

# **BANK LEUMI LE-ISRAEL B.M. AND SUBSIDIARIES**

## **Condensed Financial Statements as at 31 March 2006**

(unaudited)

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**31 May 2006**

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## A. General Developments in the Business of the Group

The Directors' Report has been prepared in accordance with the directives on reporting to the public of the Supervisor of Banks. The principles used in preparing the interim reports are consistent with the principles used in preparing the Annual Report to 31 December 2005. The interim report should be read in conjunction with the Annual Report for 2005.

### Description of the Leumi Group's Business Activities and their General Development

Total assets under the management of the Group (balance sheet items, customers' securities portfolios, and provident and supplementary training funds) amounted to some NIS 585 billion at the end of March 2006, as compared with NIS 568 billion at the end of 2005, an increase of some 3.0%.

Net profit of the group in the first quarter of the year totaled NIS 1,112 million, as compared with NIS 528 million in the corresponding period of 2005, an increase of 110.6%. The increase in the net profit derived from the sale of non-banking holdings in consequence of the legal restrictions that apply to the Bank. For further details see below on pages 40-41.

The net operating profit for the first quarter of the year amounted to NIS 400 million, as compared with the NIS 531 million in the first quarter of 2005, a decline of 24.7%.

The decline in profit is principally explained by a decline in the contribution of companies included on the equity basis, a decrease in the profits of a number of subsidiaries in Israel and a decrease in the Bank's profit as a result of an increase in special expenses. On the other hand, in consequence of positive exchange rate differentials in respect of the investments in overseas subsidiaries, their contribution increased and partially offset these decreases.

Net profit per share in the first quarter of 2006 was NIS 0.786, compared with NIS 0.373 in the corresponding period in 2005.

Based on data of the banking system as at 31 December 2005, as published by the Bank of Israel, the Leumi Group's share among the five largest banking groups was as follows:

	31.12.2005	31.12.2004	31.12.2003
	in %		
Total assets	30.3	30.1	29.8
Credit to the public	30.3	29.9	30.0
Deposits of the public	30.5	30.3	30.2
Operating profit before tax	30.3	34.7	32.0
Operating profit after tax	30.6	33.9	31.7

### Control of the Bank

On 31 March 2006 the State of Israel held 14.79% of the issued share capital of the Bank (fully diluted – 13.96%) and 19.78% of the voting rights in the Bank (fully diluted – 18.66%)

### Sale of Shares in the Bank by the State

On 15 November 2005, the Bank was informed by M.I. Holdings Ltd. ("MIH") that further to the procedure for the sale of up to 20% of the shares of the State in the Bank which was published by

the Accountant-General of the Ministry of Finance and MIH on 14 September 2005, Barnea Investments B.V. ("Barnea") had been chosen as the preferred bidder. Barnea was incorporated in the Netherlands, and is a wholly owned subsidiary of Barnea S.a.r.l., incorporated in Luxembourg, which is held jointly and indirectly by Stephen Feinberg and J. Ezra Merkin, through the Cerberus and Gabriel private investment fund groups which are controlled by Mr. Feinberg and Mr. Merkin respectively.

The sale was completed on 24 November 2005 (the "Closing Date"), when Barnea paid some NIS 2.474 billion for 9.99% of the share capital of the Bank (NIS 17.51 per share), together with interest, a total of some NIS 2.475 billion.

Of the shares purchased, shares representing 4.99% of the Bank's share capital are held in trust and Barnea and the trustee have executed a power of attorney empowering the committee appointed pursuant to Section 12 of the Bank Shares (Arrangement Shares) (Temporary Provision) Law, 1993 (the "Committee"), including whoever succeeds it in this capacity, as provided under said Law, or any other person that whom Minister of Finance shall empower, to (1) participate and vote such shares at all meetings of the Bank and (2) to exercise the right to appoint directors in the Bank with respect to all shares of the Bank held by Barnea.

The State also granted to Barnea an option to purchase a further 10.01% of the capital of the Bank, pursuant to the conditions of the option agreement signed between the government, MIH and Barnea on 23 November 2005 (the "Option Agreement"), and conditional, *inter alia*, on their having obtained all necessary permits from the Bank of Israel and the other relevant supervisory bodies in Israel and overseas for the purchase of the shares and control of the Bank. The option, which took effect from the Closing Date, was exercisable 180 days after the Closing Date, subject to extension for up to an additional 12 months under certain conditions. On 24 May 2006, MIH advised the Bank that on that day an application had been received from Barnea requesting the extension of the exercise period of the said option for an additional 12 months, until 24 May 2007, and that in said application, Barnea stated that, *inter alia*, they had filed with the Bank of Israel a request for a permit to control the Bank. MIH added that the said application was still under consideration.

The price per share for exercising the option was fixed at NIS 14.70, bearing annual interest at 2%, the price and interest being linked to the CPI. The option will expire, *inter alia*, in the event that percentage of the shares that are held by Barnea falls below 7.5% of the Bank's issued share capital, as the result of the transfer of shares by Barnea (whether shares held directly by Barnea or whether shares held by the trustee mentioned above).

Regarding certain conditions relating to activities during the exercise period of the Option Agreement, which commenced from the Closing Date, and regarding restrictions in connection with the distribution of dividends, which apply from the time of the granting of a control permit to the purchasers by the Bank of Israel, see pages 14 and 15 of the Annual Report for 2005.

For details regarding the issuance of options to employees and the sale of shares to employees see pages 4-6.

## **Capital Resources and Transactions in the Shares of the Bank**

**Shareholders' Equity** of the Group at 31 March 2006 amounted to NIS 17,283 million, compared with NIS 16,000 million at the end of 2005, an increase of 8.0%. The increase in shareholders' equity derives mainly from the profit for the quarter and from changes in adjustments in respect of the presentation of securities available for sale according to fair value.

The securities portfolio (nostro) is mainly composed of government debentures, which generally represent the use of raised sources and the available capital. The major part of the securities

portfolio is classified as available for sale securities and is included in the balance sheet on the basis of fair value. The income is recorded in the statement of profit and loss on an accrual basis, and the difference between the value on an accrual basis with regard to debentures and on a cost basis with regard to shares and the fair value is directly recorded in a separate item in shareholders' equity, after the deduction of the effect of related taxes.

As a result of adjustments in respect of presentation of securities available for sale according to fair value, a net increase in value of NIS 145 million was recorded in shareholders' equity in the first quarter of the year, compared with a net decrease in value of NIS 49 million in the corresponding period in 2005 (all of the amounts are stated net after the effect of related taxes) arising mainly due to the change of classification of the investment in Migdal Insurance and Financial Holdings Ltd.

The total net aggregate balance of adjustments of securities held in the available for sale portfolio to market value as at 31 March 2006 totaled an amount of NIS 191 million (after the effect of taxes).

According to the principles of the capital adequacy computation, the balance in respect of adjusting securities to fair value does not affect the capital computation for the purpose of the minimum capital ratio, save for losses that have not yet been realized from adjustments to fair value of shares available for sale less the effect of taxes.

**Shareholders' Equity relative to Total Assets** on 31 March 2006 reached 6.3%, compared with 5.9% on 31 December 2005.

**Shareholders' Equity relative to Risk Assets** reached 12.01% on 31 March 2006, compared with 11.55% on 31 December 2005. This ratio is higher than the minimum ratio of 9% set by the Supervisor of Banks. The ratio of Tier I capital to risk assets was 7.81% on 31 March 2006, compared with 7.46% at the end of 2005.

The improvement in the capital adequacy ratios derives primarily from the profits in the first quarter of the year.

#### **Issues of Debentures and Subordinated Capital Notes**

In the first quarter of 2006, Leumi Mortgage Bank Ltd. issued subordinated notes in the amount of NIS 303 million.

#### **Interested Persons' Transactions in the Shares of the Bank**

On 19 January 2006, Eliahu Insurance Company Ltd. acquired 194,131 shares, such that the overall holding of the Eliahu Group in the Bank amounted to 9.9969%.

For details in respect of the sale of shares by the State see above on pages 2-3.

#### **Issue of Options to Employees**

On 2 February 2006, the Bank's General Meeting approved a plan for the issue of options to entitled employees, as determined in the outline published by the Bank on 24 January 2006 (the "Outline"). In accordance with this program, on 14 February 2006, 84,853,960 options, exercisable into 84,853,960 ordinary shares of the Bank, were allotted. The said options are subject to all the terms of the Outline, including:

1. The options will be exercisable in two equal annual tranches, the first tranche at the end of two years from the date of the allotment of the options and the second tranche as from the end of the second year from the date of the allotment of the options and up to the end of the third year from the date of the allotment of the options.

2. The options were issued to the employees free of consideration.
3. The exercise price per share will be NIS 13.465 and will be linked to the CPI (commencing from September 2005). The price will be adjusted for the distribution of dividends (whose amounts will be linked to the CPI), bonus shares and the bonus element of rights issues, if such issues take place.

In respect of the issue of the said options, the Bank will record salary expenses in accordance with the fair value of the options with the addition of salaries tax and national insurance contributions. This expense will be recorded in the Bank's financial statements over a period of two years from the date of allotment.

The estimate of the fair value of the options, as of the date of allotment, which was prepared by an external valuer in accordance with the Black & Scholes model, is some NIS 422 million. The calculation of the fair value is based upon the following principal criteria:

- standard deviation of the annual yield: 25%.
- risk free linked interest rate: 3.5%.
- price per share – the closing rate of NIS 17.30 per share on 14 February 2006.
- dividend distribution policy: 50% of the net profit.
- rate at which employees leave during the course of the vesting of the options: 2%.

The Bank received approval from the tax authority for the operation of the plan as a "plan for the allotment of shares by means of a trustee" within the context of section 102 of the Income Tax Ordinance, on the capital gains taxation path. The profit benefit portion (which will be considered to be income from work in the hands of the employees) at the time of the granting of the options is some NIS 368 million. In respect of this portion, the Bank will pay salary tax and national insurance contributions in the amount of some NIS 83 million, and as against this the Bank will save companies tax and profits tax in the amount of some NIS 163 million. This saving will be recorded in the Bank's books over the period of two years from the date of the allotment, in parallel with the recording of the expense. The amount of the expense in respect of the fair value will be recorded against capital account. In the first quarter of the year, the Bank recorded some NIS 40 million as salary expenses in the statement of profit and loss.

### **Sale of Shares to Employees**

In March 2006, agreement was reached with the Accountant-General regarding the offer of ordinary shares of the Bank by the State to the employees of the Bank, and this in accordance with the agreements in respect of the privatization of the Bank and decisions of the Finance Committee of the Knesset. According to the above agreement, the shares will be offered to the employees in two stages, in respect of the first of which, in which 2.873% of the share capital (40,630,905 shares) will be offered, an outline was published on 9 May 2006 (and amended on 10 and 25 May 2006). The second stage, in which a further 1% of the share capital of the Bank will be offered to the employees, will be carried out after completion of the privatization process. The base purchase price was set at NIS 16.10 per share (the average price of the shares as agreed in the sale to Barnea). The shares will be offered to the employees at a discount of 25% below the base price, the price being linked to the CPI for September 2005 up to the date of exercise of the offer with the addition of interest of 2% per annum from 24 November 2005 (the "Exercise Price"). The Exercise Price will be adjusted for the dividend distribution on 28 February 2006 (NIS 0.78 per share).

The benefit granted to the employees in respect of the said purchase (according to the price per share on 25 May 2006) will be recorded as a salary expense in the sum of NIS 155 million against the capital account when the shares are allotted, which is expected to occur in the second quarter of 2006. In addition, there will be additional taxation costs of some NIS 57 million, with the overall

cost to the Bank amounting to some NIS 212 million. In order to finance the purchase of the shares, the employees will be granted the right to receive loans, which will be repayable at the end of the lock-up period of the shares, which is four years. The loans will be linked to the CPI, will not bear interest and will not be granted on non-recourse conditions. The granting of the loans has been approved by the Supervisor of Banks, who noted in his approval that when determining the repayment terms, the Bank is requested to take into account the fact that approval will not be given for the extension of the repayment period of the loans beyond the end of the lock-up period. The maximum amount of the loans in respect of all of the shares being offered is some NIS 473 million and the actual amount of the loans will be deducted from the Bank's capital. Further, total costs of NIS 69 million will be recorded in salary expenses in respect of the interest benefit related to the said loans.

The Bank has received from the tax authority a draft confirmation that the provisions of section 102 of the Income Tax Ordinance will be applied to the program.

The above figures, including the price per share, are estimates only and the final figures will be determined on the date when the shares are transferred to the employees against payment.

## **Distribution of Dividends**

### **A. Dividend Policy for 2006-2007**

On 29 March 2006 the Bank's Board of Directors resolved to determine the following dividend policy:

It is the intention of the Board of Directors to recommend to the General Meeting the distribution of an annual dividend, for the years 2006 and 2007, in an amount constituting at least 50% of the net annual distributable profit of the Bank, if there is no adverse change in the profits of the Bank and/or in its business and financial condition and/or in the general economic situation and/or in the legal and fiscal environment.

All dividend distributions will comply with the provisions of the Companies Law, 1999, which provides, *inter alia*, that the Bank may make a distribution out of its profits provided that there is no reasonable concern that the distribution will prevent the Bank from meeting its present and anticipated obligations, when they become due. The Bank is also required to comply with the limits laid down by the Supervisor of Banks such as: minimum capital ratio of not less than 9%, compliance with the requirements of Section 23A of the Banking (Licensing) Law, 1981, which placed limits on the percentage of equity that a banking corporation may invest in non-banking (real) corporations, and also compliance with the limits determined by the Supervisor of Banks regarding granting credit as a percentage of equity and the limits he determined regarding dividend distributions, such as: no dividend will be distributed if the non-monetary assets exceed equity or if the dividend distribution will cause such a situation; no dividend will be distributed out of capital reserves or positive differentials arising from the translation of the financial statements of autonomous overseas units; or where one or more of the last three calendar years ended with a loss.

The abovementioned policy is also subject to the restrictions on distribution of dividends arising from the privatization process relating to the Bank, which will apply after the grant of a control permit by the Bank of Israel to the purchasers. (See "Sale of Shares of the Bank by the State" on page 15 of the Annual Report for 2005.)

The above declaration of policy does not constitute any undertaking towards any third party (including concerning the dates of payment of the dividend or the rates of dividends in the future).

Certain declarations appearing above in this section contain "forward-looking information". For the meaning of this term, see the section "Description of the Banking Corporation's Business and Forward-Looking Information in the Directors Report" on pages 13-14.

**B.** The dividend policy for the years 2003 to 2005 (inclusive) was to recommend to the General Meeting the distribution of a dividend in an amount that constituted at least 35% of the annual distributable net profit of the Bank, and this in similar language to the policy for the years 2006 and 2007 detailed above.

**C. Dividend for 2005**

The Special General Meeting of Shareholders convened on 2 February 2006 approved the recommendation of the Board of Directors of 4 December 2005, regarding the distribution of a cash dividend at the rate of some 65.9% of the net profit for the first nine months of 2005 (some NIS 1,103 million), at the rate of 78.0% of the paid-up capital.

The dividend was paid on 28 February 2006 to shareholders of record on 15 February 2006 (the record date). The stock traded "ex" dividend on 16 February 2006. The dividend was at the rate of NIS 0.78 for every ordinary share of NIS 1.0 par value.

**Bank Leumi le-Israel B.M. and its Subsidiaries and Affiliates**  
Principal Data of the Leumi Group

	Jan. - March	Jan. - March	Year
	2006	2005	2005
<b>Income, Expenses and Profit (NIS millions):</b>			
Net interest income before provision for doubtful debts	1,645	1,592	6,628
Provision for doubtful debts	201	445	1,426
Total operating and other income	940	887	3,718
Total operating and other expenses	1,821	1,420	6,070
Of which: Costs of Voluntary Retirement	3	5	107
Operating profit before taxes	563	614	2,850
Provision for taxes	240	233	1,193
Net operating profit	400	531	2,059
After-tax net profit (loss) from extraordinary items	712	(3)	77
Net profit for the period	1,112	528	2,136
Proposed dividend	-	-	1,103
Net profit per share (in NIS)	0.786	0.373	1.510
<b>Assets and Liabilities at End of Period (NIS millions):</b>			
Total assets	272,999	256,905	272,824
Credit to the public	177,584	168,921	177,255
Securities	48,365	44,692	47,825
Deposits of the public	221,807	210,109	221,828
Shareholders' equity	17,283	15,461	16,000
<b>Major Financial Ratios in Annual Terms (%):</b>			
Credit to the public / Total assets	65.0	65.8	65.0
Securities / Total assets	17.7	17.4	17.5
Deposits of the public / Total assets	81.2	81.8	81.3
Shareholders' equity (excluding minority interest) / Total assets	6.3	6.0	5.9
Shareholders' equity / Risk assets (a)	12.01	11.72	11.55
Tier I capital / Risk assets	7.81	7.72	7.46
Net profit / Shareholders' equity (excluding minority interest) (c) (d)	30.8	14.9	14.3
Net operating profit / Shareholders' equity (excluding minority interest) (c) (d)	10.4	14.9	13.7
Rate of tax provision from the profit	42.6	37.9	41.9
Provision for doubtful debts / Credit to the public (d)	0.45	1.06	0.80
Provision for doubtful debts / Total credit risk (d)	0.30	0.71	0.53
Net interest income before provision for doubtful debts / Total assets (d)	2.43	2.50	2.43
Total income / Total assets (b)	3.84	3.92	3.79
Total income / Total assets managed by the group (b) (d) (e)	1.79	1.98	1.83
Total operating and other expenses / Total assets (d)	2.69	2.23	2.22
Total expenses / Total assets managed by the group (d) (e)	1.26	1.13	1.07
Net profit / Total average assets (d)	1.65	0.83	0.82
Net operating profit / Total average assets (d)	0.59	0.84	0.79
Financial margin including income and expenses from derivative financial instruments	1.58	1.76	1.60
Operating expenses (excluding costs of voluntary retirement) / Total income (b)	70.3	57.1	57.6
Operating and other income / Operating and other expenses (excluding costs of voluntary retirement)	51.7	62.7	62.4
Operating and other income / Total income (b)	36.4	35.8	35.9

- (a) Shareholders' equity - plus minority interest and less investments in the capital of companies included on the equity basis and various adjustments.  
(b) Total income - net interest income before provision for doubtful debts plus operating and other income.  
(c) Shareholders' Equity - at the beginning of the period.  
(d) On an annual basis.  
(e) Includes off-balance sheet activities.

