351	2,012	45,955
94	125	137	207	119	48,166	127	47,947
2,463	3,953	3,178	267	(64)	(1,815)	1,885	(1,992)
13	3	(7)	1	-	2,536	-	2,374
90	37	12	1	-	586	-	586
1,747	1,712	5,245	1,298	34	17,695	252	14,604
1,366	1,783	6,087	2,618	2	17,015	74	13,681
381	(71)	(842)	(1,320)	32	680	178	923
(3)	-	-	-	-	(515)	-	(407)
-	-	2	-	-	60	-	60
2,072	840	2,233	231	1	34,399	644	33,376
72	51	275	1	-	33,867	27	34,047
2,000	789	1,958	230	1	532	617	(671)
(16)	2	13	-	-	(2,066)	-	(1,967)
(90)	(37)	(14)	(1)	-	(646)	-	(646)
159	114	-	-	-	3,864	28	3,637
1	-	-	-	-	3,145	-	3,137
158	114	-	-	-	719	28	500
-	-	-	-	-	-	9,383	9,383
-	-	-	-	-	-	178	178
-	-	-	-	-	-	9,205	9,205
6,535	6,744	10,793	2,003	90	102,309	12,319	106,955
1,533	1,959	6,499	2,826	121	102,193	406	98,990
5,002	4,785	4,294	(823)	(31)	116	11,913	7,965
(6)	5	6	1	-	(45)	-	-
-	-	-	-	-	-	-	-
5,651	5,995	12,679	1,856	185	94,923	11,867	98,737
1,306	1,495	7,704	1,989	117	94,464	290	92,019
4,345	4,500	4,975	(133)	68	459	11,577	6,718
(20)	(9)	6	-	-	(36)	-	-
-	-	-	-	-	-	-	-

(2) Includes past-due receivables totaling NIS 1,335 million (2005: NIS 1,177 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.

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS**

	Consolidated		The Bank	
	December 31		December 31	
	2006	2005	2006	2005

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	1,982	1,944	553	564
Credit guarantees	1,976	*2,006	1,367	1,258
Guarantees for home purchasers	2,834	*3,036	1,381	1,303
Other guarantees and obligations <sup>(3)</sup>	3,898	*2,296	3,341	*1,902
Unutilized credit line for credit cards	12,862	12,250	8,251	8,212
Unutilized revolving and other credit lines	8,457	4,500	7,200	3,905
Irrevocable commitments to extend credit approved but not yet granted	11,341	12,168	4,000	5,188
Commitment to issue guarantees	2,732	2,105	2,045	1,258

**B. Off-Balance Sheet Commitment at Year-End**
**Regarding activity based on loan repayments<sup>(1)</sup>**

1. Balance of loans granted out of deposits repayable

 according to the repayment of the loans<sup>(2)</sup>

Israeli currency - non linked	291	272	257	233
Israeli currency - linked to the CPI	2,194	2,322	32	41
Foreign currency	723	778	723	779
<b>Total</b>	<b>3,208</b>	<b>3,372</b>	<b>1,012</b>	<b>1,053</b>

\* Reclassified

Footnotes:

(1) 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).

(2) Standing loans and government deposits made in respect thereof, totaling NIS 211 million (2005: NIS 255 million), have not been included in the table.

(3) See Note C 6.

## 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<sup>(1)</sup>

December 31,2006	2005						Total	Total
	Up to 1 year	Over 1 and year up to 3 years	Over 3 and years up to 5 years	Over 5 years and and up to 10 years	Over 10 years and up to 20 years	Over 20 years		
Future contractual flows	18	31	28	56	51	2	186	201
Expected future flows based on Management's estimates of early repayments	18	30	25	45	34	1	153	168
Discounted expected future flows based on Management's estimates of early repayments <sup>(2)</sup>	17	28	22	35	22	-	124	129

## 3. Information as to the granting of loans during the year by the mortgage banks:

	31.12.2006	31.12.2005
Loans out of deposits repayable according to the repayment of loans	95	107
Standing loans	2	1

## 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 total amounts repayable according to collection of loans granted therefrom.

(2) Discounted at the rate of 3.78% (2005: 4.01%).

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)**
**C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS**

	Consolidated		The Bank	
	December 31		December 31	
	2006	2005	2006	2005
	in NIS millions			
1. Long-term lease contracts - rent payable in future years <sup>(2)</sup> :				
First year	88	79	42	39
Second year	74	75	35	37
Third year	63	48	27	24
Fourth year	47	42	16	20
Fifth year	53	35	8	15
Sixth year and thereafter	145	153	12	30
Total	470	432	140	165
2. Guarantees to ensure rights of members				
in provident funds <sup>(3)</sup> (nominal)	6,699	7,170	6,699	7,170
3. Commitment to acquire buildings and equipment				
	26	15	1	7
4. Borrowed securities <sup>(1)</sup>				
	316	425	28	111

## Footnotes:

(1) Not including transactions of lending securities to cover securities short sales, where the Bank serves as an at-risk broker between customers and institutional bodies, which are presented in the Bank's balance sheet as credit to the public and as deposits of the public, respectively. The balance of these transactions at December 31, 2006 was NIS 35.

(2) For details as to long-term lease agreement, see section 19 hereunder.

(3) See Section 21 hereunder.

6. The Bank and Mercantile Discount Bank, which are members of the Ma'of Clearing House Ltd., are responsible along with other Ma'of Clearing House members towards the Clearing House for any financial obligations resulting from option transactions conducted on the Stock Exchange.

For this purpose, the Ma'of Clearing House established a risk fund. The share of the Bank in the risk fund as of December 31, 2006, amounts to NIS \_\_ million, comprising \_\_% of the total risk fund at that date in favor of the Ma'of Clearing House by way of securities (Government bonds) in an amount that would cover their possible liability in respect of their share in the risk fund, as stated, as well as an additional amount derived from the volume of operations in this field of each of the banks (see Note 15 F and G).

Each of the banks is also committed to pay the Ma'of Clearing House any monetary charge that may result from operation of their customers involving the writing of options traded within the framework of the Clearing House.

7. A mutual guarantee of members of the Tel-Aviv Stock Exchange Clearing House was in effect until May 2005, according to which members of the Clearing House were obliged at the request of the Clearing House, to cover any loss sustained by the Clearing House as a result of a shortage of securities or default of one of its members.

The share of each member in such loss is based on the ratio of the monetary turnover of the member to the overall monetary turnover of all members responsible for covering the loss caused to the Clearing House, over a period of twelve months ending on the last day of the month preceding the month in which the event causing the loss occurred.

The validity of this guarantee expired in May 2005, and as from that date the arrangements with the Stock Exchange Clearing House were changed according to the articles of the Stock Exchange and the byelaws of the Clearing

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)****C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)**

House. The members are committed towards the Clearing House to cover any amount resulting from the obligations on behalf of themselves or their customers as well as for other Stock Exchange members who are not members of the Clearing House and their customers, in respect of transactions conducted by way of the Clearing House. In addition, each member is responsible for its share in the risk fund based on the ratio of the monetary turnover as described above. As collateral for their obligations towards the Clearing House, the Bank and Mercantile Discount Bank pledged their rights to accounts maintained at the Clearing House (in which securities are deposited) and at another bank (in which cash is deposited). (See Note 15 L and M).

8. a) The Bank is committed to indemnify the subsidiary Tachlit Investment House Ltd. (hereinafter – “Tachlit”) in respect of professional liability lawsuits filed against it in excess of the insured amount of US\$12 million, purchased by Tachlit. The amount of indemnification is limited to US\$4.5 million in accordance with a claim that will be received from Tachlit until March 31, 2007
- b) Tachlit is committed towards Tachlit Global Dollar Ltd., held by Tachlit at the rate of 20%, and toward Synergetica Ltd., which owns approximately 80% of Tachlit Global Dollar Ltd., to transfer to Tachlit Global Dollar Ltd., a company that issues basket certificates, a total amount not exceeding US\$1 million, to cover its current operating expenses and to fulfill its obligations towards the holders of its basket certificates. The Bank granted Tachlit an indemnification as collateral for the said commitment.
- A similar indemnification from the Bank, in an identical amount, was given by the Bank in respect of Tachlit Basket Certificates Ltd.
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.
- 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

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)****C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)**

d) Discount Manpikim Ltd., a wholly owned and controlled subsidiary of the Bank, has granted indemnification to its Directors, with respect to a financial liability that might be imposed on any of them and with respect to reasonable legal expenses in connection with a Prospectus for the public issue and the listing for trade of subordinated capital notes, published in March 2004, of subordinated capital notes in a total amount of NIS 500 million, under terms specified in the letter of indemnification. In any event, the maximum amount of the indemnification payable to all Directors as a group will not exceed the gross proceeds of the said issue.

Discount Manpikim Ltd. has granted its Directors identical indemnification in connection with a Prospectus regarding the offer to the public and the listing for trade of subordinated capital notes issued in November 2004, of subordinated capital notes in a total amount of NIS 600 million.

e) Discount Manpikim Ltd. granted in September 2006 indemnification to directors as well as the CEO of the company with respect to monetary liability that might be imposed on any of them and with respect to reasonable litigation expenses in connection with a shelf prospectus for the issue and listing for trade of subordinated capital notes, dated September 2006, and this under terms specified in the letter of indemnification. In any event, the maximum amount of the indemnification granted to all of the directors as a whole and to the CEO shall not exceed the gross proceeds of the said issue, and in any case no more than NIS 1.5 billion.

f) Concurrently with approval of the engagement in an agreement for the sale of the provident fund management activity, as stated in Note 6 E 5 above, the Bank committed to indemnify Discount Management of Provident Fund Ltd. and its officers under conditions and circumstances in which the Bank is permitted to grant such indemnification in accordance with the relevant provisions of the Companies Law, with respect to their activity as officers of the company relating to approval of the sale agreement and implementation of the said sale, including any financial liabilities, expenses, consultation with legal and other experts, as required, and reasonable litigation expenses, provided that the cumulative amount required to be paid by the Bank shall not exceed the consideration receivable by the Bank under the sale agreement, and provided that realization of the indemnification will not impair the capital adequacy ratio, which the Bank is required to maintain under Proper Banking Management Directive No. 311, all as stated in the indemnification letter.

- 11.** 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 found; and a similar indemnification that the Bank gave to an expert who had provided the bank with an economic opinion.

- 12.** 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

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)****C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)**

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.

- 13.** 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.

- 14.** Various actions against the Bank and its consolidated subsidiaries:

Various actions are pending against the Bank and its consolidated subsidiaries. These include class action suits and requests to approve actions as class action suits. Among others, allegations are raised in these claims with regard to the unlawful debiting of interest and/or the debiting of interest not in accordance with agreements, subjecting one service to another service, failure to execute instructions, applications for the confirmation of attachment orders in respect of attachments served by third parties on the assets of debtors which they allege are held by the Bank, the unlawful debiting of accounts, mistakes in value dates, the invalidity of collateral security and the realization thereof, applications for injunctions ordering the Bank to refrain from paying out bank guarantees or documentary credit, as well as allegations pertaining to provident funds, securities, construction loans, applications for the removal of restrictions on an account pursuant to the Dishonored Checks Law, 1981. In the opinion of the Management of the Bank, which is based, inter alia, on legal opinions and/or on the opinion of managements of its consolidated subsidiaries, which are

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

based upon the opinion of their counsels, respectively, as the case may be, adequate provisions have been included in the financial statements, where required.

The total exposure with respect to claims filed against the Bank and its consolidated subsidiaries, whose prospects of materializing, in whole or in part, has been assessed as reasonably possible, amounts to approximately NIS 124 million.

#### 14.1 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:

**14.1.1** In November 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. 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. According to the plaintiff, who maintained a business account with the Bank, the Bank exploited his mental and physical condition, and made use of his account and the accounts of his family members as if they belonged to the Bank, while opening dozens of additional accounts without permission, concealing information, forging signatures, taking out loans in the name of the plaintiff, buying and selling securities fictitiously and embezzling funds.

Hearings in respect of this claim commenced in January 2004, and continue to date.

The Bank, *inter alia*, raised an argument of obsolescence and the Court determined that this argument will be considered in the framework of the verdict.

Based on the opinion of legal counsel, management of the Bank believes that the amount of the claim is excessive and the arguments of the plaintiff are baseless.

**14.1.2** 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, the plaintiff 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

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

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. The plaintiff also submitted an objection to this petition.

On April 8, 2005, the Federal Court in Los Angeles dismissed the action on the grounds that the appropriate forum for dealing with this action is the Court in Israel. The Court did not refer to the other arguments of the Bank including the argument regarding the jurisdiction.

On May 6, 2005, the plaintiff appealed the said decision. The Court has fixed dates for the submission of briefs. The parties submitted their summaries in writing and a hearing on the appeal was fixed for April 9, 2007.

The Management of the Bank is of the opinion that the amount claimed is highly excessive. It should be noted in this regard that, in the United States, a plaintiff is not required to pay court fees calculated according to the amount of the claim. Dismissal of the appeal does not preclude the filing of a claim in Israel. 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.

#### 14.2 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.

See section 15.1 hereafter for details of an action filed against the Bank in relation to the same subject matter, based on other grounds.

#### 14.3 On November 27, 2002, a personal legal action was filed against the Bank and against a third party (also in relation to the subject matter of the proceedings discussed in Note 14.2 above and in note 15.1 hereunder) by a customer of the Bank, who is also the brother of that third party with whom he held control over a publicly traded company. The action is in an amount of NIS 24 million. On February 24, 2003, the Court permitted the claimant to amend the amount of the claim to NIS 45 million.

The claimant alleges that the Bank and the third party, contrary to the law, conspired to artificially cause the public issue of shares by the said company to succeed, by opening bogus accounts and unlawfully providing credit to these accounts, so that the share issue will deem to comply with the requirements of the Stock Exchange as to proper dispersal and minimum holdings. The claimant further alleges that even after the issue of the shares, the Bank and the third party continued to carry out unlawful transactions in the shares by way of share price hiking.

The Bank had submitted a defense brief on April 10, 2003. The other defendant (the said third party) submitted a defense brief on May 27, 2004.

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)****C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)**

In 2005, mediation proceedings were conducted in this regard, which terminated unsuccessfully in January 2006.

During March 2007, the Court is to determine the date for submission of affidavits of principal evidence and also the dates for additional hearings in respect of the claim.

**14.4 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. It was argued, inter alia, that the Bank compelled the plaintiffs to purchase these insurance policies as a condition for signing the loan and mortgage agreements. The amount set in the class-action suit is NIS 500 million, with no specific allocation to the banks involved.

Whereas, with respect to another request to approve an action as a class action, in a matter practically identical, the Court had already handed down its decision, which was appealed against, the Judge presiding in this case has decided that it will be heard only after the Supreme Court will issue a judgment in principle on the matters in dispute that were raised in the appeal against the ruling already given with respect to the other motion.

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. A verdict has also been given in an additional hearing in this case at the Supreme Court, according to which it is not possible to file a class action suit under Regulation 29 of the Civil Code Regulations.

In a preliminary hearing held on January 26, 2006, the plaintiff waived the cause of action in as much as they rely on the said Regulation 29. The hearing of this action was again suspended with no date.

**15. 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.

**15.1 A request to approve a certain action against the Bank as class action suits.**

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),

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

violating the Banking Laws (Banking Rules Customer Service [Investment consulting]), violated proper banking procedures, caused damaging injustice (negligence, fraud and violation of legal obligations) and also performed illegal acts.

It should be noted that the corporation and its Chief Executive Officer were indicted in criminal proceedings to which the Bank was not a party.

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.

On October 23, 2006, the District Court admitted one of the preliminary motions served by the Bank and Mercantile Discount Bank, and ordered the appellants to pay the Court fees in respect of the personal claim of each of them by November 30, 2006. The fee that the appellants were ordered to pay amounts to NIS 70 thousand. The Court also ruled that if the appellants do not comply, their motion to approve their claim as a class action would be dismissed. As to the other preliminary motions, the Court has decided to hear them only after evidence of fees remittance, as ordered, is presented.

On November 20, 2006, the appellants paid NIS 20 thousand in respect of the first half of the Court fees. On November 30, 2006, the Bank petitioned the Court for dismissal of the claim following the non-payment of the full amount of the first half of the Court fees, as alleged by the Bank. No decision has yet been received in this regard.

See section 14.2 above for details of the action filed against Mercantile Discount Bank in relation to the same subject matter, based on other grounds. For details of an additional action filed against the Bank and against a third party in relation to the same subject matter, see Section 14.3 above.

- 15.2** On September 1, 2004, an application for exemption from the Court fee was submitted to the Tel Aviv District Court in connection with a suit in a sum of NIS 500 million brought by the liquidators of a company against forty defendants, one of which was the Bank. The Court partially accepted the request for exemption and determined the fee at NIS 320 thousand.

The suit against the Bank turns on three causes only, which relate to alleged injury valued at \$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.

It should be noted that the liquidators claim that the behavior of the Bank as described above led to the final liquidation of the company without any specific claims having been made by the liquidators as to the injury attributable to the

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)****C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)**

Bank in relation to this cause of action.

The Bank submitted its defense brief on October 3, 2006. A date for a hearing on the case has not yet been fixed.

- 15.3** On December 8, 2005, a former customer of the Bank (hereinafter – ‘the plaintiff’) filed a lawsuit in the amount of US\$300 million in the Court of the State of California, USA, being a counterclaim following proceedings instituted by the Bank in the United States, for the enforcement of Court rulings given in Israel against the Plaintiff, in an amount of US\$13 million. It should be noted that on January 15, 2007, the Israeli Supreme Court dismissed the plaintiff’s appeal of the verdicts against him, the enforcement of which is the subject of the claim filed by the Bank in the United States. The counterclaim is based on the argument that the Bank had violated its obligation to provide credit to the plaintiff and to a company of which he was one of the owners (hereinafter – “the company”), for the purpose of purchasing another company. It is also alleged that false and negligent representation had been provided to the plaintiff.

The direct damages were set at an amount of at least US\$100 million in respect of loss of earnings as a result of the failure of the transaction to purchase that other company, and at least US\$200 million in respect of loss of earnings as a result of the collapse of the company. Punitive damages are also claimed in an amount not estimated by the plaintiff. It should be noted that a similar action filed by the plaintiff and others already in 2000 was dismissed in limine with the consent of the company’s Liquidator, and that the proceedings instituted in the USA by the plaintiff several years ago with respect to the issue which is the subject of the claim, had been dismissed by the Court in New York, following the admittance of the Bank’s argument regarding improper forum.

The Bank motioned the Court in the United States for a dismissal in limine of the action on grounds of lack of authority due to the condition of exclusive jurisdiction, improper forum and immunity.

At this stage, the preliminary arguments of the Bank have not yet been heard, as a preliminary hearing is in process regarding the appropriate Court to deal with such preliminary arguments (a Federal Court or the Court of the State of California). No final ruling has been given in this matter as yet.

- 15.4** Motion for approval of a certain action against the Bank and against Mercantile Discount Bank as a class action suit: On January 25, 2006, an action was filed at the Tel-Aviv District Court against the Bank and against Mercantile Discount Bank (hereinafter – “the banks”), together with a motion to approve the action as a class action suit.

The plaintiffs, customers of the banks, allege that in 2001 the banks changed the method of interest computation in a manner that they had been charged on deviation from a credit facility with an exceptional addition to the maximum interest charge, instead of an exceptional addition to the interest charge agreed between them and the bank, as was previously customary.

The plaintiffs allege that the banks have violated the principles of fair disclosure determined under the Banking Law (Customer service), 1981 (hereinafter – “the banking Law”), and have thus acted contrary to sections 5 and 15 of the banking law; moreover, they ascribe to the banks a transgression of Sections 3 and 4 of the banking law, prohibition on misleading customers and the exploitation of customers’ ignorance and lack of experience.

The plaintiffs motioned the Court for a declaration that the mechanism of interest computation implemented since 2001 is illegal, that the agreements regarding interest rates that they require customers to sign are not in compliance with the requirements of the law in accordance with the principles of fair disclosure, and accordingly instruct the two banks to refund all the customers the excessive interest paid by them (the difference between the agreed risk premium and the maximum addition, in respect of all those customers who had paid the reduced risk premium but

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

were charged with excessive interest in the period from December 31, 2001 to date of filing of the action).

The plaintiffs claim a personal damage of NIS 5,954 as regards Discount Bank and NIS 13,985 as regards Mercantile Bank. The Plaintiffs estimate that the total refundable amount to be charged to Discount Bank is NIS 44 million and NIS 10 million to be charged to Mercantile Discount Bank. The Bank filed its response to the motion for approval. The Bank and the plaintiffs reached a procedural agreement, according to which as part of the response of the plaintiffs to the response of the Bank, a chapter is to be included dealing with the application of the new Law to the action, and the Bank would be entitled to respond to this chapter only.

- 15.5** A lawsuit was filed on September 12, 2006, against the Bank, Bank Leumi Le'Israel Ltd. and Bank Hapoalim Ltd., together with a motion for approval of the lawsuit as a class action suit. The claimant assess the amount of the claim at NIS 7 billion in respect of all the defendants, while reserving the right of amending the amount according to developments in the case.

The claimant argues that the defendant banks provide most of the credit to the public (about 80%) and that they exploit their central position in the credit market in order to regulate between them the interest rate, credit allocation commission and ledger fees in everything relating to non-linked Shekel credit accounts in general, and to current loan accounts particularly.

As argued by the claimant, the complete similarity between the three banks resulted in enormous profits on the one hand, and in an enormous loss to the public and to the economy on the other hand. The claim is based on the findings of the Bachar Committee and on data provided by the Bank of Israel as well as on the financial reports of the defendant banks for the years 1998-2005.

The claimant argues that it has a cause of action both under the Restrictive Trade Practices Law, the case constituting a prohibited Binding Arrangement, and under the Banking Law (Customer Service), as according to their claim the banks took advantage of the customers' distress, ignorance and lack of experience to provide them with banking services under unreasonable terms.

The claimant submits the claim in respect of the personal loss caused to it by conducting its account at the Bank, as well as requesting permission to sue on behalf of all the customers of the Banks who received non-linked Shekel credit based on the prime rate interest, as well as on behalf of business customers who received non-linked Shekel credit in current loan accounts.

The relief claimed is a retroactive reduction in the prime rate of interest and in the interest on current loan accounts, cancellation of the credit allocation commission and a reduction in ledger fees, all relating to interest and commission fees charged in the last decade.

The Bank has not yet responded to the motion for approval of a Class Action Suit.

- 15.6** On June 19, 2006, an action was filed together with a motion for its approval as a class action against the State of Israel and 31 other defendants, including the Bank, Mercantile Discount Bank, Discount Management of Provident Fund and the Provident funds of Mercantile Discount Bank.

The claimants allege that the defendants have unlawfully received payments in respect of foreclosures imposed by those who were granted execution through the magnetic media. The principal claim is that the defendants do not provide the service required by law, in that they do not provide full and detailed information in their reply to the Bailiff Office, and accordingly are not entitled to the payment determined in the regulations.

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)****C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)**

The amount of the claim against all defendants totals NIS 233 million. The claim does not specify the amount claimed from each of the defendants. The Bank estimates that the maximum exposure of the companies of the Discount Group involved in this case would not exceed NIS 10 million.

On October 18, 2006, the Bank motioned the Court for the dismissal of the claim in limine concurrently with a plea for extension of the date for submission of a response brief to the motion for approval of the claim as a class action. As claimed by the Bank, the claim is to be dismissed being based on a cause existing between the Bank and its customer, while the Claimants are not considered customers of the Bank and the service being the subject of the claim does not constitute a banking service. A decision with respect to this motion has not as yet been given.

- 15.7** On November 23, 2006, a lawsuit was filed to the Jerusalem District Court together with a motion for its approval as a class action suit against the Bank, Bank Hapoalim BM and Bank Leumi Le Israel BM. The claimants assess the amount of the claim at between NIS 5.2 and NIS 5.6 billion for all the defendants, while they reserve the right to amend the claim brief. In the claim brief the claimants argue that the defendant banks charge the private household sector interest at an exorbitant rate, which is much higher than the interest rate charged to the commercial and business sectors, this without any economic and commercial justification. According to the claimants, they have a cause of action under the Restrictive Trade Practices Law, due to the defendant banks constituting, as alleged by them, a monopoly, which according to them misuses its monopolistic power, and because, as they claim, there exists prima facie a binding contract between the defendant banks, and also under the Banking Law (Customer service) and under the Consumer Protection Law in respect of - according to their claim - the misleading of customers while utilizing their distress and ignorance for engaging them in transactions at unreasonable terms and/or for the purpose of receiving consideration that exceeds the accepted consideration.

The claimant apply for relief by way of the refund of interest at an average yearly rate of 2.2% in respect of the credit taken in the past seven years by each member of the class, which the claimant assess at about 950 thousand account holders, holding some 2 million bank accounts. The personal claim of each member is assessed by the claimants at between a few Shekels and NIS 10,000, while the amount of the average claim is estimated by them to be NIS 2,630 per class member. The personal claim of one of the claimants who owns a bank account amounts to NIS 430.

The Bank has not yet responded to the motion for approval of the class action.

- 15.8** On January 31, 2007, members of provident funds and of further education funds filed a lawsuit at the Tel-Aviv District Court together with a motion to approve the lawsuit as a class action suit, against the Bank and two other banks.

The plaintiffs allege that the banks collected excessive commissions with respect to securities operations of provident funds and further education funds managed by them, while exploiting their control over these funds. Among other things, the plaintiffs base their claim upon the Report by the State Comptroller and Ombudsman for 2003.

The plaintiffs allege that the banks violated various provisions of the Banking Law, the Banking Regulations and the Rules for approval of provident funds, relating, among other things, to the duty of fair disclosure, investment consultancy and customer service.

The plaintiffs' petition for the reimbursement of all commissions collected from the provident and further education funds in respect of securities operations, and alternatively, determining lower rates for such commissions and the repayment of the difference.

The plaintiffs assess the claim against all the Defendants at NIS 200 million, without allocating the amount among the

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

Defendants. According to an annex attached to the claim brief, the share of the Bank amounts to NIS 50 million.

The Bank has not yet responded to the motion for approval of the class action.

#### 15.9 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 borrowers are insured. The action is for an amount of NIS 105 million.

The borrowers claim, inter alia, that DMB has insured their properties for amounts which exceed their reinstatement value, since the insured amounts included the land component, and that the sum insured was increased in excess of the increase in the Consumer Price Index.

On September 10, 2000, DMB filed its response to the petition for approval of a class action suit, in which the Court is requested to dismiss the petition in limine and as regards its substance. It should be noted that Phoenix Insurance also responded to the petition requesting the Court dismiss the petition in limine and as regards its substance.

On October 29, 2000, the claimants submitted their reply to the above response, in which they repeat the request for approval of a class action suit.

On December 25, 2000, the Court decided that the arguments raised in this petition were similar to the arguments raised in the pleas for approval of class actions discussed in 14.4 above, and consequently the Court decided to defer the hearing of the said petition until after the verdict is given in those other pleas. The Supreme Court rejected on April 4, 2001, a plea for permission to appeal this decision.

In its decision of December 25, 2000, the District Court did not determine that proceedings against Phoenix Insurance should also be deferred. Phoenix Insurance petitioned the Supreme Court for permission to appeal in this respect. On January 28, 2002, the Supreme Court admitted the plea of Phoenix Insurance and ordered to stay proceedings against it at the District Court, as well.

The hearing of the pre trial in this action has been set for June 28, 2007.

#### 15.10. 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 DC MI 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. On May 18, 2006, the court decided, among other things, to acquit DCMI and its two former employees from the charges brought against them.

On June 26, 2006, the State Attorney placed an appeal against this verdict. This appeal has not yet been heard.

The hearing of the pre-trial in this action has been set for June 28, 2007.

#### 16. Certain requests for approval of class actions against FIBI.

The financial statements of FIBI in describing details of requests for approval of class actions that are pending against this bank and against its subsidiaries, and with respect to which management of FIBI, after consulting with legal advisors, is unable to estimate, at this stage, the prospects of these claims and therefore no provision has been made therein, make mention of the following procedure:

In 1997, claims were brought in the Tel Aviv District Court against two subsidiaries of FIBI – the First international Mortgage Bank Ltd. and Atzma'ut Mortgage and Development Bank Ltd. (hereinafter: "the mortgage banks in the First

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)****C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)**

International Group”), which in the meantime have been merged into FIBI, and against other mortgage banks, in which it was claimed that the said banks unlawfully charged borrowers with a commission relating to life assurance and property insurance policies, and that the borrowers are entitled to the refund of such amounts. These claims total approximately NIS 1.5 billion (in nominal values). A petition to approve these actions as a class action suits was also filed. The said claims and petition did not include the manner of calculation of the said amount; neither did they include details as to what part of the amount is attributed to the mortgage banks in FIBI Group.

In November 1997, the Court ruled as to the action filed in July 1997, according to which it dismissed the claim in the form of a class action according to the Banking Law (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.

In a hearing held by the Supreme Court in the above appeal on November 25, 2001, the parties accepted the suggestion of the Court to stay the hearing of the appeals until a judgment is given in another appeal case pending at the Supreme Court, in which a fundamental decision is to be given in the matter of the status, applicability and terms of Section 29 of the Civil code Regulations, a question standing at the heart of the said appeal.

On April 2, 2003, a judgment was given in that other appeal in the matter of the status and applicability of Section 29 for the purpose of submitting a class action. Therefore, on April 10, 2003, the Supreme Court decided that the parties submit their arguments in writing as to the continuation of the appeal proceedings. All the parties have already submitted their briefs as stated. The decision of the Supreme Court in the matter has not yet been given.

On September 1, 2005, a decision was given in the further hearing in the matter of the status and application of Regulation 29, which left the ruling as is. This ended, for the time being, the use of Regulation 29 as an instrument for serving class action suits.

Pursuant to the Class Action Suits Law, 2006, published on March 12, 2006, new arrangements have been established, essentially different from the laws in existence prior to the enactment of the above law, as regards to the filing of class action suits. According to the law, the Court is empowered to also apply the provisions of the new law to actions that had been pending prior to its enactment, under terms specified in the law. Until the date of publication of these financial statements, no such motions have been filed by any of the claimants as stated above.

Gross earnings recorded by FIBI Group’s mortgage activity, from management fees and services in respect of life assurance and property insurance of borrowers provided as collateral within the mortgage activity, amounted in 2006 to NIS 20.2 million, compared with NIS 21.5 2005. If the said motions were granted, the earnings of FIBI Group would be significantly reduced.

- 17.** Discount Israel Capital Markets and Investments Ltd. (“DCMI”) is a partner in several venture capital funds, and in this respect is obligated to invest in these funds. Furthermore, DCMI 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.

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

As of December 31, 2006, DCMI has a commitment to additional investments in 11 venture capital funds amounts totaling US\$39 million (as of December 31, 2005, US\$ 30 million).

DCMI, within the framework of Manif Company, also has an obligation to extend guarantees to contractors in the amount of US\$17.3 million. In addition, as of December 31, 2006, the Bank is committed to invest US\$58.3 million in a venture capital fund. Furthermore, Mercantile Discount Bank has a commitment to invest in five venture capital funds amounts totaling NIS 3.8 million, as of December 31, 2006 (as of December 31, 2005 – NIS 7 million).

- 18.** 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.

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.

Due to the complexity and scope of the project, it was initially divided into ten stages of execution called roll out. At each such stage, several systems have been released for operational use. Due to the gradual release of the systems, the project includes a material component of co-existence between the old and the new systems.

The first roll out was launched in the second half of 2003 and included infrastructure systems and the customer management system. The second roll out was launched in the second half of 2004, and among other things, included a system relating to deposits.

In the course of 2006 the Bank successfully launched the third roll out at all the branches of the Bank and of Mercantile Discount Bank. The principal modules of the system operating at the Bank after completing the third roll out are: IBM infrastructure, customers, current accounts, deposits, clearing, taxation, the main ledger, system schedules including the central commissions schedule, product system, central mailing, branch management, cash inventory management and more.

With the completion and integration of the third roll out systems, the principal assignments of integrating the core banking system purchased from Accenture and operating as the central system of the Bank, have been successfully achieved. These systems, developed as part of the Ofek Project, constitute, as stated, the center of the core banking operations. With the completion of the third roll out, the Bank has exhausted most of the potential embedded in the core systems purchased from Accenture, while completing about 70% of the project for renewal of the computer infrastructure. In view of this, the Ofek Project has been to de-facto completed. Completion of the conversion of systems from the Unisys to the IBM environment, and completion of development of systems that had begun within the framework of the Ofek Project, would now be carried out within the framework of the current development work of the Bank, as part of the regular development budget, while considering their preference within the general development assignments of the Bank.

Until December 31, 2006, an amount of approximately US\$159 million (excluding VAT) was invested in the project.

### **19. 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

**19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)****C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)**

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.

In July 2005, the Bank entered into an agreement with Meshulam Levinstein Buildings (1986) Ltd. (hereinafter – “the Company”) for the purchase from the Company of office space of 12.5 thousand square meters, basement and parking areas with regard to the “Discount Tower” which is being constructed on Yehuda Halevi Street.

Upon the signing of the said agreement, the said commitment of the Bank, pursuant to the agreement dated June 2002 for the lease of an office space was cancelled.

The Bank has also entered into an agreement with Meshulam Levinstein Contracting Ltd. and Engineering (the parent company of the Company) to supply construction services in respect of an additional 4 thousand square meters in the “Discount Tower”.

The total cost of the area, which the Bank received in the Tower, including betterment levy, acquisition tax and value added tax, amounts to US\$67 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. The Articles of “Tamar, “Geffen” and “General Severance Pay Fund” provident funds state that the Bank has guaranteed each of its members that the provident fund would pay the member no less than the total amount of the deposits made by the member or on his behalf. Therefor, in the event that the total amount to be received by a member from the provident fund, according to his entitlement therein is lower than the total amount deposited by him or on his behalf with the provident fund, the Bank would pay the difference to that member. A similar arrangement also exists with the “Mercantile Central Severance Pay Fund” managed by Mercantile Discount Bank. As a general rule, the amounts accumulated in the said funds significantly exceed the amounts guaranteed by the Bank and Mercantile Discount Bank. In view of the above and based on past experience, the Bank believes that the amounts that the Bank and Mercantile Discount Bank might have to pay in respect of the said guarantees are negligible.

The Articles of the provident funds “Tamar” and “Geffen” and the Articles of “General Severance Pay Fund” have been changed at the beginning of 2006, and it has been determined in them that the guarantee of the Bank shall not apply to members who will join the funds subsequent to June 30, 2006 and to accounts opened subsequent to this date (based on an assessment made by the Bank, the fair value of the said guarantee amounts to NIS 0.5 million).

On January 29, 2007, an agreement was signed for the sale of the provident fund activity, including Tamar, Gefen and the General Severance Pay Fund. The said agreement prescribes, inter alia, that as from date of closing of the

## 19. CONTINGENT LIABILITIES AND SPECIAL COMMITMENTS (CONTINUED)

### C. CONTINGENT LIABILITIES AND OTHER SPECIAL COMMITMENTS (CONTINUED)

transaction, the Bank will be released from the said guarantee, and, insofar as required, Clal Insurance will accept the alternative obligation towards the members (subject to the approval of the Commissioner of Capital Markets). For details see Note 6 E above.

### 21. The sale of KAHAL:

On May 26, 2006, the Bank, Bank Leumi Le'Israel B.M., KAHAL – Employee Training Fund Ltd. (hereinafter – “KAHAL”) and KAHAL Training Fund Management (1996) Ltd. (hereinafter – “KAHAL Management”), entered into an agreement with Migdal Capital Markets (1965) Ltd. on behalf of a company controlled by it and Migdal Insurance Holding and Finance Ltd. on behalf of a company controlled by it (hereinafter – “the Purchaser”) for the sale of goodwill, management rights, additional rights and the means of control of the banks in KAHAL, and for the sale of goodwill, operations, assets and liabilities connected to the training funds managed by KAHAL Management, all in consideration of NIS 260 million, adjusted for the volume of assets of the training funds sold at date of the closing of the transaction. The Bank's share of the consideration amounts to approximately NIS 110.5 million (42.5%)

Among other things, it has been agreed upon that the Bank will enter into a distribution agreement with KAHAL and with the Purchaser, according to which the Bank shall distribute the training funds in consideration for a distribution commission at the maximum rate specified in the regulations.

The closure of the transaction is subject to regulatory approvals being obtained and to the fulfillment of certain conditions.

The Bank estimates that the pre-tax profit to be derived from this transaction may reach approximately NIS 110 million, subject to adjustments, and it would be recorded in the quarter of the closing of the transaction.

## 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 type of the product.

The credit risk during the period of engagement is assessed at the amount that a similar engagement would have cost, had it been entered into at the reporting date with the same customer and for the period remaining until its

## 20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

expiration. The Bank's policy as regards the collateral required in respect of customer derivative financial instrument transactions resembles the policy regarding other credit granted, excluding customers' Ma'of activity. The collateral comprises various types. The Bank may also grant to customers' credit facilities without collateral, as the case may be.