## **B. Other Information**

### **Principal Developments in the Economy\***

#### **General**

In the first quarter of 2006 the economic growth in the economy continued at a rapid pace. The gross domestic product expanded by a real rate of some 5.7% as compared with the corresponding period in 2005. In the first months of the year the growth of the economy was based on domestic demand (primarily private consumption and investments) and less on export. The rapid expansion in economic activity found expression in a considerable increase in the State's revenues from taxes and also contributed to an increase in the inflation environment. Unemployment was at a level of some 8.7%, in the first quarter of 2006, compared with 9.2% in the first quarter of 2005.

#### **Business Product and Economic Sectors**

Israel's business sector product expanded in real terms in the first quarter of 2006 by some 7.8%, as compared with the corresponding period in 2005. This increase was primarily affected by an expansion in many trading and services sectors. The Bank of Israel's companies survey pointed to a continuing upswing in economic activity during the first quarter of the year. According to the companies report, the increase in activity was recorded in all sectors, including construction (for the first time for a lengthy period). The anticipations of the companies participating in the review are for a continuation of the upswing in activity in the coming quarter as well, in all sectors.

The increase in tourism to Israel continued in the first quarter of 2006, with an upturn of some 2.5% in the number of tourists arriving in Israel by air, on the basis of trend figures, as compared with the last quarter of 2005. This trend was greatly influenced by the stabilisation of the security situation. The increase in the number of tourists was a principal factor in the increase in the number of total overnight stays in hotels, both as compared with the last quarter and even more in comparison with the corresponding quarter in 2005. Thus, the number of overnight stays by tourists in the first three months of 2006 rose by some 41%, compared with the corresponding period in 2005, while the number of overnight stays of Israelis increased by some 6% in the same period.

#### **The Budget and its Financing**

In the first quarter of the year there was a surplus in the State Budget of some NIS 7.7 billion, as compared with the deficit target (without the granting of credit) for 2006 of some NIS 17.2 billion, representing some 3.0% of GDP. The significant surplus in the first quarter of the year, which was the highest in the same period for the last two years, originates from a particularly low level of expenses, and also the effect of the lack of approval of the Budget Law. In addition, revenues from taxes rose by some 10.5% in real terms as compared with the corresponding period in 2005, primarily due to revenues from direct taxes, although part of the increase derived from exceptional and one-time transactions.

During May a new government was established and a number of changes were delineated in its guidelines the realisation whereof may have budgetary and other effects: an increase in the real rate of growth of government expenditure of up to 1.7% of last year's budget (in lieu of 1% to date), a gradual increase in the minimum wage, an increase in old age allowances and in the health basket.

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\* Sources of data: publications of the Central Bureau of Statistics, the Bank of Israel, the Ministry of Finance and the Tel Aviv Stock Exchange

## Foreign Trade, Capital Flows and Exchange Rates

Israel's trade deficit amounted in the first quarter of the year to some US\$ 1.8 billion, an increase of some 31% compared with the deficit that was recorded in the corresponding period in 2005. On deducting the effect of the increase in energy prices, an increase in the deficit was also recorded, albeit relatively small. The explanation for the considerable increase in the deficit is a combination of an increase in import, in particular in the sphere of energy and consumer products, and relative stability in the export of goods, while in recent months an upward trend was recorded in this sphere. It appears that a principal explanation for this phenomenon is a slowdown in the preceding year in the real rate of expansion of imports of goods by the advanced countries (as a result of a certain economic slowdown), which, according to estimates of the International Monetary Fund, fell from some 9.4% in 2004 to some 5.9% in 2005.

During the first quarter of the year there was a surplus of some US\$ 0.7 billion in foreign residents' investments in Israel over investments of Israelis overseas, in the non-banking private sector. This is compared with a surplus of incoming capital flows (net) of some US\$ 1.1 billion in 2005. In the first three months of the year, households conspicuously increased the accrual of monies in mutual funds invested abroad in an aggregate amount of some US\$ 1.1 billion, compared with some US\$ 0.9 billion throughout 2005.

In the first three months of the year total foreign currency credit to the public at the **Bank** in Israel declined by US\$ 370 million (4.3%).

The factors that were noted above alongside an increase in the degree of political uncertainty led to a strengthening of the dollar and the basket of currencies against the shekel. In total, as compared with the basket of currencies, there was a depreciation of some 2.0% in January to March, while against the dollar there was a more moderate depreciation of some 1.3%. In April, in consequence of the weakening of the dollar throughout the world, and a certain decline in the degree of political uncertainty, a significant weakening was recorded of some 3.5% in the dollar exchange rate and of some 2.4% in the basket of currencies exchange rate, against the shekel.

The public's foreign currency and foreign currency-linked deposits with the **Bank** amounted at the end of March 2006 to some US\$ 16.9 billion dollars, compared with US\$ 16.6 billion at the end of 2005.

The value of the foreign securities portfolio of customers of the **Bank** was up 2.9% in that period, from some US\$ 7.0 billion at the end of 2005 to some US\$ 7.2 billion at the end of March 2006. Foreign currency conversion turnovers increased by some 16.6% from some US\$ 28.3 billion in January to March 2005 to some US\$ 33.0 billion in January to March 2006.

## Inflation and Monetary Policy

In the first three months of 2006 the Consumer Price Index rose by 0.6%, while in the 12 months ending March 2006 its increase totalled some 3.6%. A significant contribution to the increase in prices in the first quarter of the year was the food item (without vegetables and fruit), the price whereof increased by 2.5% (a contribution of some 0.4%), against the background of the effect of price increases of raw materials throughout the world (fuel prices in particular) and apparently the effect of domestic demand factors.

In the period under review, the Bank of Israel increased the interest rate by a moderate rate of 25 basis points, from 4.5% in December 2005 to 4.75% in March 2006. At the end of the period, against the background of the Central Bank's estimations of the expansion of demand in the economy and a trend of closing the difference *vis-a-vis* the economy's potential output, while at the same time the increase in interest rates in the world (particularly in the USA) continued, it was decided to continue increasing interest rates in Israel. The actual increases in prices, which were

relatively large (the annual rate of the increase in the CPI deviated from the upper limit of the price stability target) also contributed to this. Accordingly, the interest rate was increased in April and May by 25 basis points in each month, to a rate of 5.25%.

## **The Capital Market**

The shares and convertible securities index rose in the first three months of 2006 by some 1.8% following a steep upturn of some 32.8% in 2005. Outstanding among the commerce sectors was an increase in prices of shares of the real estate companies, and the Tel Aviv Real Estate Index - 15 rose by some 20.7%. The moderate price increases are partially explained by the political uncertainty that prevailed in the first quarter against the background of the elections in Israel and in the Palestinian Authority. The moderate increase in interest rates and the increase in Israelis' overseas investments also contributed to moderating the demand for shares on the local market. The trading turnover of shares and convertible securities on the Tel Aviv Stock Exchange expanded considerably, amounting to some NIS 1,320 million on daily average, compared with NIS 895 million on daily average in 2005, up by some 48%.

The upswing in economic activity was also reflected at **the Bank**, which recorded a transition from deposits to capital market activity. The increase in the activity volume on the capital market resulted in 13.4% higher income for the Bank from customer activity, up from some NIS 179 million in January to March 2005 to some NIS 203 million in the first three months of 2006.

The CPI-linked government debenture index rose in January to March 2006 by some 1.0%. Most notable was the increase of some 1.6% in short term (up to two years) debentures, in consequence of a certain increase in the inflation environment. Unlinked fixed interest government debentures declined by some 0.5%, and debentures with a term to redemption of more five years posted a higher decline of some 1.3% with an increase in yields to redemption (for eight years) from some 6.2% at the end of December 2005 to some 6.6% at the end of March 2006.

## **Financial Assets of the Public**

The value of the financial assets portfolio of the public amounted at the end of March 2006 to some NIS 1.92 trillion, an increase of some 5.2% (some NIS 96 billion) since the beginning of the year. An examination of the various portfolio components indicates an increase in all components. There was a conspicuous increase in the component of investments in shares both in Israel and overseas. In total, the weight of the total shares component reached some 31.8% of the asset portfolio, a record level in the last two decades. The increase in investments in shares overseas (some 25% since the beginning of 2006) brought their weight to some 3.9%, the highest since the end of 1999 until the beginning of 2001. This is a reflection of a change in the public's tastes, against the background of the change in taxation and the desire to spread risks, with a preference in recent times for expanding investments in the share markets of the world.

The public's total financial assets managed by the **Group** (deposits of the public, debentures and capital notes, security portfolios including mutual funds and also provident funds and supplementary training funds) amounted at the end of March 2006 to some NIS 550 billion, compared with NIS 534 billion at the end of December 2005, an increase of 3.0%.

## **Bank Credit**

In the first quarter of the year, there was a slight nominal decline of some 0.2% in bank credit to the public in the economy (average monthly figures, including mortgage banks), primarily in consequence of a reduction in CPI-linked credit, as compared with a contraction of some 0.8% in credit in the first quarter of 2005.

Part of the explanation for the relative stability in the credit volume, notwithstanding the growth of the economy, is the continued debenture issuances by companies that may constitute an alternative to bank credit. Nonetheless, the volume of such issuances contracted in the first quarter of 2006 as compared with the volume in 2005. According to Tel Aviv Stock Exchange data (that, apparently, represent an under-estimate), in the months January to March 2006 the volume of listed and non-listed issuances of debentures by Israeli companies (exclusive of banking subsidiaries, structured debentures, exchange traded certificates and certificates of deposit) totalled some NIS 3.7 billion, a figure equal to an increase of some 2%, in annual terms, in bank credit.

The **Bank's** credit to the public amounted at the end of March 2006 to some NIS 121.7 billion, a decrease of 0.4% as against the end of 2005.

### **Credit Rating of the State of Israel and Bank Leumi**

The Moody's credit rating company announced on 10 May 2006 that it was raising the foreign currency credit rating outlook of the State of Israel from stable to positive. The announcement gives expression to the company's evaluation that Israeli society and the political and economic decision-makers have proved to be extremely robust in facing the many challenges of recent years. The company emphasized that Israel is demonstrating considerable growth per capita, in purchasing-power terms, and it is nearing a GDP per capita level that is more often associated with advanced economies than developing ones.

Further to this announcement, the company announced on 12 May 2006 that it was raising the foreign currency rating outlook for the deposits of five Israeli banks, including Leumi, from stable to positive. The raising of the rating reflects the continuation of the high prospects of support by the Israeli authorities.

The S&P credit rating company announced on 28 February 2006 that it was raising the long term credit rating of the Bank from BBB+ to A-. The rating outlook is stable. The raising of the rating is explained by the company's evaluation that the Government of Israel would provide significant assistance to the Bank in times of distress.

The Israeli Maalot rating company, a strategic partner of S&P, announced on 11 May 2006 that it was raising the rating of the liabilities of the Bank from AA+ to AAA. This rating also relates to issues that the Bank makes through Leumi Finance Company, a wholly-owned subsidiary of the Bank, which is its financing arm (the proceeds of the issues are deposited with the Bank, and the Bank also undertakes to the trustee to pay the principal, interest and linkage differences to the holders of the capital notes, pursuant to the issued capital notes). Furthermore, the rating also relates to the notes that the Leumi Finance Company intends issuing during the coming year (until April 2007) of up to NIS 4 billion. In the background of the decision is the significant improvement in profitability that principally derives from the boom in the capital market and the improvement in the credit portfolio. In Maalot's opinion, the Bachar Reform does not threaten the financial strength of the Bank.

**Below are details of changes in the CPI and in the exchange rates:**

	For three months ended 31 March	For the year
	2006	2005
	2005	2005
	(Percentages)	
Rate of increase (decrease) of the "known" CPI	<b>0.10</b>	(0.3)
Rate of increase in the rate of the US dollar - nominal	<b>1.35</b>	1.2
Rate of increase (decrease) in the rate of the currency basket - nominal	<b>2.03</b>	(0.5)
Rate of increase (decrease) in the rate of the euro - nominal	<b>3.95</b>	(3.9)

## **General Environment and the Effect of External Factors on Activities**

### **Description of the Banking Corporation's Business and Forward-Looking Information in the Directors' Report**

On 30 June 2004, Amendment No. 23 to the Securities Law, 1968 was published, further to principles recommended by the Barnea Committee (the "Amendment to the Securities Law").

Together with the Amendment to the Securities Law, on 14 September 2004 an amendment to the Securities Regulations was published, further to the principles recommended by the Barnea Committee (the "Amendment to the Securities Regulations"). *Inter alia*, the Amendment to the Securities Regulations regulates the disclosure rules regarding the information required in a prospectus, substantially expands the disclosure required in periodic reports, changes the structure of the periodic report and also includes requirements for the disclosure of forward-looking information.

In accordance with the Amendment to the Securities Regulations, the requirement to expand the disclosure in the periodic reports (Regulation 8(b) and 8A of the Securities Regulations (Periodic and Immediate Reports)) does not apply to banking corporations.

In the light of this, the need arose to apply the requirements of expanded disclosure which were added to the Securities Regulations to banking corporations, pursuant to clarifications given by the Israel Securities Authority, subject to the changes required due to the nature of the business of banking corporations.

In accordance with the above, the Supervisor of Banks amended the public reporting directives and on 19 February 2006 published temporary provisions (the "Temporary Provisions") whereby additional information must be included in the Directors' Report, mostly based on the Amendment to the Securities Regulations, subject to the amendments that the Supervisor deemed appropriate to apply to the banking corporations. Pursuant to the Temporary Provisions, information has also been included in the Directors' Report which does not fall into the category of a description of past facts, and is therefore forward-looking information, as defined in the Amendment to the Securities Law.

The Director's Report includes, as mentioned above, in addition to data relating to the past, information that relates to the future, which is defined in the Securities Law, 1968 as "forward-looking information". Forward-looking information relates to a future event or matter, the realization of which is not certain and is not within the exclusive control of the Bank.

**Forward-looking information** is generally drafted by way of words or phrases such as "the Bank believes", "the Bank foresees", "the Bank expects", "the Bank intends", "the Bank plans", "the Bank estimates", "the Bank's policy", "the Bank's programs", "the Bank's forecast", "strategy",

"aims", "likely to affect" and additional phrases testifying to the fact that the matter in question is a forecast of the future and not a past fact.

Forward-looking information included in the Directors' Report is based, *inter alia*, on forecasts of the future regarding various matters related to economic developments in Israel and abroad, and especially to the currency markets and the capital markets, to legislation, to directives of regulatory bodies, to the behavior of competitors, to technological developments and to personnel matters.

As a result of the inability to foresee with certainty that these forecasts will be realized, and the fact that in reality events may turn out differently from those forecasted, readers of the Report should relate to information defined as "forward-looking" with caution, since reliance on such information involves risks and uncertainty and the future financial and business results of the Leumi Group are likely to be materially different.

The Bank does not undertake to publish updates of the forward-looking information in this Report.

### **The Management of Current Account Credit Lines**

In February 2005, the Supervisor of Banks issued a Proper Banking Management Directive on the subject of "The Management of Current Account Credit Lines", which took effect from 1 January 2006. The Directive is intended to minimize the uncertainty caused to both the customer and to the banking corporation as a result of the practice that allows for exceeding credit limits in current accounts.

Before the Directive took effect, the Bank of Israel made a number of concessions for the transition period, primarily: the deferral of the prohibition on the creation of excesses on current accounts (the prohibition will come into effect on 1 July 2006) and the possibility of unilaterally making available credit even for a customer who has not signed on the required documentation (this concession will be in force until 1 January 2007).