- C. Market liquidity risk derives from the fact that it might not be possible to contain rapidly the exposure involved, mainly in markets of low level trading.
2. Where a derivative instrument is not intended as a qualified hedging, it is stated according to its fair value, 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 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.

## 20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

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 anticipated 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 2006, the Bank did not record any expenses 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 2005: NIS 0.02 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 (CONTINUED)**  
**A. VOLUME OF ACTIVITY ON A CONSOLIDATED BASIS**

	December 31, 2006				
	Interest rate contracts		Foreign currency contracts	Contracts on shares	Commodities and other contracts
	Shekel/CPI	Other			
	in NIS millions				
<b>1. Par value of derivative instruments</b>					
<b>A. Hedging derivatives<sup>(1)</sup></b>					
Forward contracts	-	834	175	-	-
Other option contracts					
options purchased	-	37	6	548	23
Swaps	-	1,551	235	-	-
Total	-	2,422	416	548	23
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	770			
<b>B. ALM derivatives<sup>(1) (2)</sup></b>					
Futures contracts	-	216	-	-	-
Forward contracts	340	1,782	27,596	-	-
Marketable option contracts					
options purchased	-	-	-	1	-
Other option contracts					
options written	-	-	43	-	-
options purchased	-	-	297	1	-
Swaps	-	15,439	2,672	-	-
Total	340	17,437	30,608	2	-
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	7,797			
<b>C. Other derivatives<sup>(1)</sup></b>					
Futures contracts	-	582	-	-	-
Forward contracts	200	2,798	170	1,449	3,064
Marketable option contracts					
options written	-	-	508	5,641	-
options purchased	-	-	487	5,624	-
Other option contracts					
options written	-	445	10,438	706	23
options purchased	-	512	10,750	206	1
Swaps	-	983	-	-	-
Total	200	5,320	22,353	13,626	3,088
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	259			
<b>D. Credit derivatives and SPOT foreign currency swap contracts</b>					
SPOT foreign currency swap contracts	-	-	4,879	-	-

Footnotes:

(1) Excluding credit derivatives and SPOT foreign currency swap contracts.

(2) Derivatives comprising a part of the asset and liability management system, which were not designated for hedging relations.

## 20. DERIVATIVE INSTRUMENT ACTIVITY –VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

## A. VOLUME OF ACTIVITY ON A CONSOLIDATED BASIS (CONTINUED)

	December 31, 2005				
	Interest rate contracts		Foreign	Contracts	Commodities
	Shekel/CPI	Other	currency	on	and other
			contracts	shares	contracts
	in NIS millions				
<b>A. Hedging derivatives<sup>(1)</sup></b>					
Forward contracts	-	1,209	172	-	-
Other option contracts					
options purchased	-	101	6	820	9
Swaps	-	1,890	276	-	-
Total	-	3,200	454	820	9
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	792			
<b>B. ALM derivatives<sup>(1)(2)</sup></b>					
Futures contracts	-	275	-	-	-
Forward contracts	982	3,815	24,624	-	-
Marketable option contracts					
options purchased	-	-	-	2	-
Other option contracts					
options written	-	-	66	-	-
options purchased	-	-	409	-	-
Swaps	-	7,452	2,676	-	-
Total	982	11,542	27,775	2	-
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	3,270			
<b>C. Other derivatives<sup>(1)</sup></b>					
Forward contracts	240	2,141	169	985	1,747
Marketable option contracts					
options written	-	18	269	2,113	1
options purchased	-	18	269	2,113	1
Other option contracts					
options written	-	478	21,030	1,004	9
options purchased	-	405	22,858	169	-
Swaps	-	785	2	-	-
Total	240	3,845	44,597	6,384	1,758
Of which, interest rate swap contracts, where the Bank agreed to pay a fixed interest rate	-	138			
<b>D. Credit derivatives and SPOT foreign currency swap contracts</b>					
SPOT foreign currency swap contracts	-	-	3,423	-	-

Footnotes:

(1) Excluding credit derivatives and SPOT foreign currency swap contracts.

(2) Derivatives comprising a part of the asset and liability management system, which were not designated for hedging relations.

20. DERIVATIVE INSTRUMENT ACTIVITY –VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)  
 A. VOLUME OF ACTIVITY ON A CONSOLIDATED BASIS (CONTINUED)

December 31, 2006					
	Interest rate contracts		Foreign	Contracts	Commodities
	Shekel/CPI	Other	currency	on	and other
			contracts	shares	contracts
in NIS millions					
<b>2. Gross fair value of derivative instruments</b>					
<b>A. Hedging derivatives</b>					
Positive gross fair value	-	17	4	108	6
Negative gross fair value	-	37	69	-	-
<b>B. ALM derivatives</b>					
Positive gross fair value	9	84	451	-	-
Negative gross fair value	-	135	475	-	-
<b>C. Other derivatives</b>					
Positive gross fair value	-	58	303	225	29
Negative gross fair value	-	202	242	127	29
December 31, 2005					
	Interest rate contracts		Foreign	Contracts	Commodities
	Shekel/CPI	Other	currency	on	and other
			contracts	shares	contracts
in NIS millions					
<b>A. Hedging derivatives</b>					
Positive gross fair value	-	74	62	221	4
Negative gross fair value	-	241	2	2	-
<b>B. ALM derivatives</b>					
Positive gross fair value	2	*33	280	-	-
Negative gross fair value	1	114	281	-	-
<b>C. Other derivatives</b>					
Positive gross fair value	1	36	1,171	147	42
Negative gross fair value	1	49	1,169	187	42

Footnote:

\* Reclassified

**20. DERIVATIVE INSTRUMENT ACTIVITY –VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)**  
**B. DERIVATIVE INSTRUMENT CREDIT RISK BASED ON THE COUNTERPART TO THE CONTRACT, ON A CONSOLIDATED BASIS**

December 31, 2006						
	Stock markets	Banks	Dealers/ brokers	Governments and central banks	Others	Total
In NIS millions						
Gross positive fair value of derivative instruments <sup>(1)</sup>	42	445	88	-	719	1,294
Net of set-off agreements	15	-	-	-	128	143
Balance of assets deriving from derivative instruments <sup>(2)</sup>	27	445	88	-	591	1,151
Off-balance sheet credit risk in respect of derivative instruments <sup>(3)</sup>	138	4,375	163	-	1,807	6,483
Total credit risk in respect of derivative instruments	165	4,820	251	-	2,398	7,634

Footnotes:

(1) Of which, NIS 277 million of positive gross fair value of derivative instruments.

(2) Of which, a balance of non-related derivative instruments of NIS 874 million reflected in the item "Other assets."

(3) Off-balance sheet credit risk in respect of derivative instruments (including derivative instruments having a negative fair value) as computed for the purpose of limitations on a single borrower indebtedness.

December 31, 2005						
	Stock markets	Banks	Dealers/ brokers	Governments and central banks	Others	Total
In NIS millions						
Gross positive fair value of derivative instruments <sup>(1)</sup>	17	*741	214	-	1,101	2,073
Net of set-off agreements	4	-	-	-	389	393
Balance of assets deriving from derivative instruments <sup>(2)</sup>	13	741	214	-	712	1,680
Off-balance sheet credit risk in respect of derivative instruments <sup>(3)</sup>	29*	3,659	67	-	2,735	6,490
Total credit risk in respect of derivative instruments	42	4,400	281	-	3,447	8,170

Footnotes:

\* Reclassified

(1) Of which, NIS 177 million of positive gross fair value of derivative instruments

(2) Of which, a balance of non-related derivative instruments of NIS 1,503 million reflected in the item "Other assets."

(3) Off-balance sheet credit risk in respect of derivative instruments (including derivative instruments having a negative fair value) as computed for the purpose of limitations on a single borrower indebtedness.

## 20. DERIVATIVE INSTRUMENT ACTIVITY – VOLUME, CREDIT RISK AND DUE DATES (CONTINUED)

## C. DUE DATES – PAR VALUE: CONSOLIDATED YEAR END BALANCES

	December 31, 2006					
	Up to 3 months	From 3 months to 1 year	From 1 Year to 5 years	Over 5 years	Total	
In NIS millions						
Interest rate contracts						
Shekel/CPI	50	430	60	-	540	
Other	3,600	10,731	7,866	2,982	25,179	
Foreign currency contracts						
	32,299	20,976	2,884	2,097	58,256	
Contracts on shares						
	12,362	1,060	754	-	14,176	
Commodities and other contracts						
	3,062	2	47	-	3,111	
<b>Total</b>	<b>51,373</b>	<b>33,199</b>	<b>11,611</b>	<b>5,079</b>	<b>101,262</b>	
	December 31, 2005					
	Up to 3 months	From 3 months to 1 year	From 1 Year to 5 years	Over 5 years	Total	
In NIS millions						
Interest rate contracts						
Shekel/CPI	202	940	80	-	1,222	
Other	4,196	5,074	7,606	1,711	18,587	
Foreign currency contracts						
	43,724	25,559	5,029	1,937	76,249	
Contracts on shares						
	5,510	306	1,390	-	7,206	
Commodities and other contracts						
	1,385	360	22	-	1,767	
<b>Total</b>	<b>55,017</b>	<b>32,239</b>	<b>14,127</b>	<b>3,648</b>	<b>105,031</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, 2006, the Bank has classified some 94% of the indebtedness which has to be classified according to the directives of the Supervisor of Banks (31.12.2005: 95%). 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 and subordinated capital notes** - Capitalizing future cash flows at a rate at which the Bank pays interest on similar deposits, or on the issue of similar bond and loan notes at the reporting date. Marketable subordinate capital notes are stated at market value.

**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 type 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. In the consolidated financial statements, the general provision of the subsidiary company was not deducted from the outstanding balance of credit in estimating the fair value.

21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS (CONTINUED)  
D. COMPOSITION - CONSOLIDATED

	Balance as of December 31, 2006			
	(1)	(2)	Total	Fair value
in NIS millions				
<b>Financial assets:</b>				
Cash and deposits with banks	24,404	1,002	25,406	25,518
Securities	33,928	4,783	38,710	38,678
Credit to the public	50,566	39,609	90,175	90,422
Credit to the Government	11	7	18	17
Other financial assets	1,345	-	1,345	1,345
<b>Total financial assets</b>	<b>110,254</b>	<b>45,401</b>	<b>155,654</b>	<b>155,980</b>
<b>Financial liabilities:</b>				
Deposits from the public	83,728	46,789	130,517	130,725
Deposits from banks	7,420	679	8,099	8,147
Deposits from the Government	36	83	119	117
Subordinated capital notes	1,146	5,156	6,302	6,530
Other financial liabilities	6,769	-	6,769	6,769
<b>Total financial liabilities</b>	<b>99,099</b>	<b>52,707</b>	<b>151,806</b>	<b>152,288</b>

	Balance as of December 31, 2005			
	(1)	(2)	Total	Fair value
in NIS millions				
<b>Financial assets:</b>				
Cash and deposits with banks	*18,412	*2,174	20,586	20,762
Securities	35,540	5,833	41,373	41,324
Credit to the public	*47,560	40,256	87,816	*88,400
Credit to the Government	64	28	92	92
Other financial assets	1,956	-	1,956	1,956
<b>Total financial assets</b>	<b>103,532</b>	<b>48,291</b>	<b>151,823</b>	<b>152,534</b>
<b>Financial liabilities:</b>				
Deposits from the public	*95,529	34,756	130,285	*130,550
Deposits from banks	5,516	1,002	6,518	6,535
Deposits from the Government	*43	93	136	*137
Subordinated capital notes	*407	*4,935	5,342	5,528
Other financial liabilities	*7,298	-	7,298	*7,298
<b>Total financial liabilities</b>	<b>108,793</b>	<b>40,786</b>	<b>149,579</b>	<b>150,048</b>

\* Reclassified

Footnotes:

(1) Financial instruments the stated amounts of which approximate their fair value – instruments stated in the balance sheet at market value or which are for an initial period not exceeding three months, or based on market interest varying at frequencies of up to three months.

(2) Other financial instruments.

**21. BALANCES AND FAIR VALUE ESTIMATES OF FINANCIAL INSTRUMENTS (CONTINUED)**
**E. COMPOSITION - THE BANK**

	Balance as of December 31, 2006			
	(1)	(2)	Total	Fair value
in NIS millions				
<b>Financial assets:</b>				
Cash and deposits with banks	20,575	7,356	27,931	28,176
Securities	16,891	-	16,891	16,891
Credit to the public	25,534	25,933	51,467	51,488
Credit to the Government	-	7	7	6
Other financial assets	833	-	833	833
<b>Total financial assets</b>	<b>63,833</b>	<b>33,296</b>	<b>97,129</b>	<b>97,394</b>
<b>Financial liabilities:</b>				
Deposits from the public	57,731	26,979	84,710	84,954
Deposits from banks	4,950	576	5,526	5,536
Deposits from the Government	-	5	5	5
Subordinated capital notes	963	2,917	3,880	4,037
Other financial liabilities	3,309	-	3,309	3,309
<b>Total financial liabilities</b>	<b>66,953</b>	<b>30,477</b>	<b>97,430</b>	<b>97,841</b>

	Balance as of December 31, 2005			
	(1)	(2)	Total	Fair value
in NIS millions				
<b>Financial assets</b>				
Cash and deposits with banks	13,119	8,609	21,728	21,986
Securities	16,834	-	16,834	16,834
Credit to the public	**22,037	27,138	49,175	**49,195
Credit to the Government	61	28	89	89
Other financial assets	1,323	-	1,323	1,323
<b>Total financial assets</b>	<b>53,374</b>	<b>35,775</b>	<b>89,149</b>	<b>89,427</b>
<b>Financial liabilities</b>				
Deposits from the public	*50,280	30,002	80,282	*80,458
Deposits from banks	2,406	564	2,970	2,978
Deposits from the Government	-	10	10	*10
Subordinated capital notes	227	3,292	3,519	3,665
Other financial liabilities	**4,061	-	4,061	**4,061
<b>Total financial liabilities</b>	<b>56,974</b>	<b>33,868</b>	<b>90,842</b>	<b>91,172</b>

\* Reclassified

\*\* Restated - see Note 1z.

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, 2006										
	Interested parties <sup>(1)</sup>				Related parties held by the Bank					
	Shareholders <sup>(2)</sup>		Directors and President <sup>(2)</sup>		Others		Affiliated		Others <sup>(3)</sup>	
	(4)	(5)	(4)	(5)	(4)	(5)	(4)	(5)	(4)	(5)
in NIS millions										
<b>Assets:</b>										
Securities <sup>(6)</sup>	-	-	-	-	-	-	1	2	14	14
Credit granted to the public	(A)*8	*8	8	8	7	97	488	488	560	564
Deposits with banks	-	-	-	-	-	-	-	4	-	-
Investments in affiliated companies <sup>(6)**</sup>	-	-	-	-	-	-	1,367	1,367	-	-
Other assets	-	-	-	-	-	-	2	2	8	8
<b>Liabilities:</b>										
Deposits from the public	-	-	2	3	85	143	356	356	1,704	1,870
Deposits from banks	-	-	-	-	-	-	207	350	-	-
Debentures and subordinated capital notes	-	-	-	-	-	-	20	26	161	210
Shares (included in shareholders' equity)	2,071	2,071	-	-	-	-	-	-	-	-
Credit risk in off-balance-sheet financial instruments <sup>(7)</sup>	4	4	-	-	-	-	456	456	447	447

\*Restated.

(A) In addition, a controlling shareholder gave a personal guarantee in the amount of NIS 37 million for credit received by a third party.

\*\* Includes unconsolidated subsidiaries in the amount of NIS 40 million (highest balance during the year NIS 40 million). For notes to the tables see after Note D.

**22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES**
**A. BALANCES (CONTINUED)**

	December 31, 2005					
	Interested parties <sup>(1)</sup>		Related parties held by the Bank			
	Directors and President <sup>(2)</sup>		Affiliated companies		Others <sup>(3)</sup>	
	(4)	(5)	(4)	(5)	(4)	(5)
	in NIS millions					
<b>Assets:</b>						
Securities <sup>(6)</sup>	-	-	9	9	4	4
Credit granted to the public	1	1	89	182	476	476
Deposits with banks	-	-	2	4	-	-
Investments in affiliated companies <sup>(6)*</sup>	-	-	1,471	1,471	-	-
<b>Liabilities:</b>						
Deposits from the public	2	4	234	311	1,400	2,596
Deposits from banks	-	-	215	317	-	-
Debentures and subordinated capital notes	-	-	28	32	221	245
Other liabilities	-	-	2	2	-	-
Credit risk in off-balance-sheet financial instruments <sup>(7)</sup>	1	1	321	346	457	457

\* Includes unconsolidated subsidiaries in the amount of NIS 42 million (highest balance during the year - NIS 42 million). For notes to the tables see after Note D.

**22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)**  
**B. SUMMARIZED RESULTS OF TRANSACTIONS WITH RELATED AND INTERESTED PARTIES**

For the year ended December 31, 2006				
	Interested parties <sup>(1)</sup>		Related parties held by the Bank	
	Directors and president <sup>(2)</sup>	Shareholders <sup>(2)</sup>	Affiliated companies	Others <sup>(3)</sup>
in NIS millions				
Income from financing activities before provision for doubtful debts <sup>*</sup>	1	2	(14)	(32)
Non-financing income	-	-	1	<sup>(8)</sup> 118
Non-financing expenses <sup>**</sup>	(15)	-	(4)	-
<b>Total</b>	<b>(14)</b>	<b>2</b>	<b>(17)</b>	<b>86</b>

For the year ended December 31, 2005				
	Interested parties <sup>(1)</sup>		Related parties held by the Bank	
	Directors and president <sup>(2)</sup>	Shareholders <sup>(2)</sup>	Affiliated companies	Others <sup>(3)</sup>
in NIS millions				
Income from financing activities before provision for doubtful debts <sup>*</sup>	-	-	(3)	(39)
Non-financing income	-	-	2	<sup>(8)</sup> 114
Non-financing expenses <sup>**</sup>	(11)	-	(40)	-
<b>Total</b>	<b>(11)</b>	<b>-</b>	<b>(41)</b>	<b>75</b>

\* See Note D.

\*\* See Note C.

**22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)**  
**C. BENEFITS FROM THE BANK AND CONSOLIDATED SUBSIDIARIES TO INTERESTED PARTIES:**

	For the year ended December 31, 2006		For the year ended December 31, 2005	
	Directors and President and CEO <sup>(2)</sup>		Directors and President and CEO <sup>(2)</sup>	
	Number of benefit		Number of benefit	
	Total benefit	Recipients	Total benefit	Recipients
	in NIS millions			
Interested parties employed by the Bank or on its behalf	12	*3	9	2
Directors who are not employed by the Bank or on its behalf	3	**20	2	12
<b>Total</b>	<b>15</b>	<b>23</b>	<b>11</b>	<b>14</b>

\* Including six Directors who retired during the year.

\*\* Including the former Chairman of the Board who retired at the end of January 2006.

For notes to the tables see after Note D.

## 22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)

### D. RESULTS OF FINANCING TRANSACTIONS (BEFORE PROVISION FOR DOUBTFUL DEBTS) OF THE BANK AND ITS CONSOLIDATED COMPANIES WITH RELATED AND INTERESTED PARTIES\*

	Consolidated			Of which from Affiliated Companies		
	2006	2005	2004	2006	2005	2004
in NIS millions						
<b>A. On assets</b>						
Credit granted to the public	44	34	24	5	4	-
Total	44	34	24	5	4	-
<b>B. On liabilities</b>						
Deposits from the public	(58)	(54)	(82)	(1)	(2)	(11)
Deposits from the banks	(3)	(6)	(7)	(3)	(6)	(6)
Debentures and subordinated capital notes	(11)	(17)	(36)	-	(1)	(2)
Other liabilities	(1)	-	-	(1)	-	-
Total	(73)	(77)	(125)	(5)	(9)	(19)
<b>C. On Derivative Financial Instrument</b>						
Financing income (expenses) from other transactions	(14)	1	1	(14)	1	1
Total	(14)	1	1	(14)	1	1
Total expenses from financing activities before provision for doubtful debts	(43)	(42)	(100)	(14)	(4)	(18)

\* In respect of transactions made on the same terms that would have been made with a person that is not a related or interested party.

Footnotes: (relating to Note 22 A, B & C):

- (1) Interested party - as defined by Securities Regulations. Related party - as defined in Opinion 29 of the Institute of Certified Public Accountants in Israel, but is not an interested party.
- (2) Including spouses and their infant children.
- (3) A corporation in which a banking corporation holds 10% or more of its issued share capital or of the voting rights therein, or is entitled to appoint 10% or more of the members of its board of directors or is entitled to appoint its president and CEO, and another corporation that a related party holds 25% or more of its issued share capital or of the voting power therein or of the right to appoint its directors.
- (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 19A.
- (7) Credit risks of off-balance sheet derivative financial instruments as calculated for the purpose of setting borrower's limits.
- (8) 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	
	2006	2005
In NIS millions		
(1) Managed by Discount Provident Fund Management Ltd. and the Bank <sup>(1)</sup> :		
Members' balance	30,947	30,153
Investments in securities of related and interested parties	515	* 128
Deposits with the Bank and with its consolidated subsidiaries and affiliated companies	1,497	* 1,108
Capital notes	142	* 171
Management fees	114	109
(2) Managed by Mercantile Discount Bank:		
Members' balance	3,778	3,567
Investments in securities of related and interested parties	66	21
Deposits with the Bank and with its consolidated Subsidiaries	257	320
Management fees	26	23

\* Reclassified

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 C 2.

**F.** As from October 31, 1993, through January 31, 2006 the State of Israel held a majority of the shares of the Bank (on December 31, 2005, 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.** On January 31, 2006, the control of the Bank passed to the Bronfman Schron Group (for additional details see Note 32 hereunder).

**H. Personal contract with the Chairman of the Board and the President & CEO.** On March 26, 2006, the board of directors of the Bank resolved to approve the engagement of the Bank in a personal contract with the Chairman of the Board. The period of the personal contract is for five years, starting on February 6, 2006, to be renewed subsequently for an indeterminate period until its cancellation. In the event that the Bank should terminate the contract before the end of the period of five years, the Chairman would be entitled to compensation in an amount equal to his full salary, including the benefits and provisions (as stated in the agreement), for the remaining period of the five years, as well as to a proportionate part of the yearly award for the year in which the contract was terminated.

The contract stipulates also, among other things, that the Bank would grant the Chairman of the Board, in respect of each year in which he holds office, starting with 2006 and as long as the agreement with him is in force, a special award (hereinafter – "the annual bonus"), derived from the annual rate of return on equity, at rates of between 0.45% of the net annual earnings if the annual return on equity will equal 8.5%, to a maximum rate of 0.70% on the net annual earnings if the annual return on equity will reach 13% or more. In computing the annual rate of return on equity, the Board of Directors is entitled to eliminate exceptional profits or losses that do not derive from current operations.

## 22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)

As regards details of the proposal for the granting of option warrants to the Chairman of the Board as part of an option plan for officers of the Bank, see Note 13.

The Board of Directors of the Bank resolved on March 26, 2006, to approve an amendment to the personal contract with the President and CEO of the Bank, in a manner that would include provisions identical to the provisions described in section I above.

The remuneration and terms of employment of the Chairman of the Board were included on the agenda of a special general meeting of shareholders called for April 26, 2006. On March 26, 2006, the State informed of its consent to the terms of service of the Chairman of the Board of Directors and of its consent with regards to voting together with the controlling shareholders, by power of the option shares held by the State. (For details as to the notice given on June 20, 2006, canceling the said consent, see Note 13 D (2) above).

As detailed in Note 13 D (2) above, at the request of the Chairman of the Board and the President and CEO, the remuneration plan in their respect was removed from the agenda of the said General Meeting and it is being brought for renewed discussion by the authorized organs of the Bank.

On January 30, 2007, the Bank's Audit Committee approved a comprehensive remuneration plan for the Chairman of the Board of Directors and for the President and CEO. The plan was formulated by the Human Resources Committee of the Board that, inter alia, reviewed remuneration plans of large companies in Israel and abroad, formed (with the assistance of experts engaged for this purpose) several models of remuneration, and performed sensitivity analyses in this regard, taking into account also data for prior years.

Representatives of the Committee also conducted negotiations with the Chairman of the Board of Directors and the President and CEO, taking into considerations extensive appreciation for the activities of the Chairman of the Board of Directors and the President and CEO and the great importance that the Bank attributes to their continued activity in the Bank. The remuneration plan approved by the Audit Committee is not similar, (in its conditions or in the amounts derived therefrom), to the remuneration plan approved as stated in March 2006, and was examined independently from the previous plan. The remuneration plan was formulated for a period of five years (as from February 2006) and includes short-term remuneration (salaries and annual bonuses) and long-term remuneration (stock option plan). The entitlement to annual bonuses and to the option plan are dependent on Discount Group's results and performance (that are measured in accordance with several parameters, mainly rates of change) and on the yield from the Bank's shares, both per se and in comparison to the other large banking groups. Entitlement to annual bonuses is limited to monetary ceilings.

In general (except regarding certain parameters relating to bonuses payable to the President and CEO upon retirement), linkage was maintained in the remuneration proposals to the Chairman of the Board of Directors and the President and CEO. The remuneration plan for the Chairman of the Board and the president and CED requires the approval, of the Board of Directors. The remuneration plan for the Chairman of the Board also requires the approval of the General Meeting of Shareholders. The allotment of stock options according to the plan may be effected only if the Bank's authorized share capital would be increased and such matter also requires approval of the General Meeting of Shareholders. Accordingly, on February 19, 2007 the Bank requested the reaction of its principal shareholders (the controlling shareholders, on one hand, and the Accountant General in the Ministry of Finance and M.I. Holdings Ltd., on the other hand) regarding the said issues. At this stage, no response from any of the shareholders has been received, and no certainty exists regarding the timing and conditions for consummation of the said plan. The Chairman of the Board of Directors has been employed by the Bank for approximately one year but has not yet received any remuneration for his work (the Bank has recorded

## 22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)

full provisions for salary and bonuses in accordance with the plan approved by the Audit Committee. No provisions were recorded in respect of the stock options component).

- I. "Interested party" transactions – IDB New York.** In September 2005, even prior to the closing of the transaction for the transfer of control of the Bank, the then management of IDB New York signed an agreement with a company controlled by Mr. Matthew Bronfman (hereinafter – "the Company"), according to which IDB New York is to sublease to the Company for a period of 10 years, one floor in the building in New York leased by IDB, in which its offices are located. Pursuant to the agreement, IDB New York is to sublease the area to the Company in consideration for a monthly rental fee of US\$45.19 per one square foot which is the fee paid by the former tenant of the area. The agreement states that the rental fees are to be paid on a monthly basis. The rental agreement further provided that IDB New York is to grant to the company a loan of US\$900,000 for the renovation of the property, for a period of ten years and at an annual interest of 7%. It has been agreed that in total the company would pay a monthly amount of US\$34,407 in respect of rent and the repayment of the loan, making US\$ 412,884 on a yearly basis.

The said floor was put at the disposal of the Company in January 2006, and in April 2006 the Company moved into it, following the completion of the renovation.

The loan of US\$900,000 was given to the Company in March 2006.

The draft report of a review performed recently at the request of IDB New York by an independent lawyer, indicates that both the sublease transaction and the granting of the loan did not receive the required approvals, including the approval of the Board of Directors of IDB New York, the transaction was not scrutinized as a related party transaction and as such, did not receive the required approvals.

It should also be noted that already on June 2006, according to the recommendations of the said lawyer, the Company repaid the loan to IDB New York.

In addition, rental fees in respect of the period April to December 2006 were paid in January 2007. As from January 2007, the rental fees are being paid in a regular manner.

The review is not yet complete and the draft report has been distributed to a number of factors for comment. To the best knowledge of the Bank, the Chairman of IDB New York has reserves as regards the draft report. Upon receipt of the final report and in the light of its findings and recommendations, the need for implementing approval procedures by the Bank and IDB New York, would be considered.

- J.** The Bank is conducting negotiations for the rental of an area of 200 Sq. Mtrs. in the "ma'ayan Soreq" location in Rishon Le'Tziyon, that is planned to be built by companies related to the Bronfman group. As apparent from the negotiations, the rental period will be three years with an option for extension. Rental and management fees will be according to terms acceptable for this location.
- K.**
1. The preceding Chairman of the Board of Directors ended his tenure of office on January 31, 2006, following the closing of the transaction for the sale of a controlling interest in the Bank (see Note 32 hereunder). His remuneration and terms of employment were approved by the general meetings of shareholders held on January 15, 1998, October 5, 1999 and June 14, 2004, including his entitlement to regular severance pay and an adaptation award equal to full twelve months salary.
  2. In 2004, the board of directors of the Bank decided that in the event that the preceding Chairman would have to terminate his tenure of office following a change in ownership of the Bank due to privatization, then he would be entitled to a payment equal to a full fifteen months salary in addition to the amounts due to him in accordance with

## 22. RELATED AND INTERESTED PARTIES OF THE BANK AND ITS CONSOLIDATED SUBSIDIARIES (CONTINUED)

the personal contract with him. This issue was on the agenda of the general meeting of shareholders held in June 2004, but was not discussed at that meeting.

3. In 2004, the board of directors of the Bank resolved to approve the preceding Chairman an additional remuneration of 6.5% as from July 2004, together with an award equal to seven months salary (comprising 89% of the award approved to the President and CEO of the Bank). These matters have not yet been brought for approval by the general meetings of shareholders.
  4. In May 2005, the board of directors of the Bank resolved to approve the preceding Chairman an award in the amount of NIS 1,255 thousand. This matter has not yet been brought for approval by the general meetings of shareholders.
  5. Without derogating from the resolutions detailed in items 2 to 4 above, the Bank intends to bring for approval of the board of directors of the Bank a proposal for a one-time payment of NIS 10 million to the preceding Chairman, as compensation for the termination of his tenure as Chairman of the board of directors and to express appreciation for his outstanding contribution to the Bank
  6. The financial statements include full provisions in respect of items 2-4 stated above.
  7. In a letter dated March 26, 2006, the controlling shareholders of the Bank informed the Accountant General at the Ministry of Finance and the CEO of M.I. Holdings Ltd. of their intention to bring for approval of the authorized organs of the Bank, as the case may be, the proposals for various payments to the preceding Chairman of the board of directors of the Bank, as detailed in items 2 to 5 above.  
The controlling shareholders clarified that, for the sake of propriety they deemed it proper to bring to the attention of the Government the proposed payments by the Bank to the preceding Chairman, as detailed above, though, in their opinion, such payments are not considered payments to an interested party within its meaning in the agreement for the sale of the controlling interest in the Bank, and therefore do not require the consent of the Government.
  8. In a letter dated March 26, 2006, the Accountant General at the Ministry of Finance informed that the State opposes the intended payments as detailed in the letter of the controlling shareholders (see 7 above). In view of the above said, the Bank did not record a provision in respect of the amounts stated in 5 above.
- L.** The Bank has a commitment to pay directly to subordinated capital notes 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, 2006, amounted to NIS 1,517 million (as at December 31, 2005 - NIS 897 million).
- M.** The Bank and Mercanile Discount Bank have commitments towards the Tel-Aviv Stock Exchange and towards the "Ma'of" clearing house as mentioned in Note 19 C 6 and Note 19 C 7.
- N.** 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.
- O.** Investee companies of the Bank are included in the framework of the undertaking granted by the Bank to VISA International (as stated in Note 19 C 12).
- P.** In respect of indemnification of related and interested parties - see Note 19C 10.
- Q.** The amount of available-for-sale securities in the consolidated balance sheet as of December 31, 2005 included NIS 231 million comprising an investment in the shares of a consolidated subsidiary (see Note 6 E 2).

**23. INCOME FROM FINANCING ACTIVITIES BEFORE PROVISION FOR DOUBTFUL DEBTS**

	Consolidated				The Bank	
	2006	2005	2004	2006	2005	2004
	in NIS millions					
<b>A. On Assets**</b>						
Credit granted to the Public	3,712	6,762	4,271	2,398	3,365	2,469
Credit granted to the Government	(2)	25	5	(2)	24	4
Deposits with the Bank of Israel and cash	(49)	48	128	(26)	9	96
Deposits with Banks	244	467	538	555	798	798
Bonds	(29)	3,460	1,450	801	872	937
Total	3,876	10,762	6,392	3,726	5,068	4,304
<b>B. On Liabilities**</b>						
Deposits from the public	(12)	(6,717)	(2,934)	(1,183)	(3,111)	(2,297)
Deposits from the Government	(1)	(10)	(6)	-	(1)	(1)
Deposits from the Bank of Israel and cash	(30)	(3)	(4)	(30)	(3)	(3)
Deposits from banks	45	(453)	(185)	(56)	(129)	(55)
Debentures and subordinated capital notes	(287)	(413)	(299)	(193)	(291)	(235)
Total	(285)	(7,596)	(3,428)	(1,462)	(3,535)	(2,591)
<b>C. In Respect of Derivative Financial Instruments and Hedging Activities</b>						
Income (expenses) net in respect of ALM derivative instruments***	(97)	182	47	(134)	190	8
Income (expenses) net in respect of other derivative instruments	105	(18)	63	84	(38)	61
Total	8	164	110	(50)	152	69
<b>D. Other</b>						
Commissions on financing activities	123	138	120	65	70	58
Other financing income	79	215	191	93	53	89
Interest income on problem debts	103	84	99	78	71	83
Other financing expenses	(114)	(70)	(11)	(27)	(31)	(7)
Total	191	367	399	209	163	223
Total income from financing activities before provision for doubtful debts	3,790	3,697	3,473	2,423	1,848	2,005
Of which: Net exchange differences	(80)	*(67)	*(39)	166	*(244)	*16

\* Reclassified.

\*\* Including the effective component of hedging relations

\*\*\* Derivative instruments comprising a part of the assets and liabilities management system of the Bank, which were not designed for hedging relations.

## 23. INCOME FROM FINANCING ACTIVITIES BEFORE PROVISION FOR DOUBTFUL DEBTS (CONTINUED)

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	in NIS millions					
<b>E. Results of Activity in Investments in Bonds</b>						
Accrual basis, financing income (expenses) from bonds:						
Held-to-maturity	(262)	611	(114)	*3	*14	*6
Available for-sale	148	2,686	1,498	693	789	866
Trading	85	163	66	105	69	65
Total included in income on assets from financing activities	(29)	3,460	1,450	801	872	937
Gains on sale of available-for-sale bonds	50	32	112	29	19	86
Losses on sale of available-for-sale bonds*	(58)	(2)	(2)	(1)	2	(1)
Provision for decline in value of available-for-sale bonds	-	-	(12)	-	-	(9)
Net realized and unrealized gains (losses) from adjustment of trading bonds to fair value**	30	2	29	23	3	(3)
Total included in other financing income	22	32	127	51	24	73
Total from investments in bonds	(7)	3,492	1,577	852	896	1,010

**F. Details of the Net Effect of Derivative Instruments Hedging Earnings From Financing Operations**

Financing income (expenses) in respect of assets (item A)						
	62	44	26	10	6	(21)
Financing expenses in respect of liabilities (item B)						
	-	(3)	-	-	(3)	-

\* Including capital notes.

\*\* Of which, 2004: NIS 9 million in respect of the transfer of bonds to the trading portfolio.

\*\*\* Of which: a part of the gains and losses relating to trading bonds that are still on hand at balance sheet date. Consolidated – NIS 134 million, the Bank – NIS 8 million (2005: consolidated – NIS 16 million, the Bank – NIS 1 million, 2004: consolidated – NIS 32 million, the Bank – NIS 12 million).

**24. OPERATING COMMISSIONS**

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	in NIS millions					
Ledger fees (in Israeli and in foreign currency)	225	268	273	146	182	184
Payment order system service (in Israeli and in foreign currency)	424	440	421	304	318	307
Income from credit cards	640	*570	*524	58	54	54
Credit and contracts service	177	150	143	114	93	92
Computerized services, information and confirmations	45	42	43	38	36	36
Foreign trade transactions and special foreign exchange services	93	80	75	60	58	56
Income from customers' securities transactions	224	214	206	164	160	143
Margins and collection fees on credit and deposits, from deposits according to collection:						
Collection commissions on credit granted out of Treasury funds	16	16	17	-	-	-
Commissions and other margins	3	4	3	3	4	3
Management fees and commissions from life insurance	15	16	14	-	-	-
Management fees and commissions from property insurance	11	11	13	-	-	-
Commission on transfer of rent	1	3	3	-	-	-
Other income	37	49	41	16	17	15
<b>Total operating fees</b>	<b>1,911</b>	<b>1,863</b>	<b>1,776</b>	<b>903</b>	<b>922</b>	<b>890</b>

\*Reclassified.