The Bank, while investing considerable resources, has adapted the computer systems, the procedures and the documentation that are necessary in order to implement the Directive. Also, the Bank has carried out appropriate training of its employees.

In addition, in order to implement the provisions, considerable efforts are being invested in signing customers on updated credit facilities and in the prevention/structuring of excess balances, while using, when necessary, and after the exercise of business judgment, the possibility of making available temporary and unilateral facilities.

Despite the aforesaid, it would appear that the rate at which customers are signing the documentation required to make credit facilities available, and likewise the reduction of excess credit balances, is too slow. This seems to derive from the lack of sufficient internalization of the principles of the Directive and its implications on the part of the customers. The Bank is examining the steps that may be taken if customers have not completed the preparations that are required with regard to the Bank by the abovementioned dates.

According to the evaluation of the Management of the Bank and taking into account the amounts of excess interest collected by the Bank, the implementation of the Directive will not have a material affect on the business of the Bank.

### **Legislation on the Reform of the Capital Market**

On 10 August 2005 three laws were published in connection with the reform of the capital market, as follows:

The Intensification of Competition and Reduction of Concentration and Conflicts of Interest in the Israeli Capital Market (Legislative Amendments) Law, 2005;  
The Financial Services (Control) (Engagement in Pension Counselling and Pension Marketing) Law, 2005;  
The Financial Services (Control) (Provident Funds) Law, 2005.

For details on the subject of the capital market reform legislation and its effect on the Bank see Note 8 to the Financial Statements.

## **Accounting Policy on Critical Subjects**

The Financial Statements have been prepared in accordance with generally accepted accounting principles and the directives of the Supervisor of Banks and his guidelines relating to the preparation of the annual and quarterly financial statements of a banking corporation, as detailed in Note 1 to the Annual Financial Statements to 31 December 2005.

The preparation of the Consolidated Financial Statements in accordance with generally accepted accounting principles and the directives of the Supervisor of Banks requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the amounts of income and expenses.

The actual results relating to these estimates may differ from the estimates and/or the assumptions.

The estimates and assumptions are generally based on economic forecasts, assumptions regarding the various markets and past experience after due consideration and which Management believes to be reasonable at the time of signature of the Financial Statements.

The principal critical accounting subjects referred to in the Annual Report to 31 December 2005 were as follows: provisions for doubtful debts, derivatives, securities, obligations regarding employee rights, obligations in respect of legal claims, buildings and equipment and taxes on income.

In the period January to March 2006 there were no changes in the accounting policy on critical subjects as compared with that described in the Annual Report for 2005.

See pages 48 to 52 of the Annual Report for 2005 for further details.

## **C. Description of the Group's Business According to Segments and Spheres of Activity**

### **Development of Income, Expenses and Tax Provisions**

**Net Profit** of the Leumi Group in the period January to March 2006 amounted to NIS 1,112 million, compared with NIS 528 million in the corresponding period in 2005, an increase of 110.6%.

The increase in net profit of the Group in the period January to March 2006 as compared with the corresponding period in 2005 is primarily explained by the following factors:\*

1. An increase in the profit from extraordinary operations in consequence of the sale of some

\* Before minority interests in consolidated companies.

of the non-banking holdings, in respect whereof a profit of NIS 711 million was recorded. See pages 40-41 below for further details.

2. A decline in the provision for doubtful debts in the sum of NIS 244 million, a decrease of 54.8% before the effect of taxes.
3. An increase in profit from net interest income before provision for doubtful debts in the amount of NIS 53 million, before the effect of taxes.
4. An increase in operating and other income of NIS 53 million, before the effect of taxes, principally in consequence of an increase in income from customers' activity in the capital market, the payment system services, credit management and credit cards.

On the other hand, the following factors partially offset the said increase:

1. An increase in operating and other expenses (including salaries) in the sum of NIS 401 million, an increase of 28.2%, before the effect of taxes. When neutralizing the special expenses, as detailed below, the increase is 10.8%.
2. A decrease in the Group's share in the profits of companies included on the equity basis in the sum of NIS 63 million, net.
3. An effective tax rate in 2006 which was higher by 4.7%, as detailed below.

**Net interest income before provision for doubtful debts** of the Leumi Group in the period January to March 2006 amounted to NIS 1,645 million, compared with NIS 1,592 million in the corresponding period in 2005, an increase of 3.3%.

The increase in the Group's net interest income before provision for doubtful debts in the period January to March 2006 as compared with the corresponding period in 2005 stems mainly from an increase of 5.5% in the volume of financial activity, that was partially offset by a decline of 0.18% in the total interest margin.

Furthermore, an expense in the sum of NIS 13 million principally from the adjustments to fair value of debentures for trading, compared with income of NIS 36 million in the corresponding period in 2005, from the sale of debentures and adjustments to fair value of debentures for trading, partly set-off the above increase.

The following table sets out the development of net interest income according to principal activity segments:

Segment	<b>31 March 2006</b>	31 March 2005	Change
	NIS millions		%
Households	<b>519</b>	453	14.6
Small businesses	<b>209</b>	187	11.8
Corporate banking	<b>390</b>	338	15.4
Commercial banking	<b>279</b>	250	11.6
Construction and real estate	<b>167</b>	150	11.3
Private banking	<b>92</b>	70	31.4
Financial management	<b>(12)</b>	140	-
Other	<b>1</b>	4	(75.0)

**Total Interest Margin** (excluding transactions in derivatives) in the period January to March 2006 was 1.95%, compared with 2.52% in the corresponding period of 2005. The interest margin including transactions in derivatives was 1.58% in the period January – March 2006, compared with 1.76% in the corresponding period in 2005, and compared with 1.60% in all of 2005.

The ratio of net interest income before provision for doubtful debts to the average balance of the financial assets was 2.58%, compared with 2.69% (in annual terms) in the corresponding period in 2005.

**The Provision for Doubtful Debts** of the Leumi Group in the period January to March 2006 amounted to NIS 201 million, compared with NIS 445 million in the corresponding period in 2005, a decrease of 54.8%.

The decrease in the specific provisions at a rate of 61.3% is a result of the continued trend of improvement in the economy and an improvement in the companies' positions.

The additional and general provisions for doubtful debts in respect of risks that are not identified in the credit portfolio and that are based upon the risk characteristics in the credit portfolio, and also in respect of a sectoral credit deviation, increased in the period January to March 2006 by NIS 34 million, compared with an increase in the sum of NIS 13 million in the corresponding period in 2005 and a decline of NIS 1 million in all of 2005.

The overall rate of the provision for doubtful debts in the period January to March 2006 was 0.45% of total credit to the public (in annual terms), compared with a rate of 1.06% in the corresponding period in 2005 and compared with 0.80% in all of 2005. The rate of the overall provision for doubtful debts in relation to the overall credit risk (balance sheet and off-balance sheet) was 0.30%, 0.71% and 0.53% respectively.

The following table sets out the quarterly development of the provision for doubtful debts:

	<b>2006</b>	2005			
	<b>First Quarter</b>	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
		NIS millions			
Specific provision	<b>167</b>	313	205	477	432
Additional provision	<b>34</b>	8	(39)	17	13
<b>Total</b>	<b>201</b>	321	166	494	445
Provision as percentage of total credit to the public (on annual basis)	<b>0.45%</b>	0.73%	0.38%	1.17%	1.06%

The aggregate balance of the general provision and the additional provision for doubtful debts (according to risk characteristics defined by the Supervisor of Banks) at the Bank and its consolidated subsidiaries amounted to NIS 1,074 million as at 31 March 2006 (constituting 0.60% of total credit to the public), as against NIS 1,040 million at the end of 2005.

The following table sets out the development of the provisions for doubtful debts according to principal activity segments:

Segment	31 March 2006		31 March 2005	
	NIS millions	in percentages*	NIS millions	in percentages*
Households	101	0.9	37	0.4
Small businesses	9	0.3	6	0.2
Corporate banking	8	0.1	241	1.8
Commercial banking	29	0.3	60	0.8
Construction and real estate	51	0.8	102	1.6

\* Percentage of total credit at the end of the period on an annual basis.

**Profit from Net Interest Income after Provision for Doubtful Debts** of the Leumi Group in the period January to March 2006 amounted to NIS 1,444 million, compared with NIS 1,147 million in the corresponding period in 2005, an increase of 25.9%.

**Total Operating and Other Income** of the Leumi Group in the period January to March 2006 amounted to NIS 940 million, compared with NIS 887 million in the corresponding period in 2005, an increase of 6.0%.

The increase in operating and other income mainly derived from an increase in income from commissions, with an increase of some 33% in commissions from payment system services, of some 42% in commission for dealing with credits and preparing contracts, of some 8% in income from customers' operations in the capital market and some 16% in income from credit cards. On the other hand, income from account management charges declined by some 38% and partially offset these increases.

The ratio of operating and other income to total income (i.e. net interest income before provision for doubtful debts and operating and other income) was 36.4%, compared with 35.8% in the corresponding period in 2005 and compared with 35.9% in all of 2005.

Operating and other income covered 51.6% of operating and other expenses, and on neutralizing special expenses, as detailed below, 60.1%, compared with cover of 62.5% in the corresponding period in 2005 and compared with 61.3% in all of 2005.

**Total Operating and Other Expenses** of the Leumi Group in the period January to March 2006 amounted to NIS 1,821 million, compared with NIS 1,420 million in the corresponding period in 2005, an increase of 28.2%. On neutralizing special expenses, as detailed below, the rate of the increase is 10.8%.

Salary expenses (including the cost of voluntary retirement) increased in the period January to March 2006 by NIS 325 million, an increase of 37.6% compared with the corresponding period in 2005. The increase in the salary expenses derived principally from the adoption of the new mortality tables published by the Supervisor of Insurance which increased the actuarial liability by NIS 136 million, from an increase in the severance and pension provision as a result of an increase in the value of the liability for severance pay that was higher than the increase in the severance pay fund, in the sum of NIS 72 million, and from the effect of recording the expenses in respect of the issue of options to the employees of NIS 40 million. On neutralizing these amounts, the increase in salary expenses was 8.9%.

Operating and other expenses (maintenance of buildings and equipment, depreciation and others) increased in the period January to March 2006 by NIS 76 million, an increase of 13.7%, compared with the corresponding period in 2005.

Operating expenses constituted 70.4% of total income and 60.5% on neutralizing the special expenses that were detailed above, compared with 57.3% in the corresponding period in 2005 and compared with 58.7% in all of 2005.

Total operating and other expenses (in annual terms) constituted 2.69% of total assets, compared with 2.23% in the corresponding period in 2005, and compared with 2.22% in all of 2005.

**Operating Profit before Taxes** of the Leumi Group in the period January to March 2006 amounted to NIS 563 million, compared with NIS 614 million in the corresponding period in 2005, a decline of 8.3% and on neutralizing the special expenses, an increase of 32.1%.

**Provision for Taxes on Operating Profit** of the Leumi Group in the period January to March 2006 amounted to NIS 240 million, compared with NIS 233 million in the corresponding period in 2005. The rate of provision for the said period was some 42.6% of pre-tax profit, compared with 37.9% in the corresponding period in 2005.

The increase in the rate of the provision for taxes was principally affected by recording deferred receivable taxes pursuant to an arrangement with the tax authorities in the first quarter of 2005 of some NIS 65 million. On the other hand, the following matters led to a decrease in the tax rate in the first quarter of 2006:

1. Reduction of the company tax rate from 34% in the first quarter of 2005 to 31% in 2006.
2. Exchange rate differentials in respect of overseas investments that are not included in the tax basis calculation were positive in the said period, compared with negative rates in the corresponding period in 2005.

**Operating Profit after Taxes** in the period January to March 2006 amounted to NIS 323 million, compared with NIS 381 million in the corresponding period in 2005, a decrease of 15.2% and an increase of 26.0% on neutralizing the special expenses.

**The Group's Share in Operating Profit after Taxes of Companies Included on the Equity Basis** in the period January to March 2006 amounted to NIS 78 million, compared with NIS 141 million in the corresponding period in 2005, a decrease of 44.7%. In the first quarter of 2006, the profits on the equity basis in respect of Africa Israel Investments, which was sold on 27 March 2006, and in respect of Migdal Insurance Holdings, 10% of the holdings in which were sold on 15 March 2006, were still included. The decline in the contribution of the companies included on the equity basis principally derived from a decrease in the profits of Israel Corporation and also from a full tax provision in respect of the profits of Africa Israel and Migdal Insurance as a result of the sales, as detailed below.

**Minority Interests in the Profits (Losses) of the Group** in the period January to March 2006 amounted to a profit NIS 1 million, compared with a loss of NIS 9 million in the corresponding period in 2005.

**Net After-Tax Profit (Loss) from Extraordinary Items** in the period January to March 2006 amounted to a profit of NIS 712 million, compared with a loss of NIS 3 million in the corresponding period in 2005. The profit derives from the sale of the Bank's holdings in Africa Israel Investments Ltd. and the sale of 10.0% of the Bank's holdings in Migdal Insurance Holdings. For details see pages 40-41 of the Report.

**Ratio of Operating Profit before Taxes to Net Shareholders' Equity\*** in annual terms was 16.9% in the period January to March 2006, compared with 19.5% in the corresponding period in 2005.

**Ratio of Net Operating Profit to Shareholders' Equity (Net Return on Equity\*)** in annual terms was 9.5% in the period January – March of 2006, compared with 11.8% in the corresponding period in 2005.

**Net Operating Profit per share** reached NIS 0.283 in the period January to March 2006, compared with NIS 0.375 in the corresponding period in 2005.

**Net Profit per share** reached NIS 0.786 in the period January to March 2006, compared with NIS 0.373 in the corresponding period in 2005.

\* Shareholders' equity together with minority interests, less capital investments in companies included on the equity basis. The profit does not include the profit of companies included on the equity basis.

**Return on Shareholders' Equity in Annual Terms (excluding minority interests) of <sup>(a)</sup>:**

	2006	2005			
	1st Qtr	4th Qtr	3rd Qtr	2nd Qtr	1st Qtr
	%				
Net profit	<b>30.8(d)</b>	11.5(c)	14.9	15.8(b)	14.9
Net operating profit	<b>10.4</b>	10.3	15.0	14.7	14.9

The return on equity was considerably affected by the special expenses as detailed on page 18 of the Report. Their effect in terms of return on equity was in a reduction of the return by a rate of some 4.5% on an annual basis.

- (a) The calculation of the return relates to the shareholders' equity at the beginning of each period.
- (b) Includes a profit of NIS 34 million from extraordinary activities which reflects 0.9% of the return for the second quarter of 2005.
- (c) Includes a profit of NIS 46 million from extraordinary activities which reflects 1.1% of the return for the fourth quarter of 2005.
- (d) Includes a profit of NIS 712 million from extraordinary activities (as detailed on pages 39-41) which reflects 19.0% of the return for the first quarter of 2006.

**Structure and Development of Assets and Liabilities<sup>(1)</sup>**

**Total Assets** of the Leumi Group on 31 March 2006 amounted to NIS 273.0 billion, compared with NIS 272.8 billion at the end of 2005, an increase of 0.1% and an increase of 6.3% compared with 31 March 2005.

The value of the assets in or linked to foreign currency was some NIS 125.3 billion, some 45.9% of total assets. In the period January to March 2006 the shekel depreciated against the US dollar by 1.35%, against the basket of currencies by 2.03% and against the euro by 3.95%. The change in the rate of exchange contributed an increase of 0.8% in total assets.

(1) The changes in percentages were calculated according to the balances in NIS millions.

**Deposits of the public** amounted to NIS 221.8 billion on 31 March 2006, similar to the balances on 31 December 2005, and an increase of 5.6% compared with 31 March 2005.

The following table sets out the development of deposits of the public according to principal segment of activity:

Segment	31 March 2006	31 December 2005	Change
	NIS millions		%
Households	<b>111,105</b>	110,364	0.7
Small businesses	<b>11,289</b>	11,391	(0.9)
Corporate banking	<b>27,546</b>	28,616	(3.7)
Commercial banking	<b>22,858</b>	23,922	(4.4)
Construction and real estate	<b>2,916</b>	3,150	(7.4)
Private banking	<b>37,548</b>	35,008	7.3
Financial Management and other	<b>8,545</b>	9,377	(8.9)

**Debentures, Capital Notes and Subordinated Capital Notes** totaled NIS 16.9 billion on 31 March 2006, compared with NIS 17.3 billion on 31 December 2005, a decrease of 2.1%, and an increase of 33.3% compared with 31 March 2005.

#### Off-balance sheet activity

The following table sets out the development of balances of the customers' financial assets\* (off-balance sheet) under the management of the Leumi Group:

	31 March 2006	31 December 2005	Change	
	NIS millions		NIS millions	%
Securities portfolios	<b>262,300</b>	245,579	16,721	6.8
of which: Mutual funds**	<b>46,777</b>	44,748	2,029	4.5
Provident funds***	<b>39,279</b>	38,626	653	1.7
Supplementary training funds	<b>10,554</b>	10,619	(65)	(0.6)
<b>Total</b>	<b>321,133</b>	294,824	17,309	5.9

\* Including an increase in the market value of securities.