## 25. NET GAIN FROM INVESTMENTS IN SHARES

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	in NIS millions					
Gains on sale of shares available-for-sale	8	-	23	8	-	23
Provision for decline in value of available-for-sale shares	(7)	(9)	(12)	-	-	-
Net realized and unrealized gains from adjustment of trading securities to fair value <sup>(1)</sup>	3	2	41	2	-	41
Dividends from available-for-sale or trading shares	61	10	51	34	-	11
<b>Total from investments in shares</b>	<b>65</b>	<b>3</b>	<b>103</b>	<b>44</b>	<b>-</b>	<b>75</b>

Footnote:

(1) Of which part of the income (loss) related to trading shares that are still on hand at balance sheet date: consolidated: NIS 1 million, Bank: NIS 2 million, (2005-consolidated: NIS (1) million, Bank: NIS (1) million, 2004-consolidated: NIS 1 million, Bank: NIS (1) million).

## 26. OTHER INCOME

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	in NIS millions					
Management fees and expense refunds from provident funds	189	177	150	114	109	104
Management fees from mutual funds	100	182	138	15	20	14
Management fees from consolidated subsidiaries	-	-	-	3	3	3
Distribution fees of mutual funds	24	-	-	47	*52	*44
Profit from severance pay funds	49	160	29	46	145	24
Other income	21	21	35	54	*49	*52
<b>Total other income</b>	<b>383</b>	<b>540</b>	<b>352</b>	<b>279</b>	<b>378</b>	<b>241</b>

\*Reclassified.

**27. SALARIES AND RELATED EXPENSES**

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	in NIS millions					
Salaries	2,208	*1,919	*1,692	1,388	*1,236	*1,071
Benefit in respect of stock options granted to officers <sup>(1)</sup>	8	-	-	8	-	-
Severance pay, pension, further education fund, seniority bonuses, vacation and medical insurance	258	*345	302	187	*232	207
National Insurance and payroll taxes	399	382	321	309	288	244
Other related expenses	99	*93	88	57	53	49
Adjustment of reserves for salary-related expenses due to changes in salaries during the year	65	*31	40	42	*27	37
Voluntary retirement program expenses <sup>(2)</sup>	164	196	121	91	196	117
<b>Total salaries and related expenses</b>	<b>3,201</b>	<b>2,966</b>	<b>2,564</b>	<b>2,082</b>	<b>2,032</b>	<b>1,725</b>
Includes: Overseas salaries and related expenses	499	394	336	17	17	17

\* Reclassified.

Footnotes:

(1) See Note 13 D.

(2) 2006 and 2005: Including payroll tax.

For details regarding a change in the definition of wages in the Value Added Tax Law, see Note 29H hereunder.

## 28. OTHER EXPENSES

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	in NIS millions					
Advertising	202	153	138	73	51	41
Communications	115	109	92	60	53	42
Computer services	256	*223	*157	206	*173	*118
Office expenses	34	29	24	12	13	11
Insurance	34	*39	*44	11	17	22
Professional services	196	*119	*101	50	39	35
Directors' fees	9	8	9	2	2	2
Instruction and training	18	10	10	13	8	7
Fees	56	45	32	20	19	20
Amortization of goodwill	11	12	7	-	-	-
Other	209	* <sup>(1)</sup> 346	*216	93	73	80
<b>Total other expenses</b>	<b>1,140</b>	<b>1,093</b>	<b>830</b>	<b>540</b>	<b>448</b>	<b>378</b>

\* Reclassified.

Footnote:

(1) Including a provision in the amount of NIS 113 million in respect of a settlement signed by IDB New York with the regulatory authorities in the USA (See Note 6 D).

**29. PROVISION FOR TAXES ON OPERATING INCOME**
**A. COMPOSITION:**

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	in NIS millions					
Taxes for current year	391	346	393	104	47	67
Taxes for previous years	1	(1)	(39)	(1)	-	(38)
Total current taxes	392	345	354	103	47	29
Addition (deduction):						
Deferred taxes for current year	(42)	(23)	(12)	-	(21)	(5)
Deferred taxes for previous years	-	2	-	-	-	-
Total deferred taxes	(42)	(21)	(12)	-	(21)	(5)
Total provision for taxes on operating profit	350	324	342	103	26	24
Includes taxes of foreign subsidiaries	62	105	154	6	-	-

## 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		
	2006	2005	2004	2006	2005	2004
	in percentage					
Statutory tax rate on banks in Israel	40.65	43.59	44.53	40.65	43.59	44.53
	in NIS millions					
Income tax at the statutory tax rate	227	298	354	80	(88)	57
Income tax (tax savings) on:						
Increment (deduction) for inflation	3	(17)	(6)	1	4	1
Income of foreign subsidiaries <sup>(1)</sup>	90	(75)	22	-	-	-
General and supplemental provision for doubtful debts	1	8	4	5	6	(2)
Income exempt from tax or taxed at preferred rates	8	3	(2)	10	5	1
Adjustment differences on depreciation and capital gains	(6)	(10)	(5)	(10)	(11)	(5)
Other non-deductible expenses	98	23	18	80	19	12
Deferred taxes in respect of non-financial assets	-	(5)	1	-	(4)	(1)
Losses and timing differences (utilization), net, in respect of which no deferred tax assets were recorded	(88)	46	(44)	(89)	42	(37)
Profit tax on payroll tax	29	25	21	24	21	17
Change in the balance of deferred taxes resulting from the change in tax rates	5	37	30	3	32	19
Taxes for prior years	(1)	1	(39)	(1)	-	(38)
Income of Israeli subsidiaries	(16)	(10)	(12)	-	-	-
Provision for taxes on income	350	324	342	103	26	24

Footnote:

(1) Excluding the tax effect of the addition to equity as of the beginning of the year on the provision for taxes for the current year.

## 29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)

- C.** (1) Final tax assessments have been issued to the Bank for the tax years up to and including 2002. Following the settlement of the tax assessments for the years 2001 - 2002, the Bank cancelled excess provisions for income tax recorded in previous years on a conservative basis, in the amount of NIS 41 million.
- (2) The major consolidated subsidiaries have received final tax assessments, or assessments deemed final, for tax years between 2001 to 2004.
- D.** The balance of carry forward losses, deductions for tax purposes and timing differences, (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, 2005, amount to NIS 878 million, and to NIS 959 million on a consolidated basis. During 2006, the Bank utilized the balance of the said losses. The consolidated balance as of December 31, 2006, of the carry forward tax losses, deductibles and timing differences amounted to NIS 146 billion.
- 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, U.S. The transfer of the shares to Bankcorp was made at their value in the Bank's books, in consideration for shares issued by Bankcorp. The transfer of the shares was made in accordance with the provisions of Section 104A of the Israeli Income Tax Ordinance. The Bank is obligated to pay taxes in Israel with respect to the said transfer of shares, if and when such shares will be sold. The Bank has provided the Israeli Income Tax Authorities with a guarantee as to the payment of such taxes.
- 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 provides for a gradual reduction in the rate of company tax, from a rate of 36% in 2004, to a rate of 30% from 2007 and onward. The net effect on the balance of deferred taxes as of January 1, 2004, was a decrease of NIS 48 million (concurrently, the Bank recorded a deferred tax asset of NIS 44 million in respect of the net change in timing differences in 2004).
- G.** On July 25, 2005, the Knesset passed the Income Tax Ordinance Amendment Law (No.147 and provisional instruction) – 2005 (hereinafter – "the Amendment"). The Amendment provides for a further gradual reduction in the rate of company tax, as follows: a rate of 31% for 2006, a rate of 29% for 2007 and onward, a rate of 27% for 2008, a rate of 26% in 2009 and a rate of 25% for 2010 and thereafter.
- In view of the said Amendment of the Ordinance, the provisions for net deferred tax expenses (deferred tax assets) have been recalculated on the basis of the tax rates that will apply in the periods in which the deferred taxes are expected to materialize. The net effect on the balance of deferred taxes as of January 1, 2005, caused an expense of NIS 37 million (concurrently, the Bank recorded a deferred tax asset of NIS 60 million in respect of the net change in timing differences in 2005).
- H. A change in the definition of salaries in the Value Added Tax Law.** The Economic Policy Law for the fiscal year 2005 (Legislation Amendments) – 2005, passed the second and third readings by the Knesset on March 29, 2005, in which the definition of salaries, in respect of the payment of payroll tax by financial institutions, was expanded to also include all the benefits that a financial institution pays its employees, such as: a grant payable upon retirement or death, excluding an award paid by a provident fund, or paid out of funds that had been deposited with a provident fund and later withdrawn by the employer for the purpose of payment of the award and any amount paid by an employer to a supplemental education fund or to a provident fund on the employee's behalf even if they are exempt from tax upon

## 29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)

transfer to the fund (and where no employee benefit value has been charged in their respect in accordance with Section 3 of the Ordinance). The Amendment is effective commencing January 1, 2005.

The said amendment has an effect on the payment of payroll tax in respect of amounts payable by the Bank and its subsidiaries to their employees, and on the increase in the payroll expense of the Group. The Bank and its subsidiaries recorded, in 2006, an expense of NIS 37 million in respect of the above (2005: NIS 49 million).

- I. Reduction in the rate of "Payroll tax" and "Profit Tax":** On June 27, 2006, the Minister of Finance signed a Value Added Tax Order (The tax rate applying to not for profit organizations and financial institutions) (Amendment), 2006, whereby the "Profit tax" and "Payroll tax" rates applying to banking corporations were reduced as from July 1, 2006, from 17% to a rate of 15.5%. Following this amendment, the statutory tax rate applying to banking corporations will also be reduced to 40.65% in 2006; 38.53% in 2007; 36.80% in 2008; 35.93% in 2009 and 35.06% as from 2010 onwards. The effect of the change on the balances of deferred taxes as of January 1, 2006, was not material.

### J. 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			
	2006	2005	2006	2005
	in NIS millions			
Balance at beginning of year	94	105	82	91
Non-deductible amount for the current year	(9)	*(11)	(8)	*(9)
Balance at end of year	85	94	74	82

\* Reclassified.

**29. PROVISION FOR TAXES ON OPERATING INCOME (CONTINUED)**
**K. 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	
	2006	2005	2006	2005	2006	2005	2006	2005
	in NIS millions							
On specific provision for doubtful debts	55	50	-	-	43	38	-	-
On provision for vacation pay, seniority bonuses provision in respect of retirees and provision in respect of encouragement of voluntary early retirement plan	328	328	-	-	290	292	-	-
On excess of deposits of severance pay	-	-	174	*190	-	-	165	*172
On income tax carry-forward deductions	287	*309	-	-	287	*295	-	-
On foreign operations	259	*263	-	-	-	-	-	-
On securities	-	-	119	14	-	-	104	6
On adjustment of depreciable non-monetary assets	-	-	87	*59	-	-	74	*53
On adjustment of other non-monetary assets	39	14	-	-	27	8	-	-
Reserve for tax on income of Investee companies	-	-	10	30	-	-	10	30
<b>Total, net</b>	<b>968</b>	<b>964</b>	<b>390</b>	<b>293</b>	<b>647</b>	<b>633</b>	<b>353</b>	<b>261</b>

\*Reclassified.

	Consolidated		The Bank	
	December 31			
	2006	2005	2006	2005
	in NIS millions			
Deferred taxes are included:				
In "Other assets" (Note 8)	602	*716	318	416
In "Other liabilities" (Note 12)	(24)	(45)	(24)	(44)
<b>Total, net</b>	<b>578</b>	<b>671</b>	<b>294</b>	<b>372</b>

\*Reclassified.

## 30. NET INCOME ON EXTRAORDINARY ITEMS, AFTER TAXES

	Consolidated			The Bank		
	2006	2005	2004	2006	2005	2004
	in NIS millions					
Capital income on sale of buildings and equipment	5	16	2	4	16	2
Capital loss on sale of buildings and equipment	(13)	(3)	(42)	(13)	(3)	(40)
Provision for impairment in value of buildings <sup>(1)</sup>	(4)	(10)	-	(5)	(10)	-
Loss on the writing-off of an investment in an affiliate	(2)	-	-	(2)	-	-
Income on sale of shares of previously consolidated subsidiary	419	-	40	419	-	40
Income before taxes	405	3	-	403	3	2
Provision for taxes on profit from extraordinary items:						
Current taxes	(73)	-	(8)	(72)	-	(8)
Deferred taxes	14	1	32	14	1	32
Total provision for taxes	(59)	1	24	(58)	1	24
Income after taxes	346	4	24	345	4	26
Bank's share in income (loss) on extraordinary items of investee (in consolidated affiliated) companies, after taxes	2	-	-	3	-	(2)
Income on extraordinary items, after taxes	348	4	24	348	4	24

Footnote:

(1) 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.

In July 2005, the Supervisor of Banks published a "Questions and Answers" file about the disclosure of segment information. The issued circular clarified that the answers appearing in the said file were to be regarded as a Statement of Opinion (SOP) of the Supervisor of Banks' staff regarding guidelines for implementation so long as the Supervisor of Banks has not issued Directives in the matter.

In the said file the number of segments that would require disclosure in the relevant note to the financial statements were, among other things, reduced to the following: Households, Private Banking, Small Businesses, Middle Market Banking, Corporate Banking, Financial Management and Other (if relevant, on a specific basis in the reporting banking corporation). The segments relating to banking products (credit cards, capital market activity, mortgage loans and construction and real estate) are to be presented in the relevant customer segments. Notwithstanding, it is required to include in the Directors' Report, in respect of each segment in a separate column, a disclosure as to the banking product.

The said file clarified that the data for the international operations segment is to be presented similarly to the segment data presentation of the operations of the Discount group in Israel. In view of the fact that the subsidiary in New York was until recently not organized to provide the necessary details, the Supervisor of banks agreed that the Bank would continue to present the international operations in one column.

IDB New York completed its preparations for presenting the data according to the required segmentation, so that beginning with the financial statements as of December 31, 2006, the data for the international operations segment is presented in the form that the operations of the Group in Israel are presented. In addition a disclosure is included regarding the said operations in the item "International operations".

Whereas the data cannot be produced retroactively in the required form, the comparative figures for 2005 are presented in the form that was presented by the Bank in the past, with the approval of the Supervisor of Banks.

### 31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

The Bank is installing a management information system to manage profit centers according to customers, products and additional profiles (the cost and profit centers system). Preparation of the segment data is based on the data supplied by the cost and profit centers system. 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 begun, though at this stage only partially. 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. On the other hand, in view of the frequent changes in the definition of segments, as discussed above, together with the fact that the system is not able to provide retroactive data, a periodic series of data segmented according to operating segments has not yet been created. 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 be noted that in the said questions and answers file, the Supervisor of Banks requires banking corporations to consolidate the data of their subsidiaries according to quantitative characteristics determined by the parent company. Providing such data requires the maintenance of a double database for earnings and segments of subsidiaries. This involves tremendous difficulties and at this stage the Bank is not prepared for its implementation. At this stage, 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.

The operations of the Group are divided into six principal segments, as detailed hereunder. The segments also include, as aforementioned, the relevant part relating to banking products (credit cards, capital market activity, mortgage loans and construction and real estate).

It should be noted that these segments of operation do not accord with the organizational structure, mainly due to the fact that certain operations are reflected in the various segments, such as credit card activities and the capital market activity, and not within the organizational framework in which they are being operated.

- **Retail Banking – Household Segment:** This segment includes customers of the Bank's Retail Division who are private customers, who are defined as customers who are either salaried employees, possess the potential for growth, or may be viewed as VIP customers (the definition excludes customers of the private banking centers). The segment also includes the customers of Mercantile Discount Bank in that bank's household segment – private customers of Mercantile Discount Bank, whose activities are typical of those of households, including credit of a volume not exceeding NIS 200 thousand and deposits of a volume not exceeding NIS 500 thousand.
- **Retail Banking – Small Business Segment:** This segment includes customers of the Bank's Retail Division which are defined as small companies and small businesses with borrowings of up to NIS 4 million. The segment also includes the customers of Mercantile Discount Bank in that bank's small business segment – that bank's small business segment customers (individuals and corporations) whose granted volume of credit does not generally exceed NIS 1 million.
- **Corporate banking:** 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 – corporations whose annual business turnover generally exceeds NIS 150 million and public companies handled by the corporate division of Mercantile Discount Bank.
- **Middle Market banking:** This segment in the Bank includes mainly companies with annual turnovers of NIS 15 – 150

### 31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

million and/or total indebtedness of NIS 4 – 40 million. The segment also includes customers of the Middle Market banking of Mercantile Discount Bank – business customers (individuals and corporations) having a medium level of activity, whose granted volume of credit exceeds NIS 1 million and who do not belong to the corporate banking segment of Mercantile Discount Bank.

**Private banking:** This segment includes customers of the Bank's Retail Division (individuals and corporations) who maintain their accounts at the private banking centers.

- **Financial Management Segment** - 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 for their own account, as well as management of market and liquidity risks and dealing room operations, including those involving financial derivatives. This segment also includes the Bank's share in the income of the First International Bank and its share in the income of its affiliated companies which operate in a supporting capacity.

The segment also includes the sub-segment of non-financial corporations. This sub-segment's main activity was the Bank's investment in Harel Ltd. that was sold (see Note 6 H) and investments undertaken by a subsidiary, Israel Discount Capital Markets and Investments Ltd., as well as direct investments by the Bank.

#### B. THE PRINCIPAL ASSUMPTIONS, ESTIMATES AND PRINCIPLES USED IN THE PREPARATION OF SEGMENT INFORMATION

The classification of the business results of the Group into the various segments of activity, as stated above, was prepared based on the principles, assumptions and estimates detailed hereunder:

##### 1) Income

**Income from financing operations before provision for doubtful debts.** The segment is credited with the margin resulting from the difference between interest on loans granted to customers of the segment and the interest paid on deposits of customers of the segment and the transfer prices.

The transfer prices reflect the marginal alternative cost of financing sources or the application thereof.

The margins are set at the date the transaction is entered into and stay in effect for the duration of the transaction free of market risks.

According to this methodology, earning or losses from financing operations resulting from changes in market conditions, are taken to the "Financial Management" segment.

Income earned on the nostro securities of the Bank 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. Some of the income derived from foreign currency operations with customers is credited to the trading desk.

##### 2) Expenses

Identifiable direct expenses are specifically and directly reflected in the related segments.

Overhead expenses (mainly head office expenses), which cannot be related to a specific segment, are charged to the segments using an estimate based on various charging formulas, most of them based on volume of operation indices and

### 31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

some of them based on estimates and assessments of the various units of the Bank. (For details see paragraph 4 hereunder).

Depreciation and amortization expenses are charged as part of the overhead expenses.

The model for the charging of expenses used in calculating the data includes the allocation of inter segment expenses, mainly in relation to operational services provided by the branch setup to customers related to other segments by charging all the branches' expenses to customers of these branches, even if these customers are not amongst the customers of the Retail Division. As stated above, this charge is made by way of an estimate based mainly upon indices for the volume of operations of customers of the Bank's branches.

Whereas, as stated, the system is in its development stage, and has not as yet been fully integrated at the Bank as a management control tool, certain changes are being made from time to time in the manner of determining assessments and in the way of allocating expenses, so that comparison between periods might be flawed.

**Taxes on income.** In order to exclude the effect of brought forwards tax losses in respect of which deferred tax assets had not been recorded, on the measurement of the profitability according to segments of operation, the following tax computation was made:

The provision for taxes of the various segments of operation was computed on the basis of the statutory tax rate of 40.65% (2005: 43.59%). Segments showing a loss recorded a tax income computed also on the basis of the statutory tax rate.

The difference between the net taxes attributed to the segments of operation and the provision for taxes recorded in the income statement, is charged to the "Financial Management" segment.

#### 3) Allocation of capital and computation of the return

Shareholders' equity and subordinated capital notes, being part of the financing sources of credit, are being allocated to each segment in respect of its risk assets. The allocated capital notes bear the actual interest expense attributed to them.

According to directives of the Supervisor of Banks, the operational segments are credited with imputed interest on the capital allocated to them, on the basis the risk assets attributed to the segment.

The computation of the return in each segment is based on the amount of shareholders' equity allocated to the segment

#### 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

### 31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS INFORMATION (CONTINUED)

another segment (referred to in the reporting format as "inter-segment activity"). The Supervisor of Banks permitted the Bank to report on the basis of the mechanism it developed for the purpose of allocating income and expenses, and in consequence thereof not to report inter-segment transfers.

## 31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)

## D. ACTIVITY SECTORS IN DISCOUNT BANK BUSINESS SEGMENTS

## Reported Amounts

For the year ended December 31, 2006								
	Households	Small Businesses	Corporate Banking	Middle Market Banking	Private Banking	Non-Financial Companies	Financial Management	Total Consolidated
in NIS millions								
Income from financing activities before provision for doubtful debts								
- From externals	487	747	1,357	1,101	814	(3)	(713)	3,790
- Intersegmental	568	(200)	(290)	(590)	(512)	(15)	1,039	0
Total Income from financing activities	1,055	547	1,067	511	302	(18)	326	3,790
Non-financing and other income	1,440	331	181	175	130	13	89	2,359
Total Income	2,495	878	1,248	686	432	(5)	415	6,149
Provision for doubtful debts	109	183	159	117	2	-	-	570
Operating and other expenses	2,189	634	701	593	375	4	524	5,020
Operating Income (loss) before taxes	197	61	388	(24)	55	(9)	(109)	559
Provision for taxes on operating income	85	31	162	(4)	32	(4)	48	350
Operating Income (loss) after tax	112	30	226	(20)	23	(5)	(157)	209
Bank's share in operating income of affiliated	(2)	-	-	-	-	56	134	188
Minority interest in the income of subsidiaries	(79)	(3)	(-)	(-)	(-)	-	-	(82)
Net gain (loss) from extraordinary items, net of taxes	220	25	2	2	8	104	160	521
Net income (loss)	251	52	228	(18)	31	155	137	836
Yield on capital (percentage)	24.1%	9.1%	9.3%	-1.9%	21.1%	431.2%	8.4%	12.2%
Net income (loss) disregarding certain components <sup>(1)</sup>	149	78	286	30	56	155	16	666
Yield on capital (percentage)	14.3%	13.4%	11.6%	3.2%	38.8%	143.3%	1.0%	9.7%
Average Assets	17,669	12,007	41,850	17,658	3,533	307	61,310	154,334
Of which- Investment in Investee companies	1	-	-	-	-	81	1,523	1,605
Average Liabilities	53,946	7,562	16,545	10,322	37,478	24	20,855	146,732
Average Risk-assets	17,357	9,787	40,886	15,786	2,397	601	19,571	106,385
Average assets of provident and mutual funds	25,381	3,499	210	1,525	1,262	-	1,917	33,794
Average customers' securities	22,543	4,347	25,461	11,000	17,390	-	-	80,741
Average other assets under management	3,552	283	130	1,584	626	-	-	6,175
Margin from credits activity	433	389	729	356	67			
Margin from deposits activity	542	96	150	116	231			
Other	80	62	188	39	4			
Income from financing activities before provision for doubtful debts	1,055	547	1,067	511	302	(18)	326	3,790

(1) The following components have been disregarded: the privatization bonus, expenses regarding early retirement incentive, a bonus to the employees in respect of the sale of the controlling interest in the Bank, payments to the supervisory authorities in the U.S. and the cost of implementing the improvements and the examinations in IDB New York, the effect of the reversal of the provision in respect of the investment in the First International Bank, the profit on the sale of shares of Harel Insurance Investments and the profit on the sale of Ilanot Discount.

**31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)**
**D. ACTIVITY SECTORS IN DISCOUNT BANK BUSINESS SEGMENTS**
**Reported Amounts**

For the year ended December 31, 2005

	Households	Small Businesses	Corporate Banking
in NIS millions			
Income from financing activities before provision for doubtful debts			
- From externals	(825)	574	1,546
- Intersegmental	1,831	(18)	(784)
Total Income from financing activities	1,006	556	762
Non-financing and other income	*1,436	383	103
Total Income	2,442	939	865
Provision for doubtful debts	85	182	303
Operating and other expenses	*1,830	697	*459
Operating Income (loss) before taxes	527	60	103
Provision for taxes on Operating Income	*250	40	*56
Operating Income (loss) after taxes	277	20	47
Bank's share in operating income of affiliated	-	-	-
Minority interest in the income of subsidiaries	(80)	(3)	8
Net income (loss)	197	17	55
Yield on capital (percentage)	*19.9%	*3.4%	3.0%
Average Assets	16,063	11,577	29,023
Of which- Investment in Investee companies	4	-	-
Average Liabilities	48,794	8,189	12,370
Average Risk-assets	16,510	8,834	31,389
Average assets of provident and mutual funds	29,384	5,060	435
Average customers' securities	12,624	3,315	20,540
Average other assets under management	3,246	244	101
Margin from credits activity	*432	*386	*601
Margin from deposits activity	541	89	102
Other	33	81	59
Income from financing activities before provision for doubtful debts	1,006	556	762

\*Reclassified.

For the year ended December 31, 2005

Middle Market Banking	Private Banking	International Activity	Non-Financial Companies	Financial Management	Total Consolidated
in NIS millions					
270	(722)	1,098	5	1,751	3,697
129	843	(150)	(20)	(1,831)	-
399	121	948	(15)	(80)	3,697
159	75	124	1	125	2,406
558	196	1,072	(14)	45	6,103
83	-	38	-	-	691
432	129	768	4	410	4,729
43	67	266	(18)	(365)	683
21	32	39	(9)	(105)	324
22	35	227	(9)	(260)	359
-	-	-	54	120	174
-	-	-	-	-	(75)
22	35	227	45	(140)	458
3.3%	125.5%	16.0%	127.9%	(16.7%)	7.2%
9,844	1,094	45,277	616	35,800	149,294
-	-	-	461	891	1,356
6,062	16,575	40,209	26	9,195	141,420
10,929	471	23,578	583	8,761	101,055
2,335	1,069	-	-	1,911	40,194
11,250	7,713	10,537	-	-	65,979
1,507	502	129	-	-	5,729
280	15	-	-	-	-
94	106	-	-	-	-
25	-	-	-	-	-
399	121	948	(15)	(80)	3,697

31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)  
 D. ACTIVITY SECTORS IN DISCOUNT BANK BUSINESS SEGMENTS (CONTINUED)  
 Reported Amounts

	For the year ended December 31, 2004			
	Households	Small Businesses	Corporate Banking	Middle Market Banking
	in NIS millions			
Income from financing activities before provision for doubtful debts	1,182	462	439	190
Non-financing and other income	*469	219	112	68
Total Income	1,651	681	551	258
Provision for doubtful debts	56	118	217	42
Operating and other expenses	*1,202	488	266	255
Operating Income (loss) before taxes	393	75	68	(39)
Provision for taxes on Operating Income	174	37	30	(16)
Operating Income (loss) after taxes	219	38	38	(23)
Bank's share in operating income of affiliated	-	-	-	-
Minority interest in the income of subsidiaries	-	-	-	-
Net operating income	219	38	38	(23)
Net gain (loss) from extraordinary items, net of taxes	-	-	-	-
Net income (loss)	219	38	38	(23)
Yield on capital (percentage)	80.2%	10.3%	2.9%	(6.4%)
Average Assets	5,592	11,595	19,886	6,985
Of which - Investment in Investee companies	-	-	-	-
Average Liabilities	55,761	8,852	6,496	4,859
Average Risk-assets	4,548	6,297	21,990	5,899
Average assets of provident and mutual funds	-	-	-	-
Average other assets under management	-	-	-	705
Margin from credits activity	220	332	344	131
Margin from deposits activity	935	80	40	47
Other	27	50	55	12
Income from financing activities before provision for doubtful debts	1,182	462	439	190

\*Reclassified.

For the year ended December 31, 2004

Private Banking	International Activity	Construction and Real Estate	Mortgages	Credit Card Activity	Capital Market Activity	Non -Financial Companies	Financial Management	Total Consolidated
in NIS millions								
87	804	259	125	89	17	(21)	(160)	3,473
9	125	26	57	536	485	51	74	2,231
96	929	285	182	625	502	30	(86)	5,704
-	35	326	78	8	-	-	-	880
67	561	74	65	424	330	11	285	4,028
29	333	(115)	39	193	172	19	(371)	796
12	169	(45)	21	83	76	2	(201)	342
17	164	(70)	18	110	96	17	(170)	454
-	-	-	-	-	-	66	69	135
-	-	18	(6)	(60)	(8)	-	-	(56)
17	164	(52)	12	50	88	83	(101)	533
-	-	-	-	-	(1)	32	(8)	23
17	164	(52)	12	50	87	115	(109)	556
94.7%	13.8%	(5.1%)	2.6%	38.0%		355.1%	(13.8%)	9.3%
1,051	41,144	9,708	9,850	1,604	47	573	34,469	142,504
-	-	-	-	-	3	414	804	1,221
10,271	36,663	1,876	2,298	760	8	-	7,420	135,264
277	19,915	16,801	7,389	2,222	44	539	6,806	92,727
-	-	-	-	-	33,839	-	-	33,839
-	119	-	2,362	-	1,773	-	-	4,959
13	-	218	124	89	-	-	-	-
74	-	16	-	-	-	-	-	-
-	-	25	1	-	17	-	-	-
87	804	259	125	89	17	(21)	(160)	3,473

**31. BUSINESS SEGMENTS AND GEOGRAPHICAL AREAS (CONTINUED)**
**D. INFORMATION ON GEOGRAPHICAL AREAS**

	Income <sup>(1)</sup>			Net Income (loss)			Assets	
	For the year end December 31						As at December 31	
	2006	2005	2004	2006	2005	2004	2006	2005
	in NIS millions							
Israel	5,201	5,031	4,775	845	231	392	121,118	113,757
Europe	84	65	58	9	5	5	4,148	2,964
North America	741	904	795	(45)	214	158	35,400	40,264
Sout America	123	103	76	27	8	1	1,872	1,735
Total Overseas	948	1,072	929	(9)	227	164	41,420	44,963
Total Consolidated	6,149	6,103	5,704	836	458	556	162,538	158,720

Footnote:

(1) Income-earnings from financing operations before provision for doubtful debts and other operating income.

### 32. SALE OF A CONTROLLING INTEREST IN THE BANK

#### A. COMPLETION OF THE SALE OF A CONTROLLING INTEREST IN THE BANK

On January 31, 2006, the transaction signed on February 1, 2005 entered into by M.I. Holdings Ltd. and the Government of Israel (hereinafter – “the Government”) on the one hand, and a corporation controlled by the Bronfman Family and others and a corporation 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”), was completed, whereby:

- The Buyers acquired 26% of the Bank’s issued share capital;
- The Buyers were granted an option for a period of three years from date of the transaction, to acquire further shares comprising up to an additional 25% of the Bank’s issued share capital;
- Arrangements have been made between the Government and the Buyers as to the coordination of their voting and of their exercise of control of the Bank.

Following the transaction closure, as above, control of the Bank has passed to the Bronfman-Schron Group

#### B. PERMIT OF THE GOVERNOR OF BANK OF ISRAEL

The Governor of the Bank of Israel issued a permit to the group of investors to acquire and hold jointly the control and means of control in the Bank. This involves matters that have an impact on the Bank, including:

1. (a) No dividends shall be distributed from earnings retained by the Bank up to September 30, 2004.

If losses were incurred after that date, no dividends shall be distributed until after such losses have been recovered. Furthermore, no dividends are to be distributed from gains on sale of significant assets of the Bank during the period of five years from date of the permit. After that date, dividends may be distributed from such gains subject to the prior written approval of the Supervisor (The retained earnings of the Bank as of September 30, 2004, which, as stated, may not be distributed, amount to NIS 2,704 million).

- (b) Notwithstanding the aforementioned, dividends may be distributed from gains on sale of significant assets of the Bank during the period of five years from date of the permit, if all the following conditions exist:

- (1) The sale results from legal requirements applying to the Bank;
- (2) The distribution of dividends from such gains shall not cause a reduction in the minimum capital ratio that existed at the Bank prior to the sale of the said assets;
- (3) The Board of Directors of the Bank shall approve such distribution after having examined the needs of the Bank and its business plans;
- (4) Prior approval of the Supervisor in writing has been given for such distribution after the Supervisor had examined the capital adequacy of the Bank and the basis for the Board’s decision.

2. Members of the Group, their relatives or corporations under the control of any of them, are not to receive management fees or any consideration or other benefit from the Bank or from corporations under the control of the Bank; however, they are permitted to provide services normally provided by suppliers of such services and at market price, as long as a written notice has been given beforehand to the Supervisor as to the type of service and the consideration, at least 14 business days prior to providing the service; in an event that the Supervisor informs that a service is not of the type provided ordinarily to others, or that the consideration for it is not reasonable, such service shall not be given.

The provisions of this Section shall not apply to Directors’ remuneration payable to all Directors of the Bank in equal amounts.

## 32. SALE OF A CONTROLLING INTEREST IN THE BANK (CONTINUED)

### C. 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 (see hereunder). 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.

Set out 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 remaining balance of 10% of the Bank's shares 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 above-mentioned concession, the employees will receive from the Government a 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 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.
- 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 Israel Discount Bank of New York is sold, then the full cash proceeds of such sale will be transferred to the Bank, and that no dividend shall be distributed out of such proceeds for a 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.

### 32. SALE OF A CONTROLLING INTEREST IN THE BANK (CONTINUED)

- 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 regard, it was clarified that the term "employees" in relation to the above does not include the employees of Mercantile Discount Bank Ltd.)
- Subject to the approval of the Employees Agreement, the parties to the Employees Agreement have mutually committed that for 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 be made by any of the parties that are not compatible with the Labor Charter. No strike or closing-down measures, in whole or in part, will be taken, nor 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 was subjected to the approval of the authorized institutions 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). On April 5, 2005 the General Meeting of Shareholders of the Bank approved the Bank joining the Employees Agreement. The Employees Agreement was also subject to the approval of the Finance Committee of the Knesset. The Finance Committee approved the Employee Agreement.

In the first quarter of 2006, soon after the closing of the agreement for the sale of a controlling interest in the Bank, the Bank and its relevant subsidiaries paid the overall bonus agreed upon in the Employees Agreement. The total cost of this bonus, including related expenses (payroll VAT and Social Security contributions) amounted to NIS 305 million out of the said amount NIS 73 million were provided for in the financial statements as of December 31, 2004. Accordingly, the bonus that is to be paid by the State will amount to NIS 175 million, of which NIS 120 was paid in March 2006, and the remaining balance will be paid upon the exercise of the option by the Bronfman-Schron Group.

**Mercantile Employees Agreement.** On May 22, 2005, the Histadrut, The Representative Committee of Mercantile Discount Bank Employees and the Accountant General at the Ministry of Finance signed an agreement, which, inter-alia, is subject to Mercantile Discount Bank's approval (see hereunder). The Mercantile Employees Agreement is intended to settle several demands raised by employees of this bank regarding their rights in light of the sale of the controlling interest in the Bank by the State.

The terms of the Mercantile Employees Agreement are as follows:

- The Histadrut, as the organization representing the workers, conceded, on behalf of the employees, their right to purchase the remaining balance of 10% of the Discount Bank's shares held by the State, at a 25% discount, and to a subsidized loan to finance this purchase, as is customary in privatization of banks being part of the "Share Arrangement"
- In exchange for the above-mentioned concession, 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.

### 32. SALE OF A CONTROLLING INTEREST IN THE BANK (CONTINUED)

- The employees would be entitled to receive from Mercantile Discount 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 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 amount of the bonus payable to the employees of Mercantile Discount Bank will be the proportional amount applicable to the Mercantile Discount Bank out of the total amount of the bonus (NIS 250 million) as defined in the said Employee Agreement. The said bonus will be paid to the employees subject to the closing of the agreement for the sale of a controlling interest in the Bank, and at dates specified in the Agreement.
- The validity of the collective labor agreements at Mercantile Discount Bank (as the term is defined in the collective agreement dated December 21, 2004 and all its Annexes) will be extended for a specified period until December 31, 2009. At the end of this period, the parties shall act as regards to the validity of the collective agreements, in accordance with the terms of Section 5 of the labor agreement dated May 17, 1968.
- The labor dispute announced at Mercantile Discount Bank on March 29, 2004, with regard to the privatization of Discount Bank, shall be terminated immediately upon the approval of the Mercantile Employees Agreement.
- Immediately following the approval of the Mercantile Employees Agreement, the employees of Mercantile Discount Bank will cooperate in any matter or action required for the closing of the transaction for the Sale of the Controlling Interest in Discount Bank, and for the sale of the remaining balance of shares held by the State, and in any other required process, if at all.
- Subject to the approval of the Mercantile Employees Agreement, the parties to the Mercantile 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 collective labor agreements. No strike or closing-down measures, in whole or in part, will be taken, nor will anything that might impair labor relations and orderly work procedures be brought into effect.

The validity of the Mercantile Discount Bank Employees’ Agreement was subject to approval of the authorized institutions of this bank, approval of Mercantile Discount Bank Employees’ Council and the approval of the Finance Committee of the Knesset.

On May 30, 2005, the Representative Committee of Mercantile Discount Bank Employees approved the Mercantile Employee Agreement. The Board of Directors of Mercantile Discount Bank approved the agreement on June 9, 2005, and the general meeting of shareholders of Mercantile Discount Bank approved the agreement on June 20, 2005. The Finance Committee of the Knesset also approved the Agreement.