\*\* Including funds of all the managers in the system.

\*\*\* Including assets of customers in respect of which the Group provides operating and other services.

**Credit to the public** totaled NIS 177.6 billion on 31 March 2006, compared with NIS 177.3 billion on 31 December 2005, an increase of 0.2%, and an increase of 5.1%, as compared with 31 March 2005.

The balance of securities of companies that were purchased by the Group totaled NIS 6,856 million on 31 March 2006, compared with NIS 6,330 million on 31 December 2005, an increase of 8.3%.

The following table sets out the development of overall credit to the public risk\* according to principal sectors of the economy:

Economy Sectors	31 March 2006		31 December 2005		Change
	Overall credit risk to the public	Percentage of total	Overall credit risk to the public	Percentage of total	
	NIS millions	%	NIS millions	%	
Agriculture	<b>2,194</b>	<b>0.8</b>	2,160	0.8	1.6
Industry	<b>40,714</b>	<b>15.1</b>	40,777	15.2	(0.2)
Construction and real estate	<b>48,643</b>	<b>18.1</b>	47,820	17.8	1.7
Electricity and water	<b>2,884</b>	<b>1.1</b>	2,743	1.0	5.1
Trade	<b>31,258</b>	<b>11.6</b>	30,340	11.3	3.0
Hotels, accommodation and food services	<b>6,142</b>	<b>2.3</b>	6,273	2.3	(2.1)
Transportation and storage	<b>6,305</b>	<b>2.3</b>	6,360	2.4	(0.9)
Communications and computer services	<b>8,493</b>	<b>3.2</b>	8,444	3.2	0.6
Financial services	<b>32,014</b>	<b>11.9</b>	33,967	12.7	(5.7)
Other business services	<b>7,333</b>	<b>2.7</b>	7,570	2.8	(3.1)
Public and community services	<b>8,327</b>	<b>3.1</b>	7,767	2.9	7.2
Private persons - housing loans	<b>31,782</b>	<b>11.8</b>	31,448	11.7	1.1
Private persons – other	<b>43,120</b>	<b>16.0</b>	42,234	15.9	2.1
<b>Total</b>	<b>269,209</b>	<b>100.0</b>	267,903	100	0.5

\* Including off-balance sheet credit risk, investments of the public in debentures and other assets in respect of derivatives.

The following table sets out the development of credit to the public according to principal activity segments:

Segment	31 March 2006	31 December 2005	Change
	NIS millions		%
Households*	<b>43,793</b>	43,668	0.3
Small businesses	<b>13,505</b>	13,476	6.5
Commercial banking	<b>34,115</b>	32,350	5.5
Corporate banking	<b>55,155</b>	57,360	(3.8)
Construction and real estate	<b>24,665</b>	24,490	0.7
Private banking	<b>4,981</b>	4,678	6.5

\* Credit to households includes also housing loans (mortgages). Upon neutralizing this credit, credit to households increased by 0.6%. Housing loans (mortgages) to households amounted to NIS 32.9 billion at the end of March 2006, and increased by a rate of 0.2%.

### Merger of the Cable Companies

In May 2006 an agreement was signed to merge the activities of the cable companies in the field of broadcasting and the field of the national internal carrier.

Under the agreement, Matav Telecommunication Systems Ltd. (the "Merged Company") would purchase the activities of the other companies in these fields, in exchange for taking-over obligations and/or the allotment of shares in the merged company.

Financing principles were agreed upon for the Merged Company as part of the agreement.

Upon completion of the merger, the owners of each of the cable companies will hold shares in the Merged Company, pursuant to the relative number of cable television subscribers that each company had on 30 September 2005.

Upon completion of the merger agreement, the Bank is expected to hold some 15.2% of the shares of the Merged Company.

In the estimation of the Management of the Bank, the procedure detailed will not have a material effect on the Bank's Financial Statements.

#### **Memorandum of Understanding regarding Tower**

In May 2006 the banks signed a memorandum of understanding with Tower Semiconductors Ltd. Under this memorandum of understanding the Bank will convert its debt of US\$ 79 million to shares in the ratio of US\$ 2 of debt to US\$ 1 of shares. The price per share will be determined according to the average price on the ten days preceding the date of signature of the memorandum of understanding. According to a preliminary calculation, the Bank will hold some 14% of the shares of the company (some 11% on full dilution). Further, a reorganization of the loans will be carried out, so that their repayment will commence in 2009, with a corresponding reduction in interest. The memorandum of understanding is subject to the investment of US\$ 100 million in capital by The Israel Corporation.

In the estimation of the Management of the Bank, the reorganization of the loans of the company will not have a material effect on the Bank's Financial Statements.

**Problem Loans** – the following table sets out the development of the problem loans <sup>(1)(6)</sup> according to the classifications determined in directives of the Supervisor of Banks:

	<b>31 March 2006</b>	31 March 2005	31 December 2005
	(NIS millions)		
Non-accrual	<b>2,518</b>	2,593	2,431
Restructured (2)	<b>1,121</b>	1,055	985
To be restructured (3)	<b>1,189</b>	1,113	1,070
In temporary arrears	<b>750</b>	826	698
Under special supervision*	<b>12,519</b>	12,697	12,485
Total balance sheet credit to problem borrowers (1)	<b>18,097</b>	18,284	17,669
Off-balance sheet credit risk to problem borrowers (1) (5)*	<b>2,313</b>	2,430	2,060
Other assets in respect of derivatives of problem borrowers	<b>118</b>	88	154
Total overall credit risk in respect of problem borrowers (1)	<b>20,528</b>	20,802	19,883
Assets received in respect of repaid credit	<b>25</b>	15	24
*Of which: debts for which there is a specific provision (4)	<b>6,757</b>	7,193	6,936
*Of which: credit for housing for which there is a provision according to the extent of the arrears	<b>673</b>	664	673

- (1) Not including problem loans that are covered by collateral that are permitted to be deducted for the purpose of restrictions on the obligations of a borrower and a group of borrowers (Proper Banking Management Directive No. 313).
- (2) Credit that was restructured during the course of the current year and also credit that was restructured in previous years with a waiver of income.
- (3) Credit to borrowers in respect whereof there is a decision of the banking corporation's management for a restructure, but the restructure has not yet been implemented.
- (4) Apart from credit for housing in respect of which there is a provision in accordance with the extent of the arrears.
- (5) As calculated for the purposes of limits on the obligations of a borrower and a group of borrowers, except for guarantees given by a borrower to secure an obligation of a third party.
- (6) Credit to problem borrowers as detailed in the disclosure format.

**Credit to Governments** as at 31 March 2006 totaled NIS 808 million, compared with NIS 848 million as at 31 December 2005, a decrease of 4.7% and, compared with 31 March 2005, a decrease of 11.5%.

**Securities** amounted to NIS 48.4 billion as at 31 March 2006, compared with NIS 47.8 billion as at 31 December 2005, an increase of 1.1%, and an increase of 8.2% compared with 31 March 2005.

The Bank is a member of the Stock Exchange Clearing House Ltd and the Maof Clearing House Ltd.

As at 31 March 2006, the Bank had pledged debentures in the sum of NIS 106 million to the Stock Exchange Clearing House and debentures in the sum of NIS 1,416 million to the Maof Clearing House, to secure its customers' operations and in respect of the Clearing House members' mutual guarantee.

On 17 August 2005, the Bank signed a debenture in favor of the Bank of Israel as security for the credit that the Bank has received or will receive from the Bank of Israel. As collateral for the debenture, the Bank created a floating charge in favor of the Bank of Israel on its inventory of Makam, Gilon, Shahar and Galil type debentures, up to the amount of NIS 5.0 billion.

As at 31 March 2006, there was no credit from the Bank of Israel, while the balance of the Bank's deposits with the Bank of Israel amounted to the sum of NIS 3.1 billion.

On 11 May 2006, the Bank entered into an agreement to purchase 5% of the share capital of Cellcom Israel Ltd from Discount Investment Corp. Ltd for a total consideration of some US\$ 72 million. Completion of the transaction is subject to such regulatory approvals as may be required. The purchaser of the shares will be the Bank or a subsidiary under its control.

## Operational Segments in the Group

The Group operates in different operational segments through the Bank and its subsidiaries in all fields of banking and financial services. Furthermore, the Group invests in non-banking corporations that operate in various fields, including insurance, real estate, shipping, energy, industry and others.

The operational segments are according to characteristics that were determined by the Bank of Israel. A detailed description of the operational segments and the manner of their measurement is detailed in the Annual Report for 2005.

The following table sets out details of the net profit according to operational segments:

Segments	<b>31 March 2006</b>	31 March 2005	Change
	NIS millions		%
Households	<b>88</b>	118	(25.4)
Small businesses	<b>52</b>	54	(3.7)
Corporate banking	<b>169</b>	10	+
Commercial banking	<b>113</b>	67	68.7
Construction and real estate	<b>62</b>	22	181.8
Private banking	<b>4</b>	11	(63.6)
Financial management and other*	<b>624</b>	246	153.7
<b>Total</b>	<b>1,112</b>	528	110.6

\* including profit from extraordinary items

## 1. Households

The following tables set out the profit and loss of the households segment:

	Banking and finance	Credit cards	Capital market	Mortgages	Total
<b>For the three months ending 31 March 2006</b>					
NIS millions					
Net interest income:					
From external sources	(617)	16	2	362	(237)
Inter-segmental	1,025	(1)	(1)	(267)	756
Operating and other income:					
From external sources	116	86	75	31	308
Inter-segmental	-	41	90	2	133
Total income	524	142	166	128	960
Provisions for doubtful debts	16	1	-	84	101
Operating and other expenses:					
External	471	94	97	49	711
Inter-segmental	-	-	-	3	3
Operating profit (loss) before taxes	37	47	69	(8)	145
Provision for taxes	16	14	28	(1)	57
<b>Net profit (loss)</b>	<b>21</b>	<b>33</b>	<b>41</b>	<b>(7)</b>	<b>88</b>
<b>% Return on equity</b>					<b>12.1%</b>
Average balance of assets	9,944	1,342	118	33,003	44,407
Average balance of liabilities	103,833	49	-	12,490	116,372
Average balance of risk assets	9,180	5,561	130	26,677	41,548
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	-	58,301	-	58,301
Average balance of securities	-	-	32,681	-	32,681
Average balance of other assets under management	293	-	-	8,521	8,814
Balance of credit to the public as of 31 March 2006	9,884	927	107	32,875	43,793
Balance of deposits of the public as of 31 March 2006	102,531	5	-	8,569	111,105

	Banking and finance	Credit cards	Capital market	Mortgages	Total
For the three months ending 31 March 2005					
NIS millions					
Net interest income:					
From external sources	(476)	12	-	299	(165)
Inter-segmental	822	1	-	(205)	618
Operating and other income:					
From external sources	122	73	68	33	296
Inter-segmental	1	35	77	2	115
Total income	469	121	145	129	864
Provisions for doubtful debts	16	-	-	21	37
Operating and other expenses:					
External	395	78	97	44	614
Inter-segmental	-	-	-	3	3
Operating profit (loss) before taxes	58	43	48	61	210
Provision for taxes	26	17	21	28	92
<b>Net profit</b>	32	26	27	33	118
<b>% Return on equity</b>					17.5%
Average balance of assets	9,036	1,073	54	31,748	41,911
Average balance of liabilities	102,962	45	-	11,099	114,106
Average balance of risk assets	7,825	5,136	54	25,528	38,543
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	-	47,807	-	47,807
Average balance of securities	-	-	26,426	-	26,426
Average balance of other assets under management	297	-	-	8,742	9,039
Balance of credit to the public as of 31 December 2005	9,846	879	130	32,813	43,668
Balance of deposits of the public as of 31 December 2005	101,594	3	-	8,767	110,364

### Main Changes in the Scope of Activity

Total credit to the public in the households segment increased by NIS 125 million compared with the end of 2005, an increase of 0.3%. On neutralizing housing loans, credit grew by 0.6% and housing loans grew by 0.2%. Deposits of the public rose by NIS 741 million, compared with the end of 2005, an increase of 0.7%.

### Pension Counselling

The Bank is actively making preparations to enter the pension counselling field, and is developing analytical systems and advanced models to adapt pension products to private customers. Furthermore, the Bank is training counsellors in the pension field and is also recruiting additional staff. The Bank intends to be prepared to provide pension counselling during the course of 2006, subject to receipt of a pension counselling license from the Supervisor of the Capital Market of the Ministry of Finance.

## Main Changes in Net Profit

Net profit in the households segment totaled NIS 88 million in the first quarter of 2006, compared with NIS 118 million in the corresponding period in 2005. The decrease in profit primarily stemmed from an increase in the provisions for doubtful debts in the mortgage sector (Leumi Mortgage Bank, see pages 45-46 below). Total income grew by NIS 96 million and was offset by a parallel increase in expenses. Net profit of the segment's activity in the Bank in Israel only grew by 6.7%.

## 2. Small Businesses

The following tables set out the profit and loss of the small businesses segment:

	Banking and finance	Credit cards	Capital market	Mortgages	Total
<b>For the three months ending 31 March 2006</b>					
NIS millions					
Net interest income:					
From external sources	222	5	3	2	232
Inter-segmental	(18)	(1)	(3)	(1)	(23)
Operating and other income:					
From external sources	88	24	4	-	116
Inter-segmental	1	(11)	7	-	(3)
Total income	293	17	11	1	322
Provisions for doubtful debts	9	-	-	-	9
Operating and other expenses:					
External	205	12	7	-	224
Inter-segmental	-	-	-	-	-
Operating profit (loss) before taxes	79	5	4	1	89
Provision for taxes	33	2	2	-	37
<b>Net profit</b>	46	3	2	1	52
<b>% Return on equity</b>					27.3%
Average balance of assets	13,000	177	218	98	13,493
Average balance of liabilities	11,460	70	-	-	11,530
Average balance of risk assets	10,290	766	250	98	11,404
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	-	5,846	-	5,846
Average balance of securities	-	-	2,423	-	2,423
Average balance of other assets under management	444	-	-	-	444
Balance of credit to the public as of 31 March 2006	13,067	152	187	99	13,505
Balance of deposits of the public as of 31 March 2006	11,289	-	-	-	11,289

	Banking and finance	Credit cards	Capital market	Mortgages	Total
For the three months ending 31 March 2005					
NIS millions					
Net interest income:					
From external sources	203	5	2	1	211
Inter-segmental	(21)	(1)	(1)	(1)	(24)
Operating and other income:					
From external sources	89	24	3	-	116
Inter-segmental	(1)	(12)	8	-	(5)
Total income	270	16	12	-	298
Provisions for doubtful debts	6	-	-	-	6
Operating and other expenses:					
External	179	12	6	-	197
Inter-segmental	(1)	-	-	-	(1)
<b>Operating profit (loss) before taxes</b>	<b>86</b>	<b>4</b>	<b>6</b>	<b>-</b>	<b>96</b>
Provision for taxes	37	2	3	-	42
<b>Net profit</b>	<b>49</b>	<b>2</b>	<b>3</b>	<b>-</b>	<b>54</b>
<b>% Return on equity</b>					<b>31.2%</b>
Average balance of assets	12,163	187	204	106	12,660
Average balance of liabilities	10,530	74	-	-	10,604
Average balance of risk assets	9,299	739	204	106	10,348
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	-	4,784	-	4,784
Average balance of securities	-	-	1,589	-	1,589
Average balance of other assets under management	429	-	-	-	429
Balance of credit to the public as of 31 December 2005	12,973	155	250	98	13,476
Balance of deposits of the public as of 31 December 2005	11,391	-	-	-	11,391

### Main Changes in the Scope of the Activity

Total credit to the public in the segment increased by NIS 29 million as compared with the end of 2005, and total deposits of the public declined by NIS 102 million.

### Main Changes in the Net Profit

Net profit in the small businesses segment totaled NIS 52 million in the first quarter of 2006, compared with NIS 54 million in the corresponding period in 2005. The reduction in profit stemmed from an increase of NIS 3 million in the provisions for doubtful debts. Further, income grew by NIS 24 million, which was offset by an increase of NIS 28 million in expenses, a rise of 14.3%.