#### D. 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’s Grant to Employees in the amount of NIS 57 million, comprising the said special bonus, was recorded in the financial statements for the first quarter of 2006, in which the conditions precedent in the Employees Agreement were 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 175 million, including 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's Grant to Employees was recorded in the financial statements of the Bank in the first quarter of 2006, in accordance with the said directive of the Supervisor of Banks, along with recording the provision for the special bonus.

### 33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE

#### GOVERNMENT RESOLUTION REGARDING THE BANKING SYSTEM

In the course of the years since 1993, the Government adopted various decisions with respect to the banking industry, a number of which turned into Law, other were formed into proposed Bills, and the remainder stayed as Government decisions, whether in their original format or subsequently changed. The principal decisions relate to the following topics:

(a) the holding of shares of 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.

Most of the amendments relating to the legislation restricted, reduced and regulated the banks' activities in the said areas. The Bank Shares in Arrangement (Temporary Provision) Law (1993) 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.

**Separation of Mercantile Discount Bank Ltd.:** The past Government resolutions specify, inter alia, that the Government and the 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, no tax 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.

In 2004, the decision of May 2, 1993, regarding the separation of Mercantile Discount Bank Ltd from Israel Discount Bank Ltd was cancelled. In view of the said decision, the provision for tax in respect of the Bank's share in the profits of Mercantile Discount Bank amounted to NIS 33 million, became superfluous, and its reversal is reflected in the financial statements as of December 31, 2004.

#### CHANGES IN THE STRUCTURE OF THE CAPITAL MARKET

In November 2004, the Government adopted the recommendations of the inter-office committee, headed by the Director General of the Ministry of Finance (hereinafter – "the Bachar Committee"), the purpose of which was to provide a competitive basis for the capital market to reduce concentration in the market and minimize conflicts of interest.

In continuation to the recommendations of the Bechar Commission, three comprehensive laws were published on August 10, 2005, which relate to the capital market and to the activities of banks and other players therein; The Law for Increasing Competition and Reducing Concentration and Conflicts of Interest in the Capital Markets in Israel (Legislation amendments), 2005 (hereinafter: "The Law for Increasing Committee"); The Supervision of Financial Services Law (Consulting and Marketing of Pension Schemes), 2005 (hereinafter: "The Pension Consulting Law"); The Supervision of Financial Services Law (Provident Funds), 2005 (hereinafter: "The Provident funds Law"). Further on in 2005 and in the years 2006 and 2007,

### 33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

various Rules and Regulations began to be published, designed to complement the arrangements by way of secondary legislation.

Following is a summary review of the main amendments to the legislation.

#### THE LAW FOR INCREASING COMPETITION

This Law amends several relevant laws, and per the letter of this Law, is intended to establish a competitive structure in the capital markets, improve efficiency and modes of operation and increase public welfare, mostly by reducing concentration and minimizing conflicts of interest among entities operating in the market, and expanding supervision and control over such entities and over those who own and control them.

#### AMENDMENTS TO THE BANKING LAW (LICENSING), 1981

- A banking corporation is forbidden to manage provident funds and mutual investment trust funds ("mutual funds") or to hold, directly or indirectly, any means of control over a company that manages provident funds or mutual funds.
- A bank is forbidden to own over 10% of corporations that control or own over 25% of a company that manages provident funds or of a company that manages mutual funds.
- Concurrently, transitional periods were determined in which banks must divest of the said holdings in a manner that banking corporations, the equity of which does not exceed NIS 10 billion (among which is the Bank), are required to reduce their holdings in provident fund management companies over a period of six years from the date the Law becomes effective, and to reduce their holdings of mutual fund management companies over a period of eight years from the date the Law becomes effective. During these periods the Bank must gradually reduce the relevant market share of the provident fund and mutual fund management companies it owns.
- A bank is forbidden to directly control or own over 5% of any type of the means of control in a portfolio manager who manages investments of a mutual fund, a provident fund or an insurer. The indirect ownership of a bank in a corporation that controls a portfolio manager as stated above was also limited to 20%.  
A transitional provision was also passed in this respect, whereby the bank will be entitled to continue exceeding the said maximum ownership until the end of six years from the date on which the Law comes into effect.
- A bank is permitted to provide pension consultation services, subject to the provisions of the Pension Advisory and Marketing Law (see hereunder).
- A duty has been imposed on banks to receive the Supervisor of Banks' approval for the ownership of auxiliary corporations.
- A bank is permitted to have the sole ownership and control of a corporation that is an insurance broker, provided that the insurance business is limited to life insurance and property insurance purchased in connection with granting housing loans to customers of the Group's banking corporations.
- Restrictions as to the ownership of corporations of various kinds have also been imposed on entities controlling banking corporations.
- The Supervisor of Banks has been authorized to impose civil penalties on a bank in respect of violations of a part of the provisions of the Banking Law (Licensing).

The said provisions are effective as from August 10, 2005.

#### AMENDMENTS TO THE BANKING ORDINANCE, 1941

- The authority of the Supervisor of Banks to issue directives as to bank management has been legislated and the status of the existing directives has been reaffirmed.

### 33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

- The Supervisor of Banks has been authorized to relate to the regulatory authorities in Israel information attained as part of the performance of his duties.
- The Supervisor of Banks has been authorized to impose a monetary sanction upon a bank if he has reasonable grounds to assume that the bank had violated Proper Banking Management Directives, or other directives issued by the Governor of the Bank of Israel and/or the Supervisor. Concurrently, provisions have been enacted as to the bank's right to appeal the Supervisor's decision.

The said provisions are effective as from August 10, 2005.

#### AMENDMENTS TO THE BANKING LAW (CUSTOMER SERVICE), 1981

- The Supervisor of Banks has been authorized to impose a monetary sanction on a bank if he has reasonable grounds to assume that this banking corporation had not corrected certain deficiencies in accordance with this Law or if it had violated certain provisions of this Law and the Regulations passed thereunder.

The said provisions are effective as from August 10, 2005.

#### AMENDMENTS TO THE LAW REGULARIZING ENGAGEMENT IN INVESTMENT ADVISORY AND INVESTMENT PORTFOLIO MANAGEMENT, 1995

- A distinction has been made between investment consultation services and investment marketing (investment advise regarding products towards which the consultant has an affinity), and the duties of those engaged in these areas have been determined. Banks will be permitted to engage in investment advisory services (by means of investment consultants) and in addition will be permitted to market structured products, options and forward contracts issued by them.
- The holder of a consultant license (including a bank) is not permitted to provide consulting services with regards to financial assets of an institutional entity that controls the bank, is controlled by it or is an interested party in the bank (or affiliated with the bank).
- Similar restrictions which were imposed on a bank have also been imposed on portfolio managers connected to that bank.
- A bank shall not be permitted to issue basket notes.

The engagement of a bank with a provident fund management company, a mutual fund management company or an insurer for the purpose of providing banking services that are not in the ordinary course of business of a bank, or which is not under accepted market terms, or which might have a significant effect upon the bank's profitability, assets or liabilities, requires the prior approval of the Chairman of the Securities Authority and of the Supervisor of Banks, and in the coming years (until 2010) also of the Commissioner of Restrictive Business Practices.

- Certain restrictions in respect of investment advisory services and the marketing of investments have been imposed also on whoever controls a bank, and also on a bank which the controlling entity holds or controls entities as above.
- Prohibitions and restrictions have been imposed upon the receipt of incentives (except for fees and the reimbursement of expenses) in connection with investment advisory services, the marketing of investments, the execution of a transaction or refraining from executing a transaction in financial assets.

Notwithstanding the aforesaid, an investment consultant is permitted to receive a distribution commission from a mutual fund management company if such commission is paid in accordance with the provisions of the Mutual Investment Trusts Law and the Regulations to be enacted thereunder.

### 33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

- A bank is not permitted to grant benefits to its employees or its units in connection with investment advisory services, investment marketing, and the execution of a transaction or abstention from executing a transaction, if such benefit is determined considering the identity of the entity that has an affiliation to the financial assets being the subject of the advisory services, the marketing or the transaction.

- The Securities Authority is empowered to impose a civil penalty on whoever violates certain provisions of the Law.

The said provisions are to become effective six months following the enactment of the Law. However, with respect to a bank, the provisions in effect prior to the said effective date, will continue to apply so long as the bank or those who control it or corporations owned by it, are holding means of control in companies managing provident funds or mutual funds, or by the portfolio management company managing the funds of financial institutions on behalf of their customers (all this in the period in which the said holdings were still permitted).

#### AMENDMENTS TO THE MUTUAL INVESTMENT TRUST LAW, 1994

- The provisions regarding the approval of a mutual fund management company and the cancellation of such an approval have been extended.
- It has been determined that the holding of 30% of a particular type of means of control in a mutual fund management company requires the approval of the Securities Authority.
- The market share of an owner of a mutual fund management company has been restricted to 20%.
- The Minister of Finance has been empowered to determine the maximum rate of commission that a distributor is entitled to collect from a mutual fund management company, provided that a uniform rate of commission is to be collected from the various mutual fund managers.
- The Minister of Finance has been empowered to determine the maximum rate of commission that a distributor is entitled to collect from a purchaser of a unit in a mutual fund.
- The Securities Authority has been empowered to issue guidelines and instructions as to the proper management of mutual funds.

The said provisions are effective as from August 10, 2005.

#### AMENDMENTS TO THE SUPERVISION OF INSURANCE BUSINESS LAW, 1981

- The authority of the Commissioner of Insurance has been extended, including his power to license the ownership of an insurer and an insurance broker.
- It has been determined that the requirement to receive a permit for holding means of control in an insurer shall also apply to the holding of means of control in an insurer as security for enforcement, unless these are held in a security deposit account of a customer with a bank, and their rate does not exceed 0.001% of the same type of the means of control.
- A pension consultant is also permitted to engage as an insurance broker, provided that the brokerage activity shall be part of the pension advisory services.
- It has been determined that a banking corporation shall not be permitted to receive an insurance brokers license in the pension insurance field.
- The Commissioner of Insurance has been authorized to impose a civil penalty and a monetary sanction on whoever acts in violation of certain provisions of the Law.

The said provisions are effective as from August 10, 2005.

### 33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

#### THE PENSION CONSULTING LAW

- The law regularizes the activity of consulting services to individuals with respect to the advisability of savings through pension products. The Law specifies two new occupations requiring a license – pension advisory services and the marketing of pension schemes, and the criteria for obtaining a license and the duties of those engaged in these fields have been determined.
- Banks shall not be permitted to engage in the marketing of pension schemes but will be allowed to engage in pension advisory services (through licensed pension consultants) on the following terms:
  - A. The banking corporation does not own over 5% in the Insurer and does not own over 10% of the means of control in another corporation which controls the insurer or owns over 25%;
  - B. The banking corporation does not own any means of control in a provident fund management company and does not own over 10% of the means of control in another corporation, which controls a provident fund management company or owns over 25% of that company;
  - C. The banking corporation does not own any means of control in a mutual fund management company and does not own over 10% of the means of control in another corporation, which controls the mutual fund management company;
  - D. The Commissioner of the Capital Market, Insurance and Savings is convinced that the granting of a license will in no way harm competition and the prevention of concentration in the relevant fields, including banking.

Concurrently, transitional provisions have been enacted according to which the Commissioner is empowered to grant a pension advisory license to a banking corporation, the equity of which and of the banking corporations controlling it or which are controlled by it, does not exceed NIS 10 billion (this includes the Bank) even if this banking corporation controls or owns more than 10% of the means of control in a mutual fund manager or in a provident fund management company, and all within the period in which a banking corporation is permitted to have such holdings.

The transitional provisions further determine that a license granted to a banking corporation with respect to pension advisory services shall, within a specified period (at least until 2009), be restricted in a way that the bank would not be permitted to provide pension advisory services as regards pension funds, provident funds and individual severance pay funds if these funds are insurance funds, and also the bank would not be permitted to provide advisory services as to life assurance schemes or disability insurance schemes that are included in a provident fund or in a further education fund.

- A banking corporation is not permitted to provide pension advisory services with respect to a pension product of an institutional entity that is an interested party in the bank or to which the bank is affiliated.
- Pension advisory services shall be provided only at the branches of the bank.
- A banking corporation is not permitted to control or to have an interest in a corporation engaged in pension advisory services unless that company is a banking corporation.
- A banking corporation is not permitted to enter into a transaction with a representative body of employees for the purpose of providing pension advisory services to such employees, nor is a bank permitted to enter into a transaction with an employer or with an employee organization for the purpose of providing pension advisory services to them or to their employees.
- The engagement of a bank, acting as a pension consultant, with an institutional entity in an agreement that is not within the ordinary course of business of the bank and which might have a significant effect upon its profitability, its assets or its liabilities, requires the prior approval of the Commissioner of the Capital Markets and of the Supervisor of Banks, and,

### 33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

in the coming years (until 2010), also of the Commissioner of Restrictive Trade Practices.

- Prohibition and restrictions have been imposed upon the receipt of incentives (except for fees and the reimbursement of expenses) in connection with pension advisory services or in connection with the carrying out of a transaction on behalf of a customer.

However, under certain conditions and at a maximum rate to be determined by the Minister of Finance, a pension consultant may receive a distribution commission from a provident fund management company. The said distribution commission is not to be computed as a rate of the management fees, which the management company collects from the customer.

- A bank, acting as a pension consultant, is not permitted to grant benefits to its employees or to its organizational units, if such benefit is determined considering the identity of the institutional entity that has an affiliated to the particular pension product or considering the type of the pension product.
- The Commissioner has been empowered to issue instructions as to proper management directives of pension advisory services.
- Certain violations of the provisions of the Law are considered a criminal offense.
- The Commissioner of Capital Markets is empowered to impose a civil penalty and monetary sanctions on whoever violates certain provisions of the Law.

The Law is to come into effect six months following its enactment. However, a bank that, prior to the effective date of the Law, engaged in investment advisory services will be entitled to continue providing such services to provident funds and to individual severance pay funds (which are not insurance funds) for a period of three and a half years from the effective date.

#### THE PROVIDENT FUNDS LAW

- This law formalized most of the instructions that had formally been included in the Income Tax Regulations (rules for approval and management of provident funds), 1964, as well as other issues, including the authority of the Commissioner of the Capital Markets to impose a civil penalty and monetary sanctions with respect to violations of certain provisions.
- It has been determined that control of a provident fund management company or the ownership of over 5% of a certain type of means of control in a management company requires the approval of the Commissioner of the Capital Markets. In this respect, the ownership of the means of control at the said rate as a security for enforcement constitutes ownership that requires a license, unless these are held in a security deposit account with a bank and their rate does not exceed 0.001% of the same type of means of control.
- It has been determined that the rights of a member of a provident fund are not transferable and may not be pledged or foreclosed, unless pursuant to conditions specified in the Law or under regulations to be determined by the Minister of Finance.
- Provident funds are required to continue and keep their cash balances with banks of institutions authorized for this purpose, to keep their securities deposits with a Stock Exchange member or with whoever has been authorized for this purpose by the Commissioner of the Capital Markets.
- A management company will be entitled to collect from the assets of the fund, from members' accounts or from other payments management fees, reimbursement of direct expenses and insurance fees only. The Minister of Finance is empowered to determine the maximum rate of the said expenses and management fees.

### 33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

- A provident fund management company, or whoever controls it is, prohibited from receiving any benefit over and above the said management fees and expenses.
- A provident fund management company is prohibited from paying a commission or other consideration in respect of a member joining the fund, except for a distribution commission, in respect of which the Minister of Finance is also empowered to determine in regulations an amount or a maximum rate and the mode of computing the commission.

The Law will come into effect 90 days after the publication thereof.

It has also been determined that a management company which had been granted a license in the past under the Income Tax Regulations (provident funds) is entitled to a license also under this Law, provided it filed a request for a license within six months from the effective date.

#### NEW LEGISLATION INITIATIVES IN THE PENSION FIELD

Two new legislation initiatives commenced at the beginning of 2007, which if passed as law, are expected to impact the activity of the Bank in the field of pension consulting services: one, the Ministers' Legislation Committee adopted a private Bill, the essence of which is to prefer banking corporations having a shareholders' equity not in excess of NIS 10 billion (among which is the Bank) at the date of entry into the pension consulting field (by applying stiffer terms to the larger banks wishing to obtain a pension consulting license and extending the period until such license may be obtained) and advancing the date on which these banking corporations would be entitled to engage also in insurance products consulting. This proposed Bill grants the Bank as well as other banks an advantage over the two largest banks with respect to the date of entry into the pension consulting field.

The second initiative is the adoption of the proposal made by the Ministry of Finance to establish by law a "compulsory pension" for each working individual. According to the proposal of the Ministry of Finance, as from 2010, the tax regulations applying to capital provident funds are to be equalized with those applying to pension provident funds, so that a working person may save under any fund while enjoying the tax benefits granted at present to the pension instrument. The decision as to the nature of the retirement savings would be deferred until retirement date, on which the worker would be entitled to convert the savings into a monthly pension or to capitalize part of the savings into a one-time payment in accordance with rules to be determined. The worker would also have the possibility of dividing the retirement savings components and acquire these from various entities and not from one entity. Each of these entities would on its part be entitled to offer the savers all the required coverage, with no subordination as to tax benefits.

This initiative, if adopted, may significantly increase the potential population requiring pension consulting services. Notwithstanding, the matter might spoil the demand for pension consultation, in view of the deferment of the date on which the customer is required to decide of the savings option, particularly to the extent that they are not allowed to provide insurance consulting services.

At this stage, it is not possible to assess whether they will at the end of the day be enacted into Law, and what would be the specific arrangements included in such legislation.

Concurrently with the legislation process in the wake of the Bachar Committee recommendations, and even more intensely, following the completion of this process, the Bank commenced the examination of the reform in the capital market, the risks faced by the Bank, and the opportunities that it presents the Bank. The Bank began to apply several moves intended to enhance its preparations for capital market activities in the post Bachar Committee era. In this context the Bank has signed an agreement in principal for the sale of all the shares in Ilanot Discount Ltd. and for the sale of the operations in the field

### 33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

of provident funds management and signed an agreement for the sale of its provident fund management activities, as detailed in Note 6 E and above. The Bank has also signed an agreement for the sale of the operations in the field of further education funds, as detailed in Note 19 C 21 above. Hence, the anticipated damage to the Bank as a result of the detachment of the provident funds and mutual funds stems mostly from the loss of income.

In addition, damage to the Bank is expected as a result of the requirement to reduce its holdings in corporations engaged in the insurance industry, as detailed hereunder in order to enable the Bank to engage in pension consulting services, and this mainly as a result of loss of income. For details regarding the agreement for sale of the Bank's holdings in Harel Insurance Investments Ltd., see Note 6 H above.