### 3. Corporate Banking

The following tables set out the profit and loss of the corporate banking segment:

	Banking and finance	Credit cards	Capital market	Overseas activities	Total
<b>For the three months ending 31 March 2006</b>					
NIS millions					
Net interest income:					
From external sources	511	3	-	63	577
Inter-segmental	(231)	(1)	-	45	(187)
Operating and other income:					
From external sources	47	28	5	11	91
Inter-segmental	-	(23)	3	-	(20)
Total income	327	7	8	119	461
Provisions for doubtful debts	8	-	-	-	8
Operating and other expenses:					
External	82	14	4	42	142
Inter-segmental	-	-	-	35	35
Operating profit (loss) before taxes	237	(7)	4	42	276
Provision for taxes	96	(2)	2	11	107
<b>Net profit</b>	141	(5)	2	31	169
<b>% Return on equity</b>					15.7%
Average balance of assets	47,643	35	34	11,032	58,744
Average balance of liabilities	20,001	123	-	13,596	33,720
Average balance of risk assets	50,135	160	39	11,636	61,970
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	-	4,471	53	4,524
Average balance of securities	-	-	46,238	1,217	47,455
Average balance of other assets under management	644	-	-	-	664
Balance of credit to the public as of 31 March 2006	44,804	1	29	10,321	55,155
Balance of deposits of the public as of 31 March 2006	15,202	-	-	12,344	27,546

	Banking and finance	Credit cards	Capital market	Overseas activities	Total
For the three months ending 31 March 2005					
NIS millions					
Net interest income:					
From external sources	390	1	-	57	448
Inter-segmental	(142)	-	-	32	(110)
Operating and other income:					
From external sources	35	19	5	11	70
Inter-segmental	2	(16)	4	-	(10)
Total income	285	4	9	100	398
Provisions for doubtful debts	241	-	-	-	241
Operating and other expenses:					
External	70	12	3	37	122
Inter-segmental	-	-	-	28	28
Operating profit (loss) before taxes	(26)	(8)	6	35	7
Provision for taxes	(13)	(2)	3	9	(3)
<b>Net profit</b>	<b>(13)</b>	<b>(6)</b>	<b>3</b>	<b>26</b>	<b>10</b>
<b>% Return on equity</b>					<b>0.9%</b>
Average balance of assets	47,200	24	24	9,498	56,746
Average balance of liabilities	21,223	104	-	12,022	33,349
Average balance of risk assets	47,906	133	24	9,538	57,601
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	-	4,565	-	4,565
Average balance of securities	-	-	32,274	807	33,081
Average balance of other assets under management	774	-	-	-	774
Balance of credit to the public as of 31 December 2005	47,065	1	39	10,255	57,360
Balance of deposits of the public as of 31 December 2005	16,405	-	-	12,211	28,616

### Main Changes in the Scope of Activity

Total credit to the public in the segment decreased by NIS 2,205 million, 3.8%, as compared with the end of 2005, and total deposits of the public decreased by NIS 1,070 million, 3.7%.

### Main Changes in Net Profit

Net profit in the corporate banking segment totaled NIS 169 million in the first quarter of 2006, compared with NIS 10 million in the corresponding period in 2005.

The increase in profit mainly stems from a decline of NIS 233 million in provisions for doubtful debts. Further, income rose by NIS 63 million, 15.8%, compared with an increase of NIS 27 million, 18.0%, in expenses.

#### 4. Commercial Banking

The following tables set out the profit and loss of the commercial banking segment:

	Banking and finance	Credit cards	Capital market	Mortgages	Overseas activities	Total
<b>For the three months ending 31 March 2006</b>						
NIS millions						
Net interest income:						
From external sources	291	2	1	5	60	359
Inter-segmental	(64)	(1)	(1)	(3)	(11)	(80)
Operating and other income:						
From external sources	63	10	19	-	9	101
Inter-segmental	-	(6)	6	-	-	-
Total income	290	5	25	2	58	380
Provisions for doubtful debts	25	-	-	4	-	29
Operating and other expenses:						
External	119	4	8	1	31	163
Inter-segmental	4	-	-	-	-	4
Operating profit (loss) before taxes	142	1	17	(3)	27	184
Provision for taxes	57	1	7	(1)	7	71
<b>Net profit</b>	85	-	10	(2)	20	113
<b>% Return on equity</b>						19.7%
Average balance of assets	27,167	47	93	386	8,665	36,358
Average balance of liabilities	17,951	40	-	332	7,327	25,650
Average balance of risk assets	27,391	259	104	426	5,301	33,481
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	-	4,899	-	147	5,046
Average balance of securities	-	-	48,320	-	2,029	50,349
Average balance of other assets under management	1,231	-	-	-	-	1,231
Balance of credit to the public as of 31 March 2006	27,709	49	81	319	5,957	34,115
Balance of deposits of the public as of 31 March 2006	15,863	-	-	75	6,920	22,858

	Banking and finance	Credit cards	Capital market	Mortgages	Overseas activities	Total
For the three months ending 31 March 2005						
NIS millions						
Net interest income:						
From external sources	269	2	1	4	47	323
Inter-segmental	(60)	(1)	(1)	(3)	(8)	(73)
Operating and other income:						
From external sources	55	10	11	-	6	82
Inter-segmental	-	(7)	11	-	-	4
Total income	264	4	22	1	45	336
Provisions for doubtful debts	62	-	-	(1)	(1)	60
Operating and other expenses:						
External	111	4	9	2	28	154
Inter-segmental	4	1	-	-	-	5
Operating profit (loss) before taxes	87	(1)	13	-	18	117
Provision for taxes	40	(1)	6	-	5	50
<b>Net profit</b>	47	-	7	-	13	67
<b>% Return on equity</b>						12.4%

Average balance of assets	25,899	51	111	429	7,915	34,405
Average balance of liabilities	14,740	53	-	378	6,690	21,861
Average balance of risk assets	25,010	202	111	421	4,630	30,374
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	-	4,540	-	-	4,540
Average balance of securities	-	-	26,219	-	1,753	27,972
Average balance of other assets under management	1,129	-	-	-	-	1,129
Balance of credit to the public as of 31 December 2005	26,412	43	104	325	5,466	32,350
Balance of deposits of the public as of 31 December 2005	17,046	-	-	60	6,816	23,922

### Main Changes in the Scope of Activity

Total credit to the public in the segment increased by NIS 1,765 million, 5.5%, as compared with the end of 2005, and total deposits of the public decreased by NIS 1,064 million, 4.4%.

## Main Changes in Net Profit

Net profit in the commercial banking segment totaled NIS 113 million in the first quarter of 2006, compared with a NIS 67 million in the corresponding period in 2005, an increase at the rate of 68.7%. The increase in profit arose from an increase in income of NIS 44 million, 13.1%, which was partly offset by an increase of NIS 8 million in expenses. There was also a decrease of NIS 31 million, 51.7%, in provisions for doubtful debts.

Net profit of the segment from activities of the Bank in Israel rose by 61% and from the activities of the segment in the U.K. there was an increase in net profit of some 43%.

## 5. The Construction and Real-Estate Segment

The following tables set out the profit and loss of the construction and real estate division:

	Banking and finance in Israel	Capital market	Overseas activities	Total
<b>For the three months ending 31 March 2006</b>				
NIS millions				
Net interest income:				
From external sources	347	-	20	367
Inter-segmental	(192)	-	(8)	(200)
Operating and other income:				
From external sources	13	1	-	14
Inter-segmental	-	-	-	-
Total income	168	1	12	181
Provisions for doubtful debts	51	-	-	51
Operating and other expenses:				
External	20	-	2	22
Inter-segmental	-	-	3	3
Operating profit (loss) before taxes	97	1	7	105
Provision for taxes	40	-	3	43
<b>Net profit</b>	57	1	4	62
<b>% Return on equity</b>				11.4%
Average balance of assets	23,869	-	1,072	24,941
Average balance of liabilities	2,913	-	327	3,240
Average balance of risk assets	29,718	-	1,153	30,871
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	202	-	202
Average balance of securities	-	10,322	6	10,328
Average balance of other assets under management	75	-	-	75
Balance of credit to the public as of 31 March 2006	23,619	-	1,046	24,665
Balance of deposits of the public as of 31 March 2006	2,631	-	285	2,916

	Banking and finance in Israel	Capital market	Overseas activities	Total
For the three months ending 31 March 2005				
NIS millions				
Net interest income:				
From external sources	306	-	15	321
Inter-segmental	(167)	-	(4)	(171)
Operating and other income:				
From external sources	10	1	1	12
Inter-segmental	-	-	-	-
Total income	149	1	12	162
Provisions for doubtful debts	102	-	-	102
Operating and other expenses:				
External	18	-	1	19
Inter-segmental	-	-	2	2
Operating profit (loss) before taxes	29	1	9	39
Provision for taxes	15	-	2	17
<b>Net profit</b>	14	1	7	22
<b>% Return on equity</b>				3.9%
Average balance of assets	25,495	-	962	26,457
Average balance of liabilities	2,217	-	222	2,439
Average balance of risk assets	30,120	-	973	31,093
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	193	-	193
Average balance of securities	-	10,432	5	10,437
Average balance of other assets under management	24	-	-	24
Balance of credit to the public as of 31 December 2005	23,407	-	1,083	24,490
Balance of deposits of the public as of 31 December 2005	2,785	-	365	3,150

### Main Changes in the Scope of Activity

Total credit to the public in the segment increased by NIS 175 million, 0.7%, as compared with the end of 2005, and total deposits of the public decreased by NIS 234 million, 7.4%.

### Main Changes in Net Profit

Net profit in the construction and real estate segment totaled NIS 62 million in the first quarter of 2006, compared with NIS 22 million in the corresponding period in 2005, an increase at the rate of 181.8%. The increase in profit mainly stems from a decline of NIS 51 million, 50.0%, in provisions for doubtful debts. Total income grew by NIS 19 million, 11.7%, which was partly offset by an increase of NIS 4 million, 19.0%, in expenses.

## 6. Private Banking

The following tables set out the profit and loss of private banking:

	Banking and finance in Israel	Credit cards	Capital market	Overseas activities	Total
<b>For the three months ending 31 March 2006</b>					
NIS millions					
Net interest income:					
From external sources	(234)	-	-	(30)	(264)
Inter-segmental	280	-	-	76	356
Operating and other income:					
From external sources	11	-	24	59	94
Inter-segmental	1	-	5	2	8
Total income	58	-	29	107	194
Provisions for doubtful debts					
Operating and other expenses:					
External	53	1	16	100	170
Inter-segmental	-	-	-	21	21
Operating profit (loss) before taxes	5	(1)	13	(14)	3
Provision for taxes	2	-	5	(4)	3
Operating profit (loss) after taxes	3	(1)	8	(10)	-
Minority interests in losses of consolidated companies	-	-	-	4	4
<b>Net profit</b>	<b>3</b>	<b>(1)</b>	<b>8</b>	<b>(6)</b>	<b>4</b>
<b>% Return on equity</b>					<b>4.9%</b>
Average balance of assets	1,781	6	-	6,405	8,192
Average balance of liabilities	24,657	-	-	13,063	37,720
Average balance of risk assets	938	44	-	3,593	4,575
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	-	3,307	1,608	4,915
Average balance of securities	-	-	25,987	35,146	61,133
Average balance of other assets under management	450	-	-	-	450
Balance of credit to the public as of 31 March 2006	1,830	6	-	3,145	4,981
Balance of deposits of the public as of 31 March 2006	25,240	-	-	12,308	37,548

	Banking and finance in Israel	Credit cards	Capital market	Overseas activities	Total
For the three months ending 31 March 2005 NIS millions					
Net interest income:					
From external sources	(130)	-	-	(5)	(135)
Inter-segmental	163	-	-	42	205
Operating and other income:					
From external sources	8	-	22	60	90
Inter-segmental	-	-	5	2	7
Total income	41	-	27	99	167
Provisions for doubtful debts					
Operating and other expenses:					
External	38	-	15	78	131
Inter-segmental	-	-	-	15	15
Operating profit (loss) before taxes	3	-	12	6	21
Provision for taxes	1	-	5	1	7
Operating profit after taxes	2	-	7	5	14
Minority interests in profits of consolidated companies	-	-	-	(3)	(3)
<b>Net profit</b>	<b>2</b>	<b>-</b>	<b>7</b>	<b>2</b>	<b>11</b>
<b>% Return on equity</b>					<b>14.8%</b>
Average balance of assets	1,514	5	-	5,986	7,505
Average balance of liabilities	21,926	-	-	11,131	33,057
Average balance of risk assets	795	36	-	3,393	4,224
Average balance of assets of provident funds, mutual funds and supplementary training funds	-	-	2,384	-	2,384
Average balance of securities	-	-	19,735	32,769	52,504
Average balance of other assets under management	513	-	-	-	513
Balance of credit to the public as of 31 December 2005	1,667	6	-	3,005	4,678
Balance of deposits of the public as of 31 December 2005	23,746	-	-	11,262	35,008

### Main Changes in the Scope of Activity

Total credit to the public in the segment increased by NIS 303 million, 6.5%, as compared with the end of 2005, and total deposits of the public rose by NIS 2,540 million, 7.3%.

### Main Changes in Net Profit

The net profit in the private banking segment totaled NIS 4 million in the first quarter of 2006, compared with NIS 11 million in the corresponding period in 2005. The decline in profit stems from the negative contribution of some NIS 11 million of the Swiss subsidiary, compared with a positive contribution of NIS 3 million in the corresponding period of 2005. Net profit of the segment from activities in Israel grew at the rate of 12.5%.

## 7. Financial Management

The loss in the financial management segment totaled NIS 131 million in the first quarter of 2006, compared with a profit of NIS 35 million in the corresponding period of 2005. The decline in profit derived from the following reasons:

- An increase in operating expenses, which were not attributed to the other segments, as a result of the adoption of the new mortality tables published by the Supervisor of Insurance and an increase in provisions for severance pay and pensions as a result of the increase in the amount of the obligation for severance pay which is greater than the increase in value of the severance pay fund.

In total, these two matters caused a reduction of some NIS 125 million in net profit.

- The decline in financing profit as a result of the decline in market value of debentures for trading and a decline in the profit from the sale of available for sale debentures caused a reduction of some NIS 30 million in the net profit.

8. **Others** – this segment includes activities not included in other segments, including the Group's share of the profits of companies included on the equity basis, as detailed above.

This segment includes the other activities of the Group, none of which amounts to a profit segment under the directives of the Bank of Israel.

This activity mainly includes: part of the activities of the capital market companies that are not allocated to other segments, credit card activities and the profits of the Group's companies that are included on the equity basis and the results of the sale of shares in subsidiary and associated companies.

In the first quarter of 2006 the net profit of the "Others" segment amounted to NIS 755 million, as compared with NIS 211 million in the corresponding period in 2005.

The following table sets out details of the main changes in NIS millions:

	<b>31 March 2006</b>	31 March 2005	Difference in %
Companies included on the equity basis	<b>78</b>	141	(44.7)
Extraordinary profit <sup>(1)</sup>	<b>712</b>	(3)	-
Operating activity at the Bank	<b>14</b>	10	40.0
Psagot Ofek	<b>2</b>	9	(77.8)
Leumi & Co.	<b>(1)</b>	14	-
Other companies in Israel	<b>(3)</b>	12	-
Overseas companies	<b>5</b>	4	25.0
Tax adjustments <sup>(2)</sup>	<b>(52)</b>	24	-
<b>Total</b>	<b>755</b>	211	257.8

(1) Profit from Extraordinary Items – (presented in the “Others” Segment)

On 15 March 2006 the Bank and Leumi Real Holdings sold 10.0% out of their holdings in the fully paid share capital of Migdal Holdings and in consequence thereof the rate of the Bank’s holding in the share capital of Migdal Holdings declined to 9.98%. The net profit after tax from the said sale totaled NIS 235 million and was recorded as profit from extraordinary items.

On 27 March 2006 the Bank sold all its holdings in Africa Israel Investments. The net profit after tax from the said sale totaled NIS 476 million and was recorded as profit from extraordinary items.

See pages 40-41 for further details in connection with the said sales.

(2) Tax differentials between tax calculations in the segments and the effective tax in the consolidated Report

### **9. Companies Included on the Equity Basis (Non-Banking)** (presented in the “Others” Segment)

This includes the operating results of the Group’s non-banking investments, and is presented in the “Others” segment.

The total investment of the Leumi Group in companies included on the equity basis was NIS 1,255 million as at 31 March 2006, compared with some NIS 2,064 million as at 31 December 2005.

The following table sets out the main changes:

Name of Company	Balance Sheet Value (in NIS millions)			Market Value (in NIS millions)	
	31 March 2006	31 December 2005	% change	31 March 2006	31 December 2005
	The Israel Corporation Ltd.	<b>1,095</b>	1,066	2.7	<b>2,118</b>
Migdal Insurance and Financial Holdings Ltd. (1)	-	534	-	-	1,355
Africa Israel Investments Ltd. (2)	-	315	-	-	1,197
Af-Sar Ltd.	<b>46</b>	46	-	-	-
Keshet Broadcasting Ltd.	<b>12</b>	11	9.1	-	-
Others	<b>102</b>	92	10.9	-	-
<b>Total</b>	<b>1,255</b>	2,064	(39.2)	<b>2,118</b>	4,915

1. On 15 March 2006 the Bank sold 10% of the share capital of Migdal Insurance and Financial Holdings Ltd, and from 31 March 2006 the balance of the investment appears under "shares available for sale" in the securities item.
2. On 27 March 2006 the Bank sold its entire holdings in Africa Israel.

The contribution to the profit of the Group of the companies included on the equity basis in the first quarter of 2006 amounted to NIS 78 million, compared with NIS 141 million in the corresponding period in 2005.

The decline in the contribution to profit derived principally from a decline in the profit of The Israel Corporation and from recording full taxes in respect of the profits of Migdal Holdings and Africa Israel, as compared with a provision for taxes payable in the future in respect of a dividend distribution only in the first quarter of 2005.

The following table sets out the companies' contribution to the Group's net profit (in NIS millions):

	Quarter Ended 31 March		
	2006	2005	% change
The Israel Corporation Ltd.	<b>26</b>	90	(71.1)
Migdal Insurance and Financial Holdings Ltd.	<b>23</b>	34	(32.4)
Africa Israel Investments Ltd.	<b>19</b>	15	26.7
Af-Sar Ltd.	<b>11</b>	1	-
Keshet Broadcasting Ltd.	-	-	-
Others	<b>(1)</b>	1	-
	<b>78</b>	141	(44.7)

#### Holdings in Non-banking Holding Corporations (Conglomerates)

The Bank's holdings in corporations are subject to restrictions determined in the Banking (Licensing) Law, 1981 (the "Banking Law"). The Banking Law determines, *inter alia*, in Section 24A to the Law that a banking corporation is entitled to hold means of control in only one conglomerate (a "Non-Banking Holding Corporation") - a corporation whose capital exceeds some NIS 1,767 million and operates in more than three branches of the economy). In the past, the Bank had holdings in two

corporations defined as conglomerates - The Israel Corporation Ltd. and Africa Israel Investments Ltd. See below with regard to Migdal Insurance and Financial Holdings Ltd.

### **Migdal Insurance and Financial Holdings Ltd. ("Migdal Holdings")**

According to the notification to the Bank at the end of June 2005 by Migdal Holdings, and the examination conducted by the Bank pursuant thereto (based on data and information provided by the Migdal Group), the Bank notified the Bank of Israel during July 2005 that pursuant to the Bank of Israel's interpretation of Section 24A of the Banking Law (an interpretation with which the Bank disagrees), as of the end of March 2005, Migdal Holdings (the company in which the Bank has holdings), operates in more than three branches of the economy and as such is also defined as a "Non-banking Holding Corporation" ("conglomerate"). Therefore, the Bank requested a reasonable transition period for complying with the requirements of the Banking Law in this regard. The Bank further requested the Bank of Israel's assistance in amending the legislation approved following the Bachar Committee's recommendations so that the recommendations regarding the banks' holdings in insurance companies would also apply to the Bank's holdings in Migdal Holdings, and that the Bank would be able to continue to hold part of its holdings in Migdal Holdings.

Following the enactment of the legislation with regard to the reform of the capital market (see Note 8 to the Financial Statements) and without prejudice to the above, and in addition thereto, the Bank was required to sell part of its holdings in Migdal Holdings so that it would no longer hold more than 10% of any type of means of control in Migdal Holdings. The Bank has carried out the sale as detailed below.

### **Sale of Two Non-Banking Holding Corporations**

The Bank of Israel has advised the Bank that it is required to sell its holdings in two conglomerates (Africa Israel and/or Migdal Holdings and/or The Israel Corporation) as soon as possible and no later than 30 September 2006. Should one of the two corporations being sold be Migdal Holdings, the Bank would be entitled to sell its holdings in Migdal Holdings in stages by 31 March 2008 as follows: by 31 March 2007 the holdings of the Bank in Migdal Holdings would not exceed 10%, and by 31 March 2008, the Bank would be required to sell the balance of its holdings in Migdal Holdings (if until such time the Banking Law is not amended so that insurance companies are explicitly excepted from the provisions of Section 24 of the Banking Law).

On 18 January 2006 the Bank notified the Bank of Israel of its intention to sell its holdings in Africa Israel and in Migdal Holdings.

On 1 February 2006, the Board of Directors approved entering into a transaction for the sale of the Bank's entire holdings in Africa Israel to Mr. Lev Leviev (the controlling shareholder of Africa Israel) or a company controlled by him, at a price of NIS 150 per share, reflecting a company value of NIS 7,075 million. On 13 February 2006 an agreement was signed for the sale. The transaction was completed on 27 March 2006. The total consideration to the Bank for the transaction was some NIS 1,131 million. The net profit from the transaction is some NIS 476 million.

On 5 March 2006 an agreement was signed between the Bank and Leumi Real Holdings Ltd., a wholly owned subsidiary of the Bank ("Leumi Holdings") and Participatie Maatschappij Graafschap Holland N.V. (the "Purchaser"), a wholly owned subsidiary of Assicurazioni Generali S.p.A., for the sale of shares in Migdal Holdings constituting 10% of the issued and fully paid share capital of the company owned by the Bank and Leumi Holdings for a total consideration of some US\$ 142 million.

After receipt of the approval of the Supervisor of Insurance, the transaction was completed on 15 March 2006. The net profit from the transaction is some NIS 235 million.

Following the completion of the transaction, 9.98% of the issued and fully paid share capital of Migdal Holdings remains in the hands of the Bank.

## Af-Sar Ltd.

An option agreement was signed between the Bank and Africa Israel Investments Ltd. on 31 August 2003, pursuant to which the Bank was granted a put option to sell all of its shares in Af-Sar Ltd. (20% of the shares of Af-Sar Ltd.) to Africa Israel at any time up to 8 March 2006.

On 8 March 2008 the Bank notified Africa Israel Properties Ltd. of the exercise of the put option under the option agreement. The transaction was completed on 9 April 2006 for a consideration of NIS 51.4 million. The net profit from the transaction is some NIS 2 million.

## Activities in Products

**A. Capital market operations** - these operations include the activities of the mutual funds, provident funds, supplementary training funds and portfolio management. In addition, these activities include the activities of Leumi & Co. Investment House Ltd., which specializes in the provision of investment banking services, business and financial services, capital raising, underwriting, organizing public and private issues, economic advice and valuations and of Psagot Ofek Investment House Ltd. which engages in portfolio management and brokerage activities.

A principal part of the capital market activities are in the stage of being sold by the Bank in consequence of the reform in the capital market, in a number of transactions that are anticipated to be concluded during 2006. The majority of the assets managed by the said subsidiaries are not consolidated in the Group's Financial Statements.

The following table sets out details of the activities in the capital market as presented in the various operational segments:

	House-holds	Private banking	Small businesses	Commercial banking	Corporate banking	Real Estate	Other	Total
<b>For the three months ending on 31 March 2006</b>								
In NIS millions								
Net interest income	1	-	-	-	-	-	6	7
Operating and other income	165	29	11	25	8	1	74	313
Total income	166	29	11	25	8	1	80	320
Operating and other expenses	97	16	7	8	4	-	73	205
Operating profit before taxes	69	13	4	17	4	1	7	115
Net profit (loss)	41	8	2	10	2	1	(1)	63
<b>For the three months ending on 31 March 2005</b>								
In NIS millions								
Net interest income	-	-	1	-	-	-	6	7
Operating and other income	145	27	11	22	9	1	87	302
Total income	145	27	12	22	9	1	93	309
Operating and other expenses	97	15	6	9	3	-	63	193
Operating profit before taxes	48	12	6	13	6	1	30	116
Net profit	27	7	3	7	3	1	21	69

Net profit from the capital market operations amounted to some NIS 63 million in the first quarter of 2006, compared with NIS 69 million in the corresponding period in 2005, a decline of 8.7%.

## B. Credit Cards - Leumi Card

This activity mainly includes the issue of credit cards to private customers and providing acquiring services for businesses.

The principal credit card activities are carried out by the subsidiary, Leumi Card, which engages in the issue of credit cards, the provision of acquiring services and the development of payment solutions.

Leumi Card ended the first quarter of the year with a net profit of NIS 17.4 million, compared with NIS 12.2 million in the corresponding period in 2005, an increase of 42.6%.

In the first quarter of 2006, the volume of activity of Leumi Card credit card holders rose by 12.9% compared with the activity in the corresponding period of 2005, higher than the overall growth of the whole credit card market, which, according to publications of the Central Bureau of Statistics, stood at 10.8%; the number of active cards in the first quarter of 2006 grew by some 13.5%, compared with the corresponding period in 2005. In addition, an increase of 9.2% was recorded in the number of businesses acquiring through the company compared with the corresponding period in 2005, their number now being 42,000.

In the first quarter of 2006, Leumi Card issued some 700 thousand pre-paid gift-cards, with a pre-paid amount of some NIS 182 million. Leumi Check (a subsidiary of Leumi Card) entered into agreements during the first quarter of 2006 with some 4,000 businesses and carries-out acquiring activities on their behalf.

The following table sets out details of the credit card activities as presented in the various operational segments:

	House-holds	Private banking	Small businesses	Commercial banking	Corporate banking	Total
<b>For the three months ending on 31 March 2006</b>						
In NIS millions						
Net interest income	15	-	4	1	2	22
Operating and other income	127	-	13	4	5	149
Total income	142	-	17	5	7	171
Provisions for doubtful debts	1	-	-	-	-	1
Operating and other expenses	94	1	12	4	14	125
Operating profit (loss) before taxes	47	(1)	5	1	(7)	45
Net profit (loss)	33	(1)	3	-	(5)	30

	House-holds	Private banking	Small businesses	Commercial banking	Corporate banking	Total
<b>For the three months ending on 31 March 2005</b>						
In NIS millions						
Net interest income	13	-	4	1	1	19
Operating and other income	108	-	12	3	3	126
Total income	121	-	16	4	4	145
Operating and other expenses	78	-	12	5	12	107
Operating profit (loss) before taxes	43	-	4	(1)	(8)	38
Net profit (loss)	26	-	2	-	(6)	22

Net profit from the credit card operations amounted to some NIS 30 million in the first quarter of 2006, compared with NIS 22 million in the corresponding period in 2005, an increase of 36.4%.

## Profit Centers in the Group

The following table sets out details of the contribution of the Group's major profit centers to net operating profit:

	January to March			January to March		
	2006*	2005*	Change	2006**	2005**	Change
	NIS millions		%	NIS millions		%
The Bank	207	237	(12.7)	162	244	(33.6)
Consolidated companies in Israel (1)	33	100	(67.0)	33	100	(67.0)
Overseas consolidated companies (2)	79	52	51.9	124	45	(175.6)
Non-banking companies (1)	81	142	(43.0)	81	142	(43.0)
Net operating profit	400	531	(24.7)	400	531	(24.7)
Overseas' subsidiaries profit, in nominal terms (US\$ millions) (3)	15.7	14.5	7.9	15.7	14.5	7.9

\* Translation adjustments in respect of overseas investments were offset against translation adjustments of the financing sources at the Bank after the effect of taxes.

\*\* According to the financial statements

(1) Leumi & Co.'s non-banking companies were included in the data of the consolidated companies in Israel.

(2) After certain adjustments to Israeli accounting principles.

(3) As reported by the overseas subsidiaries, including overseas branches and minority interests.

### Following are the Main Changes in the Contributions of the Profit Centers (after translation adjustments):

- The decline in net operating profit at the Bank principally derived from an increase in salary expenses as explained above on pages 18-19 and from an increase in the rate of the provision for taxes, that was partially offset by a decrease in the provisions for doubtful debts and an increase in operating and other income.
- The decrease in the net operating profit of consolidated companies in Israel primarily derived from the negative contributions of Leumi Mortgage Bank and Leumi & Co., compared with positive contributions in the corresponding period in 2005.
- The increase in the profit of overseas subsidiaries primarily derived from positive exchange rate differentials in respect of the investment, as compared with negative exchange rate differentials in the corresponding period in 2005.
- The decline in the contribution of companies included on the equity basis principally derived from a decrease in the profits of The Israel Corporation and also from the reduction in the Bank's share in the profits of Migdal Holdings and Africa Israel Investments, due to the change in the provisions for tax in consequence of the sales.

The overseas subsidiaries' profits in nominal terms as published by them (including the Bank's overseas branches and minority interests) totaled some US\$ 16 million, an increase of US\$ 1 million. The contribution of the overseas subsidiaries in shekels, after certain adjustments to Israeli accounting principles, totaled NIS 79 million, compared with NIS 52 million in the corresponding period in 2005. Excluding the effect of the translation adjustment, the profit of the overseas subsidiaries amounted to NIS 124 million, as compared with NIS 45 million in the corresponding period in 2005, an increase of NIS 79 million, mostly arising from positive exchange rate differentials in respect of the overseas investments.

The following table sets out a summary of the above data:

	January to March	
	2006	2005
	NIS millions	
Profits of the subsidiaries in shekels (the Group's share)	50	56
Exchange rate differentials on the investment	74	(11)
Exchange rate differentials on the net cost of sources of finance	(45)	7
Total contribution of the subsidiaries (after setting off net sources of finance)	79	52

## Activities of Major Subsidiaries and Affiliates

### Consolidated Subsidiaries in Israel

The Bank's investments in consolidated subsidiaries in Israel amounted to NIS 4,346 million on 31 March 2006, compared with NIS 4,178 million on 31 December 2005. The contribution to net profit was NIS 33 million in the period January to March 2006, compared with NIS 100.1 million in the corresponding period in 2005, a decrease of 67.1%.

The following table sets out the contribution of the major consolidated companies in Israel to the net profit of the Group:

	Return on Group's Investment		Contribution to Group's Profit (1)		Change
	31 March 2006	31 March 2005	31 March 2006	31 March 2005	
	%		NIS millions		
Leumi Mortgage Bank	-	7.3	(14.1)	29.5	-
Arab Israel Bank	24.8	23.4	18.3	16.6	10.2
Leumi Card	-	-	18.4	11.8	55.9
Leumi & Co. Investment House (2)	-	43.4	(4.1)	13.9	-
Psagot Ofek Investment House	13.8	47.1	3.3	7.8	(57.7)
Leumi Real Holdings	-	27.8	(0.5)	15.1	-
Leumi Leasing and Investments	3.5	1.6	6.1	2.6	134.6
Others	2.7	1.4	5.6	2.8	93.1
<b>Total consolidated subsidiaries in Israel</b>	<b>3.2</b>	<b>10.7</b>	<b>33.0</b>	<b>100.1</b>	<b>(67.1)</b>

(1) The profit (loss) shown is according to the Group's share in the results.

(2) Including the profit and/or loss of the companies included on the equity basis of Leumi & Co.

### Leumi Mortgage Bank Ltd.

Leumi Mortgage Bank's loss for the first quarter of the year amounted to NIS 14 million, compared with a profit of NIS 30 million in the corresponding period in 2005.

The loss derives primarily from the increase of some NIS 64 million in the provision for doubtful debts, as follows: On 1 January 2006 the Bank of Israel published directives that deal with all matters relating to the manner of calculation of the provision for doubtful debts regarding housing credit. The directives determined, *inter alia*, that a bank that had elected to calculate the provisions in respect of loans in accordance with the depth of arrears method, even if it was not required to do so under the directives, is not entitled to reduce the provisions by means of a decision to make specific provisions. In addition, clarifications were given as to the manner of calculation of the depth of arrears, directives as to the manner of calculation of the provision in respect of

arrangements and the re-organization of loans, and also the manner of calculation of the provision in respect of loans in which the principal is repaid in one payment. Further, the directives relate to the clearance of a debt in arrears after the balance sheet date, and do not allow the reduction of the provision even if cash is received in respect of the arrears after the balance sheet date, including cash in respect of the sale of an apartment before the balance sheet date.

The Supervisor's directives determine further that a bank is entitled to change the accounting policy regarding the making of provisions and to implement specific provisions for loans for which it provided in accordance with the depth of arrears, despite the fact that according to the directives of the Bank of Israel it is not obligatory to calculate the specific provision in respect thereof in accordance with the depth of arrears method and this is in respect of the borrowers who are not problematic at the time of the change in policy (that is, there are no arrears in respect of any of their loans).

Leumi Mortgage Bank is considering changing its accounting policy in accordance with the said directives.

The effect of the directives, which apply from the first quarter of 2006, on the provision for doubtful debts, is a one-time addition in the amount of NIS 63.7 million, in respect of amounts that had accumulated up to 31 December 2005, and which are detailed below:

	NIS millions
Assets the realization of which is expected in the near future	24.6
Assets realized and the proceeds from which have been received after the balance sheet date	10.6
Clearing of loans in arrears after the balance sheet date	6.7
Expected receipts in respect of insurance cover	11.1
Prohibition on rounding down of months in arrears	10.7
<b>Total</b>	<b>63.7</b>

As from 1 January 2006, Leumi Mortgage Bank has been acting in accordance with the new directives of the Bank of Israel.

### **Overseas Consolidated Subsidiaries**

The Bank's investments in overseas consolidated subsidiaries amounted to NIS 4,407 million on 31 March 2006, compared with NIS 4,220 million on 31 December 2005.

The contribution of the overseas consolidated subsidiaries to the net profit of the Group as reported in shekels, in the period January to March 2006, after offsetting translation adjustments, amounted to a profit of NIS 79.3 million, compared with a profit of NIS 52.4 million in the corresponding period in 2005.