The Regulations regarding the distribution commissions that a bank would be entitled to collect from provident fund and mutual fund management companies, their rates, the basis of their calculation and circumstances of collection might also have an adverse effect. The Regulations pertaining to these matters came into effect on April 1, 2006. The arrangement determined in the Regulations, in particular with regards to provident funds, might adversely effect the income of the Bank. This in view of the fact that the earning of a distribution fee in respect of provident fund savings of customers is conditional upon the customers signing a pension consulting agreement (an act that may begin only after the pension consulting license is obtained). In September 2006, the Capital Market Commissioner issued a circular regarding agreements for the providing of operational services to institutional bodies. Among other things, the circular regularizes the matter of the payment that banks would be entitled to collect from the managing companies in respect of the "existing inventory" of members' assets in the provident funds being sold. A transitional period until the end of 2007 has been determined, during which the banks, under certain terms, would be entitled to an annual payment of 0.25% of the value of assets of provident fund members who have not as yet signed a consultation agreement with the bank and continue to hold their assets with the provident fund that had been sold. The circular letter also regularized the maximum amount of operating fees that may be charged to the management company for management services provided to it, fixing it at 0.1% of the assets of the members in respect of which the services are provided. At this stage it is not yet possible, to assess what implications these Regulations, the Commissioner's circular and other arrangements to be determined by the market and by the authorities, might have on the Bank's income and on the volume of its activity in distributing the said products and the Bank estimates a material decrease in income from provident funds and mutual funds in the coming years.

The limitations imposed on the additional activities that would be permitted to banks, on the one hand, and the uncertainty regarding arrangements to be established by legislation, in view of the new legislation initiatives in the pension field, on the other hand, make it difficult to assess, at this stage, the income that the Bank would derive from the implementation of the new legislation, including the income to be earned from new areas of operations on the one hand, and the loss of income from provident funds and mutual funds and from the investment in Harel on the other hand.

The Bank believes that even after entering the sale agreements as aforementioned, the implementation of the new legislation may have an adverse effect on the Bank's business and on its results of operations. However, in view of everything stated above, the future implications of the implementation of the capital market reform and new legislation initiatives in this field on the position and the Bank's results of operations cannot yet be evaluated or quantified.

The income from management fees and the reimbursement of expenses by provident funds amounted to NIS 189 million in 2006, compared to NIS 177 million in 2005.

Income from mutual fund management fees amounted to NIS 100 million in 2006, compared with NIS 182 million in 2005,

### 33. GOVERNMENT RESOLUTIONS REGARDING THE BANKING SYSTEM AND SUGGESTED CHANGES IN THE CAPITAL MARKET STRUCTURE (CONTINUED)

nearly all of which was income received by Ilanot Discount Ltd.

Income from mutual fund management fees amounted in the second half of 2006, to NIS 3 million, due to the sale of Ilanot Discount (see Note 6 E below), compared with NIS 98 million in the corresponding period last year.

Earnings from distribution fees charged to managers of mutual funds since the Regulations came into effect on April 1, 2007, amount to approximately NIS 24 million.

The contribution of Harel to the net earnings of the Bank amounted to NIS 37 million in 2006, compared with NIS 50 in 2005. As to the income of the Group from fees for the management of provident and mutual funds, see also Note 26.

For details regarding the sale of the shares of Ilanot Discount and regarding an agreement for the sale of the activity of the provident funds, see Note 6 E above. For details regarding the agreement for the sale of KAHAL, see note 19 C 21 above. For details regarding the agreement for the sale of the holdings in Harel, see Note 6 H above.

### 34. CREDIT CARD ACTIVITY

#### A. HOLDING MEANS OF CONTROL IN ISRAEL CREDIT CARD LTD. (HEREINAFTER – “ICC”)

**1) Acquisition of means of control from Leumi Financial Holdings Ltd.** 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. LFH has undertaken to indemnify the Bank for certain claims detailed in the agreement. 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 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.

During 2000, several agreements were signed with a number of strategic partners – Fishman Chain Stores Ltd., the First international Bank Ltd. (“FIBI”) 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. Additional shares in ICC and Diners were sold to Fishman Chains in 2001. In total, agreements have been signed for the sale of ICC shares granting a 49% equity interest and 37% of the voting rights as well as a right to appoint directors as well as shares in diners constituting 21.38% of the equity and 37% of voting rights, and additional shares granting the right to appoint Directors.

**2) Acquisition of the ICC shares held by Fishman Store Chains.** Fishman Store Chains Ltd. (hereinafter – “Fishman”) informed ICC and its shareholders on May 31, 2006, of its intention to sell all of its ICC shares, which are 24% of ICC’s equity, as one package along with all the rights and liabilities of Fishman as a shareholder in ICC, in return for an amount reflecting a company value of approximately NIS 1.5 billion, subject to adjustments and terms detailed in the announcement.

The shareholders of ICC had the right of first refusal in respect of the shares offered for sale, commensurate with their proportionate holdings in ICC.

On July 28 and 31, 2006, the Bank and the FIBI, respectively, announced the exercise of their right of first refusal in acquiring the said shares. Concurrently, the Bank and FIBI reached agreements with respect to the adjustments and

### 34. CREDIT CARD ACTIVITY (CONTINUED)

changes in the arrangements between them as regards their holdings in ICC, to apply following the acquisition of the offered shares. In the beginning of August, 2006, the Bank and FIBI, announced the exercise of their right to acquire the balance of the offered shares, which was not exercised by Harel.

On December 10, 2006, a transaction was consummated for the acquisition by the Bank of 17.2% of the equity and 13% of the voting rights in ICC in consideration for NIS 232 million, following fulfillment of all related conditions (the said amount is after the deduction of dividends distributed by ICC to Fishman in November 2006 in the amount of NIS 10 million, in respect of the shares purchased by the Bank). On March 13, 2007, additional consideration in the amount of NIS 21.2 million was paid in accordance with the business results of ICC for 2006.

Since the completion of the acquisition of the Fishman shares in ICC, the Bank holds 68.2% in the equity and 76% in the voting rights in ICC, while FIBI holds 26.8% in the equity and 20% in the voting rights in ICC.

**3) Acquisition of ICC shares held by Harel.** On March 1, 2007 the Bank and FIBI entered into a transaction to acquire the shares of ICC held by Harel (5%) according to their proportionate share in ICC.

The price of the transaction is the same as the price determined in the transaction for the sale to the Bank and to FIBI of the ICC shares held by Fishman. The basic consideration with respect to the shares to be purchased by the bank was fixed at NIS 48.7 million. The additional consideration based on the results of ICC for 2006, was fixed at NIS 4.4 million. The basic consideration and the additional consideration have been deposited in a trust account in the name of Harel.

Consummation of the transaction is subject to fulfillment of contingent conditions, including regulatory approvals, where applicable.

Once the acquisition of the Harel shares in ICC is completed, the Bank will hold 71.8% in the equity and 79.0% in the voting rights in ICC, while FIBI will hold 28.2% in the equity and 21.0% in the voting rights in ICC.

#### B. HOLDING MEANS OF CONTROL IN DINERS

**1) Transfer of control in Diners.** An agreement was signed in January 2005 between ICC and its shareholders, according to which ICC would acquire the balance of the shares in Diners, so that following completion of the sale, ICC would own 100% of the equity and voting rights in Diners. Diners International has approved the transfer of the shares. On August 22, 2006, the Supervisor of Banks approved the move.

**2) The establishment of a new customer club and the sale of the means of control in Diners.** On November 29, 2005, ICC entered into an agreement with Dor-Alon Energy in Israel (1988) Ltd. and Blue Square Israel Ltd. (hereinafter together – “the Purchasers”) according to which ICC has committed to sell to the Purchasers shares comprising 49% of the issued and paid share capital of Diners Club Israel Ltd. (hereinafter – “Diners”) in consideration of NIS 21.3 million. Concurrently, Diners entered into an agreement with the Purchasers for the establishment of a customer club. The transaction was consummated on December 18, 2006, following fulfillment of all relevant conditions.

The consideration for the shares has been financed by a loan granted to the Purchasers by ICC. The shares sold are to serve as collateral for the loan, which is to be repaid at different dates over a number of years, during which the Purchasers are entitled to decide on returning the shares to ICC instead of repayment of the loan, and ICC on its part is entitled to demand the return of the shares, all in accordance with the terms stated in the agreement for the sale of the shares.

It should be noted that to the Bank’s best knowledge, The Purchasers in accordance with this agreement include certain controlling shareholders which, at the time of entering into and consummation of the transaction, constituted

### 34. CREDIT CARD ACTIVITY (CONTINUED)

part of the Purchasers in accordance with the agreement for the purchase of the control core of the Bank, or were related thereto. (see Note 32 hereunder).

#### C. 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, FIBI and 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. The exemption included 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.

The exemption has been extended from time to time and its terms updated taking account of the proceedings conducted at the Restrictive Business Practices Court, as detailed hereunder:

- 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 included certain terms among which: 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 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 of, the rate of the cross commission, which in their opinion

### 34. CREDIT CARD ACTIVITY (CONTINUED)

should apply in Israel. The said opinion has been submitted by the VISA companies

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.

The exemption has been extended from time to time and its terms updated taking account of the proceedings conducted at the Restrictive Business Practices Court, as detailed hereunder:

- 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 acted in accordance with the agreement and subject to the provisions determined by the Commissioner.

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.

Within the framework of the Court proceedings, the appellants presented a methodology for the determination of the Cross Clearing Commission rate. The Antitrust Authority opposed the methodology proposed by the appellants and offered a different one. Four additional objections have been submitted against the motion for approval of the binding arrangement. Several of the objections opposed in full to the methodology of the appellants, while others opposed certain parts of the methodology. The objectors also submitted a motion for the revocation of the provisional permit granted by the Court.

On December 22, 2002, the Court 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. On February 25, the Court approved the compromise agreement reached between the Commissioner of Restrictive Trade Practices and the appellants with respect to the cross clearing commission.

### 34. CREDIT CARD ACTIVITY (CONTINUED)

On August 31, 2006, the Antitrust Court handed out a ruling regarding the methodology for the determination of the Cross Clearing Commission, while adopting the principal points of the Commissioner's position on the matter. Among other things, the Court ruled that the proper methodology for calculating the Cross Clearing Commission is composed of a transaction approval fee, the cost of securing the payment and the cost of the credit granted. The Court further ruled that the categories for the purpose of the Cross Clearing Commission shall be determined based on the cost of securing the payment in the different transactions, the cost of approving the transaction and according to the benefit derived from securing the payment.

The Court decided that an independent expert should determine the rate of these costs, to the extent that the appellants will inform of their wish to appoint such an expert. The court noted that whereas the period of the binding arrangement is drawing to a close, the parties should inform whether they wish to appoint such an expert. The Court also noted that the appellants have the option of terminating the Cross Clearing Arrangement, though the Court recommends and wishes they will not do so. ICC and the Bank are studying the possibility of appealing the Court's decision.

- 2) a. A tri-party Cross Clearing Agreement.** Negotiations have been conducted in the months preceding the Courts' decision between the Commissioner and the credit card companies – ICC, LeumiCard and Isracard – regarding the agreement for the formation of a cross clearing system for VISA cards and MasterCard.

In view of the said negotiations, the appellants requested the Commissioner to issue a provisional permit, enabling them to complete the negotiations prior to the expiration of the provisional arrangement between them. On September 6, 2006, the Commissioner of the Antitrust Authority granted the request, extending the exemption granted to the existing arrangement between the parties until October 31, 2006.

On October 30, 2006, the Commissioner, the credit card companies and the banks owning the credit card companies entered into an agreement for the Cross Clearing of Visa and MasterCard credit cards (hereinafter – "the Agreement"). The agreement came into effect upon the granting of a provisional permit by the Antitrust Court on October 31, 2006, and will both expire on July 1, 2013 (hereinafter: "the period of the agreement") unless the Court rules otherwise at a prior date. The agreement further provided that a joint interface would be established and operated by May 30, 2007, enabling the three credit card companies to conduct the clearing of transactions effected by way of VISA and MasterCard credit cards.

The Agreement specifies, among other things, the rates of the Cross Clearing commissions and the structure of the categories of the Cross Clearing commissions applying to the credit card companies during the effective period. The Agreement outlines a gradual decrease in the rates of the Cross Clearing commissions down to a rate of 0.875% starting on July 1, 2012, alongside the reduction in the number of categories over the effective period. The Agreement specifies general guidelines that, among other things, prohibit the inter-dependence between various types of credit cards being cleared by a trader with each of the credit card companies. The guidelines also prohibit the deterioration in the terms of clearing following a reduction in the number of credit card types being cleared by a particular trader.

The Agreement specifies further rules that, among other things, do not permit banks that control credit card companies, to link between the services provided to the trader and the terms of engagement with the clearing entity. Further rules prohibit banks from discriminating between customers of a bank holding a credit card issued by that bank and other customers of that bank who do not hold credit cards issued by it.

### 34. CREDIT CARD ACTIVITY (CONTINUED)

Within the framework of the agreement, certain provisions were determined according to which, under certain circumstances, the Commissioner would withdraw the declaration of IsraCard as a monopoly with regards to the clearing of IsraCard and MasterCard credit cards, and an undertaking of the parties to apply to the Court for approval of a cross clearing commission for the period following the termination of the arrangement, in case they would request the continuation of the cross clearing.

- b. A joint issuance agreement between ICC and FIBI.** Among other distribution agreements signed by ICC (including Diners) with several banks, is also an agreement signed with FIBI for the joint issue of VISA and DINERS credit cards to customers of the FIBI for a period of six years as from August 1, 2000, at the end of which the agreement would be renewed for an additional period of three years. However, as from February 2006, each of the parties is entitled to terminate the engagement at any time giving prior notice of six months.

FIBI announced on August 17, 2006, the cancellation of the said agreements in their present format, at the end of six months from the date of the announcement. At the same time, FIBI informed ICC of its wish to conduct, as early as possible, a fast negotiation for the renewal of the engagement between them, based on existing agreements and their appendices, without granting preference to credit cards issued by ICC, and including additional changes that might arise through the negotiation.

- c. Arrangements between FIBI and the IsraCard.** Reports of FIBI regarding an agreement signed in January 2006 with Bank Hapoalim, for the purchase of means of control in Otzar Hachayal Bank Ltd., stated among other things, that the parties to the agreement determined "arrangements for the continued engagement between Otzar Hachayal Bank and IsraCard Concern and for the cooperation between the bank and the IsraCard".

The approval for the merger granted by the Commissioner of Restrictive Trade Practices to the FIBI and Otzar Hachayal Bank, it was provided that the said banks would not be party to exclusivity arrangements, unless a prior approval of the Commissioner is granted. The said banks and Bank Hapoalim were ordered to cancel any exclusivity arrangement to which they are party, in a manner that not restriction shall apply to the said banks as regards the marketing of charge cards that are not charge cards of Bank Hapoalim or of a company under its control. ICC and FIBI signed an agreement on February 14, 2007, for the extension of the joint issuance agreement until March 31, 2007. ICC and FIBI are negotiating the extension of the joint issuance agreement for the coming years.

An exclusivity arrangement is any arrangements that provides an undertaking according to which any of the said banks would market charge cards of Bank Hapoalim or companies under its control, including any undertaking involving the number of charge cards of Bank Hapoalim Group that would be marketed by the said banks or the percentage of charge cards of Bank Hapoalim Group out of the total charge cards to be distributed by the said banks.

Due to the difficulties encountered in assessing the vast data existing in the credit card field and in particular with respect to the consequences of the joint clearing on the various credit cards, it is not yet possible to assess the impact of the changes in the charge cards market on the business results of ICC.

### 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. EARNINGS PER SHARE

	Consolidated		
	2006	2005	2004
<b>Basic earnings<sup>(1)</sup> Per share(1) of NIS 0.1 (in NIS)</b>			
Net operating income	0.32	<sup>(2)</sup> 0.47	<sup>(2)</sup> 0.54
Net income from extraordinary items, net of taxes	0.53	-	<sup>(2)</sup> 0.03
Net income	0.85	0.47	0.57
Weighted average of the number of shares	980,639	980,639	980,639

Footnotes:

(1) In computing the earnings per share, stock options to officers of the Bank have not been taken into account due to their anti-dilutive effect.

(2) Restated - See Note 1 S.

### 37. INFORMATION BASED ON NOMINAL DATA - THE BANK

	December 31	
	2006	2005
in NIS millions		
<b>Balance Sheet</b>		
Total assets	106,450	*98,349
Total liabilities	98,980	*92,011
Shareholders' equity	7,470	6,338

\* Restated - See Note 1 Z.

	For the Year Ended on December 31	
	2006	2005
in NIS millions		
<b>Statement of Income</b>		
Net income	713	489

### HEAD OFFICE

Tel Aviv, 27 Yehuda Halevi Street. Tel.: 972-3-5145555

### OVERSEAS BRANCHES

London, United Kingdom: 65 Curzon Street

### REPRESENTATIVE OFFICES

Paris, France: 33 Rue Galilee  
Berlin Germany: Friedrichstrasse 90  
Buenos Aires, Argentina: Corrientes 447 6°  
Santiago, Chile: Av. Vitacura 2771 Of. 804

### SUBSIDIARY BANKS ABROAD

Israel Discount Bank of New York website: <http://www.idbbank.com>  
Main New York Office: 511 Fifth Avenue. **New York Branch:** 1350 Broadway  
Beverly Hills, CA Branch: 9401 Wilshire Boulevard, Suite 600  
Downtown Los Angeles, CA Branch: 888 South Figueroa Street, Suite 550  
Aventura, FL Branch: Harbour Centre, 18851 NE 29th Avenue, Suite 600  
Miami, FL Branch: 1000 Brickell Avenue  
Boca Raton, FL Branch: 2500 N. Military Trail, Suite 150  
Grand Cayman (B.W.I.) Branch: P.O. Box 694GT, 11 Dr. Roy's Drive  
International Banking Facility: 511 Fifth Avenue  
Representative Offices of Israel Discount Bank of New York: Paris, France  
/ Santiago, Chile

Discount Bank Latin America, Uruguay  
Montevideo Head Office: Rincon 390  
Punta del Este Branch: Avenida Roosevelt y Parada 12

Israel Discount Bank (Switzerland) SA  
Geneva, Switzerland Head Office: 100 Rue du Rhone

### SUBSIDIARIES IN ISRAEL

Banking Mercantile Discount Bank | Discount Mortgage Bank **Capital Markets** Israel  
Discount Capital Markets & Investments | Tachlit Investment House | Discount Management  
of Provident Fund **Financial** Israel Credit Cards | Diners Club Israel | Discount Leasing | Discount Manpikim |  
**Trust Services** Discount Trust

Website: [www.discountbank.co.il](http://www.discountbank.co.il)