The following table sets out the contribution of the major overseas consolidated companies to the net profit of the Group:

	Return on Group's Investment		Contribution to Group's Profit <sup>(*)</sup>		
	<b>31 March</b>	31 March	<b>31 March</b>	31 March	Change
	<b>2006</b>	2005	<b>2006</b>	2005	
	%		NIS millions	%	
Leumi USA (BLC)	<b>7.7</b>	8.1	<b>43.9</b>	42.9	2.3
Leumi UK	<b>14.7</b>	5.8	<b>32.2</b>	12.9	149.6
Leumi Switzerland	-	-	<b>(7.0)</b>	(6.7)	(4.5)
Leumi Luxembourg	<b>17.6</b>	2.3	<b>4.5</b>	0.6	650.0
Leumi Re	<b>18.7</b>	16.1	<b>4.3</b>	1.9	126.3
Others	<b>3.6</b>	2.2	<b>1.4</b>	0.8	75.0
<b>Total foreign consolidated subsidiaries</b>	<b>7.6</b>	5.3	<b>79.3</b>	52.4	51.3

(\*) Translation adjustments in respect of the overseas investments were offset against translation adjustments in respect of the Bank's financing sources after the effect of taxes in the amount of NIS 44 million (NIS (8) million in 2005). The sums offset were:

Leumi USA - NIS 18 million in 2006, compared with NIS 15 million in 2005;  
Leumi UK - NIS 13 million in 2006, compared with NIS (6) million in 2005;  
Leumi Switzerland - NIS 9 million in 2006, compared with NIS (15) million in 2005.

The increase in the contribution to profit derived mainly from the effect of the depreciation of the exchange rate of the shekel against all currencies. The effect of the exchange rate differentials was to increase pre-tax profit by NIS 74 million in the period January to March 2006, compared with a reduction of pre-tax profit by NIS 11 million in the corresponding period in 2005. Net financing expenses that were incurred by the Bank and offset part of these exchange rate differences totaled some NIS 45 million in the period January to March 2006, compared with income of NIS 8 million in the corresponding period in 2005.

The following table sets out details of the net profit of the overseas subsidiaries as reported by them:

	<b>31 March</b>	31 March	Change
	<b>2006</b>	2005	
	millions		%
Leumi USA (BLC) (US\$)	<b>6.4</b>	7.3	(12.6)
Leumi (UK) (£)	<b>3.0</b>	2.1	39.7
Leumi Switzerland (CHF)	<b>2.5</b>	1.1	134.3
Leumi Luxembourg (euro)	<b>0.5</b>	0.3	46.3
Leumi Re (US\$)	<b>0.8</b>	0.4	100.0

The nominal profit of the overseas consolidated subsidiaries as reported by them in the period January to March 2006 totaled US\$ 15.1 million, compared with US\$ 13.2 million in the corresponding period in 2005, an increase of 13.9%.

#### **Bank Leumi USA and the Bank's agency in New York**

As the result of examinations conducted by the supervisory authorities in the USA, Bank Leumi USA and the Bank's agency in New York have agreed to take certain steps, primarily to improve and strengthen the controls and procedures for the prevention of money laundering.

Regarding legal claims and other matters that are connected to consolidated companies, see Notes 3, 5 and 6 to the Financial Statements.

## Capital Market and Financial Services Activities of the Bank and the Group

The activities of the Group include a variety of capital market services for all customer sectors, including institutional entities, businesses and households, amongst them counselling on securities and financial assets, the provision of securities brokerage services to customers, the provision of securities custodian services, management and underwriting of securities issues, activities in the fields of options, futures contracts and structured products, services for portfolio managers who manage their customers' portfolios at the Bank, the provision of services connected with the lending and borrowing of securities and more.

The Group also provides varied financial services through subsidiaries that specialize in additional fields, such as credit card issuance and operation and trust services.

In the first quarter of 2006, subsidiary companies of the Bank engaged in additional activities: management of provident funds, supplementary training funds and mutual funds and the management of discretionary securities portfolios. The major part of these activities was sold by the Bank, as the result of the reform of the capital market, in a number of transactions that are expected to be completed in the course of 2006. Most of the assets managed by these subsidiary companies are not consolidated in the Financial Statements of the Group.

The following table sets out details of income from management fees from mutual funds and provident funds, including supplementary training funds (in NIS millions):

	First Quarter		Year
	2006	2005	2005
Mutual funds	118	95	427
Provident funds	54	51	201
Supp. training funds	7	7	32
<b>Total</b>	<b>179</b>	<b>153</b>	<b>660</b>

Following the reform, the Group's activities in the capital market will focus mainly on the provision of investment counselling, the field of pension counselling when the Bank receives a license to engage in this activity, the provision of various services in connection with customers' activities in securities and the provision of operating services to entities operating in the capital market.

Also, the Bank is expected to begin to act as a chief market-maker in Israeli government debentures, having been appointed by the Ministry of Finance to be one of the chief market-makers, when market-making trade commences. In April 2006, the Bank was also appointed as a market maker for futures contracts on Shahar government debentures, which have begun to be traded on the Tel Aviv Stock Exchange.

For further details in respect of the effect of the reform of the capital market and the sale of the holdings in mutual funds and provident funds, see Note 8 to the Financial Statements.

## **Mutual Funds**

The value of the assets of the mutual funds managed by the Group in Israel on 31 March 2006 was NIS 33.8 billion, similar to the value of the assets at the end of 2005. The value of the assets of the mutual funds managed by the Group at the end of March 2006 constituted 27.01% of all mutual funds in the sector.

In connection with the notice from the Tel Aviv District of the State Attorney's Office that was received by the Bank and by subsidiary companies, and similar notices that were received by a number of employees of the Bank and of the subsidiary companies, in the matter of alleged offences pursuant to Section 82 of the Joint Investment Trust Law, see below on page 57.

In connection with the legislation regarding the reform of the capital market, see Note 8 to the Financial Statements.

The Group operates two mutual fund management companies in Israel:

**Leumi-Pia** - on 31 March 2006 Leumi-Pia managed 51 mutual funds with assets totaling some NIS 14.1 billion, compared with NIS 15.1 billion at the end of 2005. Its share of total assets of the mutual funds sector at the end of March 2006 was 11.3%.

Following the reform of the capital market, the Bank decided on 15 September 2005 to sell its holdings in Leumi-Pia, at a price of NIS 535 million, to Harel Insurance Investments Ltd. The sale is subject to the signing of an agreement by the parties and the receipt of regulatory approvals.

**Psagot** - on 31 March 2006 Psagot managed 58 mutual funds with assets totaling some NIS 19.7 billion, compared with NIS 18.7 billion at the end of 2005. Its share of total assets of the sector at the end of March 2006 was 15.71%.

The Bank decided on 28 November 2005 to enter into an agreement, together with Psagot Ofek Investment House Ltd. and its subsidiaries, including Psagot Managers of Mutual Funds – Leumi Ltd. (the "Psagot Ofek Group"), in a transaction for the sale of goodwill, activities, assets and liabilities relating to all the assets of Psagot Ofek, with York Capital Management ("York"), on behalf of entities managed by it, at a price of NIS 1,350 million. In addition, the Bank received an option to purchase from York half the means of control in the company that will manage the portfolio management activities. The completion of the transaction is subject to the receipt of regulatory approvals and other conditions precedent.

## **Provident Funds**

The provident funds managed by the Leumi Group include provident funds for the self-employed, provident funds for salaried employees, central funds for severance pay and a fund for the payment of sick pay.

The value of the assets of the provident funds managed by the Leumi Group on 31 March 2006 was some NIS 35.9 billion, compared with some NIS 36.0 billion at the end of 2005.

The Group, through Leumi Gemel Ltd, provides operating and other services to corporate and private funds. The total value of the assets of these funds amounted to NIS 3.4 billion as at 31 March 2006, compared with NIS 2.6 billion at the end of 2005.

In the period from January to March 2006 the real yields of the provident funds were positive. The Otzma provident fund, the largest of the funds managed by the Bank, achieved a positive real net yield of 1.5%.

Following the legislation on the reform of the capital market, the Bank decided on 26 November 2005 to enter into agreements together with Leumi Gemel Ltd. for the sale of the goodwill, activities, assets and liabilities relating to the provident funds managed by Leumi Gemel Ltd.

A group of five provident funds, the largest of which are the Otzma, Taoz and Rimon provident funds and the management system of these provident funds, was sold to Harel Insurance Investments Ltd., at a price of NIS 675 million. The other provident funds, the largest of which are Sion, the Central Severance Pay Fund, Tzur and Sagi, were sold to Solomon Provident Funds Ltd., a company controlled by A. Solomon Investments Ltd., at a price of NIS 473 million. The Leumi Group will continue to provide operating services in relation to the provident funds that were sold, subject to the signing of operating agreements. The transactions are subject to the receipt of regulatory approvals.

### **Employees' Supplementary Training Funds**

**Kahal Employees Supplementary Training Fund Ltd. ("Kahal")** (which is under the joint management of the Bank and Israel Discount Bank Ltd.) – the value of the assets managed by Kahal and Kahal Paths Supplementary Training Fund (managed by Kahal Management of Study Funds (1996) Ltd., a joint subsidiary of the Bank and Israel Discount Bank Ltd. ("Kahal Management") reached some NIS 10.5 billion on 31 March 2006, compared with some NIS 10.6 billion as at the end of 2005.

The real net yield of Kahal in the period January to March 2006, was positive on all of the paths.

Following the reform of the capital market, on 26 May 2006, an agreement was signed between the Bank, Israel Discount Bank Ltd., Kahal and Kahal Management, and between Migdal Capital Markets (1965) Ltd. on behalf of a company under its control and Migdal Insurance and Financial Holdings Ltd. on behalf of a company under its control (the "Purchaser"), for the sale of the goodwill, management rights, additional rights and means of control of the banks in Kahal, and for the sale of the goodwill, activities, assets and liabilities relating to the supplementary training funds managed by Kahal Management, for a consideration of NIS 260 million, to be adjusted in accordance with the volume of the supplementary training fund assets being sold as at the date of completion. The Bank's share of the consideration amount is NIS 149.5 million.

It has been agreed that the Bank will enter into an agreement with Kahal and with the Purchaser to provide operating services to the funds sold, and also a distribution agreement, under which the Bank will distribute the funds.

Completion of the transaction is subject to the fulfillment of certain conditions and receipt of regulatory approvals.

### **Non-Banking Activities of Companies Included on the Equity Basis**

Total investments of the Group in companies included on the equity basis amounted to NIS 1,255 million on 31 March 2006, compared with NIS 2,064 million on 31 December 2005.

In the first quarter of 2006 the Bank sold all of its holdings in Africa Israel Investments and also 10.0% of its holdings in Migdal Insurance and Financial Holdings Ltd. As a result, on 31 March 2006 the balance of the holding in Migdal was classified as an investment in securities, in the available for sale portfolio.

In the period January to March 2006, the contribution to net profit amounted to a profit of some NIS 78 million, compared with a profit of some NIS 141 million in the corresponding period in 2005.

Details of the Group's investments in the major companies included on the equity basis follow:

**The Israel Corporation Ltd.**

The Israel Corporation Ltd is a holding company whose principal holdings are in the areas of chemicals (holding 53% of the shares of Israel Chemicals Ltd.), shipping (holding some 97.5% of Zim Integrated Shipping Services Ltd.) and additional interests.

The net profit in the period January to March 2006 totaled some NIS 244 million, compared with a profit of some NIS 479 million in the corresponding period in 2005.

The consolidated assets of the Israel Corporation totaled some NIS 26.3 billion as at 31 March 2006, compared with NIS 25.8 billion at the end of 2005.

Shareholders' equity totaled some NIS 5,492 million as at 31 March 2006, compared with some NIS 5,398 million at the end of 2005.

**Migdal Insurance and Financial Holdings Ltd.**

The Migdal group's net profit for the period January to March 2006 reached NIS 131 million, compared with some NIS 144 million in the corresponding period in 2005. The net return on equity in annual terms reached 23.0%, compared with 22.4% in the corresponding period in 2005.

The profit from life insurance amounted to some NIS 168 million, compared with NIS 160 million in the corresponding period in 2005.

The profit from general insurance amounted to some NIS 30 million, compared with some NIS 52 million in the corresponding period in 2005.

The group has total assets of some NIS 52.4 billion, of which some NIS 43.3 billion are life insurance reserves and some NIS 4.3 billion are general insurance reserves. Shareholders' equity as at 31 March 2006 totaled some NIS 2,467 million, compared with some NIS 2,682 million at the end of 2005.

## **Exposure to Risk and Methods of Risk Management**

### **Market Risk and Liquidity Risk Management**

#### **Market Risk**

Market risk management policy is intended to assist in achieving business goals, while limiting the losses that can stem from exposure to changes in the money and capital markets, interest rates, exchange rates and inflation, while estimating the profit anticipated from risk management.

The policy of Management is to manage the risks arising from market exposure in a controlled manner, within the framework of the limits determined by the Board of Directors, and to determine the level of exposure on an ongoing and updated basis, pursuant to economic forecasts regarding developments in the capital and financial markets, and inflation and expected relative prices in the various segments.

The management of market risks at the Bank also includes most of the subsidiaries in Israel, with the exception of Leumi Mortgage Bank Ltd. ("Leumi Mortgage Bank") and Leumi & Co. Investment House Ltd., which have independent market risk policies and management, due to the dissimilar nature of their activity as compared with the Bank.

In accordance with Proper Banking Management Directive No. 339 of the Supervisor of Banks, the risk management system must "take into account the exposure to risks of the subsidiaries in Israel and overseas, based on available information from these bodies as part of the management information system".

Accordingly, all the subsidiaries have established an independent policy for market risk management and frameworks for market risk exposures in a uniform format as set by the Bank, in addition to their own internal frameworks. These frameworks have been examined by the Bank's Manager of Market Risks and found to be reasonable.

Information regarding the position of the exposures according to the frameworks that have been determined is received from the subsidiaries once a month or upon request, and is taken into account in the overview of the Group's exposures.

#### **Basis Exposure**

The basis exposure risk is defined as the loss that can occur in consequence of changes in the CPI and exchange rates and arises from the difference between the value of the assets and liabilities, including the effect of futures transactions, in each of the linkage sectors: CPI-linked sector, foreign currency and foreign currency-linked shekels sector and the unlinked shekel sector.

Since 2004, with the transition to nominal accounting, the exposed capital has been defined as an unlinked shekel source for the purpose of measuring basis exposure.

The exposed capital includes shareholders' funds and certain reserves, less investments in subsidiaries and affiliates and fixed assets, with the addition of the investments in overseas subsidiaries that are financed from deposits in foreign currency.

The following table sets out the actual exposure at Group level compared with the limits fixed by the Board of Directors. The data is presented in terms of percentage of the exposed capital:

	<b>31 March 2006</b>	31 March 2005	31 December 2005	Maximum Surplus or Deficit
Unlinked	<b>(23.2%)</b>	(30.5%)	(8.2%)	50% -(100%)
CPI-linked	<b>23.2%</b>	30.5%	8.2%	100% -(50%)
Foreign currency	-	-	-	25% -(10%)

During the first three months of 2006, an average of some 12.0% of the exposed capital was routed to the CPI-linked sector and the balance of the exposed capital was routed to the unlinked shekel sector. No significant amount of capital was routed to the foreign currency (and foreign currency-linked) sector.

In the first quarter of 2006, the maximum amount of capital that was invested in the CPI-linked sector was 23.2% in March 2006, and the minimum amount was 7.1% in February 2006.

The Bank complied with all the basis exposure limits during the first three months of 2006.

### Interest Exposure

Interest risk derives from exposure to future changes in interest rates. These changes may potentially cause erosion of the economic capital, shareholders' equity and accounting profit. The exposure to changes in interest arises from the different sensitivity to changes in the interest rates of the assets as compared with the liabilities in each of the sectors.

The following table sets out a summary of the interest exposure (in NIS millions):

	<b>Potential Erosion of Economic Value</b>			<b>Potential Erosion of Annual Profit*</b>		
	<b>31 March 2006</b>	31 March 2005	31 December 2005	<b>31 March 2006</b>	31 March 2005	31 December 2005
Effect of a change of 1% in the yield curve						
Group	<b>653</b>	563	420	<b>156</b>	126	156

\* The maximum erosion in annual profit, on the basis of an examination of the next three years.

The interest exposure limits are to a maximum change in the economic value at the Group level of NIS 1,000 million, and to a change in the annual profit of NIS 500 million.

The Bank complied with all the interest exposure limits during the first three months of 2006.

### Liquidity Risk

Pursuant to Proper Banking Management Directive No. 342 of the Supervisor of Banks regarding liquidity management, Leumi has been implementing an internal model since the beginning of 2005, the purpose of which is to accurately evaluate the liquidity resources at the Bank's disposal and its liquidity requirements, under regular operating conditions and under extreme scenarios.

In accordance with the approved limits, the liquidity ratio must be higher than one and the liquidity gap must be higher than zero, in each of the scenarios (as detailed on pages 163-165 of the Annual Report for 2005) during the planned periods of one day, one week and one month.

The Bank complied with the limits during the first three months of 2006.

## Value at Risk (VAR)

VAR is an estimate of the maximum potential loss arising from the composition of a portfolio (the forecast decrease in fair value of assets less liabilities) over a given time horizon (holding period) and at a given confidence level, due to possible changes in the market values of debentures, foreign currencies, inflation, shares and interest rates in a direction which adversely affects the Bank. The VAR is calculated once a month at the Group level, and more frequently for specific portfolios.

Since 2004, following the transition to nominal reporting, the base currency for calculating market exposure, including for calculating the VAR, is the unlinked shekel.

The VAR calculations, as presented below, and the limits in VAR terms, are based on the parametric approach, with a confidence level of 99%, and a holding period of two weeks.

The following table sets out estimates of VAR amounts:

	<b>31 March 2006</b>	31 March 2005	31 December 2005
	NIS millions		
Total VAR	<b>256</b>	124	148
VAR of MTM re-valued portfolios	<b>51</b>	30	37

The Board of Directors' VAR limits are NIS 500 million at Group level and a limit of NIS 300 million for the VAR of Mark to Market re-valued portfolios.

The Bank complied with the limits during the first quarter of 2006.

For further details regarding management of market risks, see pages 158-168 of the Annual Report for 2005. See pages 168-176 of the Annual Report for 2005 with regard to operating risks, legal risks and credit risks.

## Linkage Status and Liquidity Status

### Linkage Status

In the first quarter of 2006 there was no change in the volume of deposits of the public. However, the increase in the volume of the securities portfolio of the Group's customers continued and amounted to 6.8%.

The balance of credit to the public increased by 0.2%, arising from an increase in unlinked shekel credit, which was partially offset by a decline in foreign currency credit.

The following table sets out the status of assets and liabilities classified according to linkage basis:

	<b>As at 31 March 2006</b>			As at 31 December 2005		
	Unlinked	CPI-linked	Foreign Currency(2)	Unlinked	CPI-linked	Foreign Currency(2)
	NIS millions					
Total assets (1)	<b>91,970</b>	<b>56,332</b>	<b>128,675</b>	95,849	55,234	127,349
Total liabilities (1)	<b>83,687</b>	<b>53,218</b>	<b>128,632</b>	87,460	53,972	127,070
Total exposure in sector	<b>8,283</b>	<b>3,114</b>	<b>43</b>	8,389	1,262	279

(1) including forward transactions and options

(2) including foreign-currency-linked.

## **Funding and Liquidity Status**

### **Liquidity Status**

#### **The System -**

In the first quarter of 2006, the net volume of *Makam* issues by the Bank of Israel increased by NIS 3.2 billion, parallel with a reduction of NIS 1.6 billion in the volume of the monetary tenders for deposits with the Bank of Israel. The average volume of the tenders during the quarter stood at some NIS 3.9 billion, and was NIS 2.0 billion at the end of the quarter.

In parallel, the Bank of Israel recommenced during the quarter the tenders for monetary loans as an additional instrument for managing monetary policy. The average volume of the tenders during the quarter stood at some NIS 2.8 billion.

The balance of the banking system's *Makam* holdings was some NIS 12 billion at the end of March 2006, a decline of some NIS 1.4 billion as compared with December 2005.

From March 2006, the Bank of Israel has increased the volume of the "repo" tender to an amount of NIS 500 million par value, while reducing the holding term to one week and increasing the frequency of holding the tenders from every two weeks to every week.

On 16 August 2005, the Bank of Israel gave notice of changes to the monetary instruments for the operation of the current interest rate policy, the principal changes being:

Commencing 1 September 2005, the Bank of Israel has been providing a "monetary loan window" for the banks, without a ceiling, against the provision of security, at a rate of interest of 1% above the Bank of Israel's interest rate, such being the rate it announces each month.

Along with monetary loans, the Bank of Israel operates a new monetary instrument – the "surplus liquidity deposit window" at the Bank of Israel, without a tender and at an interest rate of 1% below the Bank of Israel's interest rate. At the same time, the payment of interest on liquidity surpluses ceased.

During the first quarter of 2006 the utilization of these tools by the banking system continued to be at a low frequency and in negligible amounts.

During the first quarter of 2006, notwithstanding the increase in the interest rate, the change in the mix of the public's financial assets continued, with a transition from deposits to the capital market. There was a slight nominal decline in the amount of bank credit, primarily as a result of a contraction of the credit in CPI-linked sector. The volume of non-banking credit to the business sector continues to be influenced by the issues of debentures by companies on the capital market.

#### **The Bank -**

At Leumi there was too a decline in the volume of deposits made at the Bank of Israel, in parallel with the utilization of the monetary loan tenders which were operated by the Bank of Israel during the first quarter of 2006.

The structure of the Bank's assets and liabilities continues to indicate a high level of liquidity.

The Bank has a liquid and high-quality securities portfolio (in shekels and foreign currency) of some NIS 31.2 billion, which is mainly invested in Israeli government debentures or in foreign securities with an average rating of A+.

The ratio of the Bank's liquid assets – cash, bank deposits and securities (excluding shares) was 36.6% of the Bank's total assets as at 31 March 2006, as compared with some 36.2% as at 31 December 2005. The ratio of such liquid assets in relation to total liabilities stood at 39.7% (31 December 2005 – 39.0%).

Leumi monitors its liquidity status and indices that are intended to warn of changes in the liquidity position, *inter alia*, using a model that was developed in 2004, pursuant to a Directive of the Bank of Israel. The various assumptions forming the basis of the model are examined and updated according to developments in the major relevant parameters.

### **Funding (in the Bank) -**

Against the background of the continued positive trend in the capital market, the transition of monies from shekel deposits to the capital market continued.

The volume of the securities portfolio of the Bank's customers increased by NIS 13.1 billion during the period under review, in consequence of a flow of new monies and an increase in market values.

The negative accrual volume in provident funds and supplementary training funds totaled some NIS 0.3 billion.

The volume of credit to the public declined during the first quarter by NIS 0.5 billion. There was an increase in unlinked shekel credit totaling some NIS 0.6 billion, 1.0%, and there was a decline in foreign currency credit of some NIS 1.2 billion, at a rate of 3.0%.

In the first quarter of 2006, the balance of deposits of the public at the Bank remained without substantial change, even though the deposit mix changed - there was an increase in the balance of foreign currency deposits parallel with a decline in shekel deposits.

Total deposits of the public in the **unlinked shekel sector at the Bank** declined by NIS 2.7 billion, a rate of 3.3%, and at the end of March 2006 reached NIS 78.6 billion. The major part of the decrease was in the deposits, exceeding NIS 100 million.

**The balance of deposits of the public in foreign currency and linked to foreign currency** increased by some NIS 2.7 billion, an increase of 3.5%, that partially derived from the depreciation in the shekel rate of exchange and the trend of increases in overseas interest rates. Less the effect of the inter-currency exchange rates, the balance increased by some US\$ 0.3 billion. In consequence of the decline in foreign currency credit and the increase in foreign currency deposits of the public, the deposits with overseas banks increased by a volume of NIS 2.2 billion.

The balance of the deposits of the public **in the CPI-linked sector** declined by some NIS 0.5 billion, a decrease of some 1.7%.

### **Legal Proceedings**

A. In the Annual Report for 2005 details were given in the Directors' Report of legal proceedings, civil and other, to which the Bank and consolidated subsidiaries are a party.

At the date of the publication of this Report, no material changes had occurred in the said proceedings, except as set forth below.

None of the proceedings pending against the Bank involves a sum exceeding 1% of the Bank's shareholders' equity as of 31 March 2006, some NIS 173 million, except the proceedings detailed in Notes 3 to 6 to the Financial Statements.

For details regarding an application for the approval of a class action filed in April 2006, see Note 4.C to the Financial Statements.

In the opinion of the Management of the Bank, based on legal opinions, appropriate provisions were recorded in the Financial Statements to cover possible damages in respect of all of the claims.

See Note 3 to the Financial Statements for further details.

B. Further to the report in paragraphs 2.1 and 2.2 on page 185 of the Annual Report for 2005, set forth below are further details:

1. The disciplinary tribunal established under the Regulation of Investment Advice and Investment Portfolio Management Law, 1995 (the "Advice Law") decided to adopt the arrangement reached between the State Attorney on the one side and the investment counsellors' representatives on the other side, and decided to impose disciplinary sanctions by way of warning and reprimand on a number of investment counsellors at the Bank, such being in respect of breach of the provisions of section 16(a) of the Advice Law.
2. In addition, the Bank and its subsidiary companies, Psagot Ofek Investment House Ltd., Psagot Managers of Mutual Funds-Leumi Ltd. and Leumi-Pia Trust Management Co. Ltd., received notice from the Tel Aviv District of the State Attorney's Office (Taxation and Economics) according to which the Bank and the said subsidiaries have been granted the right to a hearing before the State Attorney in respect of offences attributed to them under the Joint Investment Trust Law (sections 82 and 124(15) (in the form prevailing at the relevant time) and 124(18)).

Similar notice was given to senior employees of the Bank and the said subsidiaries.

## **Description of the Taxation Position**

On 25 July 2005, the Knesset passed the Income Tax (Amendment No. 147 and Temporary Provision) Ordinance, 2005 (the "Amendment"). The Amendment provided for a gradual reduction of the tax rate for companies from 34% in 2005 to 25% in the following manner: for the 2005 tax year the tax rate was 34%, for 2006 it will be 31%, for 2007 it will be 29%, for 2008 it will be 27%, for 2009 it will be 26%, and from 2010 and thereafter the tax rate will be 25%.

The Bank, by virtue of its being a "financial institution" for the purposes of the Value Added Tax Law, the reduction of company tax will result in a reduction of the overall tax rate that will apply to the Bank to a lower rate, so that for 2005 the overall tax rate that applied to a "financial institution" was 43.59%, the tax rate for 2006 is 41.03%, for 2007 - 39.32%, for 2008 - 37.61%, for 2009 - 36.75% and from 2010 and thereafter the tax rate will be 35.90%.

## **D. Additional Matters**

### **Leumi for the Community**

#### **Leumi for the Community - Donations and Sponsorships**

Leumi, which was founded as part of the Zionist vision, has since its establishment acted to develop the economy, the society and the communities in which it operates.

Leumi continues and deepens its involvement in the community and society and supports the achievement of important objectives in various social spheres, primarily education, and also culture, health, welfare, the community and more.

The Group's contribution to the community is made in a number of ways:

- donations through organizations (institutions and non-profit societies) that operate to promote social projects that concentrate on the education and welfare of children and young people;
- involvement by means of providing sponsorships for educational and cultural activities which benefit the Bank's customers and cultural institutions in Israel and abroad;
- individual care for sections of the population suffering serious hardship;
- the involvement of employees and managers of the Bank in social projects by investing time and other resources for the advancement of social objects.

#### **“Leumi Tomorrow - The Centennial Fund for Endowing Israel's Future Generation”**

##### **The 2005-2006 Year of Activity**

The fifth year of activity of “Leumi Tomorrow - The Centennial Fund for Endowing Israel's Future Generation” is at its peak. Of the 51 army preparation groups of "Youth Leading Change", 13 were directly funded by "Leumi Tomorrow" – in Dimona, Beer Sheva, Katamon - Jerusalem, Kiryat Menachem - Jerusalem, Ofakim, Pnimitiyat Amit Petach Tikvah, Pnimitiyat Hakfar Hararok, Krayot, Holon, Tiberias, Daliat El Carmel, Afula and Jaffa. The number of participants is on average 25 per group.

Nine learning centers for matriculation in mathematics were opened, eight of which are funded by "Leumi Tomorrow" – in Acre, Haifa, Netanya, Jaffa, Tiberias, Hadera, Jerusalem, Beer Sheva and Kiryat Gat. 100 students commenced their studies in the centers' winter semester.

Within the context of the decision of Leumi's Management to increase community involvement, joint projects were launched with representatives of the "Shevach" School – a learning center for business studies, and an information security course. Leumi granted 10 scholarships to high school pupils who are simultaneously taking academic studies with the object of assisting them in concentrating on their studies.

In the Galilee panhandle a new initiative was inaugurated together with the Tel Hai College. As part of the “Striving for the Excellence as Far North as Possible” program, 30 students of the Tel-Hai College will tutor some 100 high school pupils from the Galilee panhandle settlements. Students participating in the activity will be supported through grants.

During the Purim festival, thousands of “Tomorrow” youth visited IDF bases throughout the country and distributed candies to the soldiers on the bases.

## **"Atidim" - Futures**

The "Atidim" program is a wide-reaching national program which began in 1999 and is intended to assist with the realisation of the untapped potential of gifted youth throughout the country. The program aspires to develop excellence, strengthen educational infrastructure and reinforce human capital in outlying areas.

The program accompanies youth from middle school, through the army and university and up to their integration into the workplace. Emphasis is placed throughout on strengthening the connection between the participants and their places of residence and the importance of the advancement of their communities.

Leumi is accompanying and supporting the project in an amount of NIS 20 million over five years.

## **“Young Israel Entrepreneurs - Established by Leumi”**

Leumi is one of the partners of the project and has supported it for more than 15 years since its establishment. Each year more than 3,000 young people from all around the country participate in an educational and challenging program, during the course of which they gain experience in establishing and managing businesses while learning the essential aspects of business promotion and practice. The participants in the program come from all the sectors of Israeli society - veterans, new immigrants and young people from the Arab sector.

A product exhibition was held in Haifa in March 2006, at which some of the groups presented their achievements, in anticipation of the regional competition.

## **Increased Involvement of Employees and Managers**

Leumi's Management views the participation of its employees and managers in the community as a central goal in the field of community involvement. Leumi is proud of its employees' involvement in the community, and the increasing number of the Bank's employees who are involved in volunteer activity.

Hundreds of Leumi's employees and managers are involved in volunteer activity in different frameworks: instructing groups of "Young Entrepreneurs", assisting IDF preparation groups of the "Youth Leading Change" Non-Profit Society, assisting at matriculation study centers and assisting families through "Equal Opportunities".

## **The Internal Auditor**

Details regarding the Internal Audit Division of the Group, including the professional standards according to which the Internal Audit Division operates, the annual and multi-year work plan and the considerations for determining it, were included in the 2005 Annual Report.

There were no material changes in these details during the reporting period.

The Chief Auditor's report for the second half of 2005 was submitted on 12 March 2006 and discussed by the Audit Committee on 19 March 2006.

A summarizing report for 2005 was submitted on 20 March 2006 and discussed by the Audit Committee on 4 April 2006.

## **Evaluation of Disclosure Controls and Procedures for the Financial Statements**

On 15 November 2004, the Supervisor of Banks published a Directive regarding the certification to be attached to the quarterly and annual statements of banking corporations, to be signed by the chief executive officer and chief accountant/treasurer of the bank or the person actually carrying out this task (in Leumi, the Head of the Finance and Accounting Division) as from the financial statements for the period ending 30 June 2005. On 18 July 2005, the Supervisor of Banks published an amended text of the certification. The text of the certification in the Directive is based on the directives of the SEC and relates to the requirements of section 302 of the Sarbanes-Oxley Act (SOX). According to the Supervisor's Directive, the certification is not brought into effect under the extensive requirements of section 404 of the SOX Act which requires the existence of a system of internal controls according to a defined and accepted framework which is far wider in extent than the disclosure controls required to be operated in relation to the Financial Statements to 30 June 2005 and thereafter.

With the assistance of external consultants, the Bank has determined procedures and set up a disclosure committee, headed by the President and Chief Executive Officer of the Bank, and including members of Management and other senior officers in the manner required to fulfill the requirements of the Directive.

The Management of the Bank, together with the President and Chief Executive Officer and the Head of the Finance and Accounting Division, have evaluated as at the end of the period covered by this Report, the effectiveness of the disclosure controls and procedures of the Bank. On the basis of this evaluation, the President and Chief Executive Officer of the Bank and the Head of the Finance and Accounting Division have concluded that, as at the end of the said period, the disclosure controls and procedures of the Bank are effective for the recording, processing, summarizing and reporting of the information that the Bank is required to disclose in its quarterly financial statements, in accordance with the Directives on reporting to the public of the Supervisor of Banks and at the time required in these Directives.

In the first quarter of 2006, no material change to the internal controls on financial reporting of the Bank occurred, except for the additional procedures that were adopted following the above Directive of the Supervisor of Banks.

### **Management's Responsibility for the Internal Control of Financial Reporting (SOX Act 404)**

On 5 December 2005 the Supervisor of Banks published a circular detailing provisions for the application of the requirements of section 404 of the SOX Act. In section 404, the SEC and the Public Company Accounting Oversight Board determined provisions as to management's responsibility for the internal control over financial reporting and as to the external auditors' opinion with regard to the audit of the internal control over financial reporting.

The Supervisor's directives in the said circular prescribe that:

- banking corporations shall apply the requirements of section 404 and also the SEC's directives that were published thereunder.
- proper internal control requires the existence of a control system in accordance with a defined and recognized framework, and the COSO model meets with the requirements and can be used in order to assess the internal control.
- application of the directive's requirements requires the upgrading and/or establishment of an infrastructure system of internal controls at the bank and the process of developing such systems obliges the bank to deploy and to determine interim stages and targets until the full application thereof.

- the preliminary preparations to carry out the project at the Bank and the subsidiaries must be completed by the date of publication of the report for the first quarter of 2006.
- the project must be completed by the end of the first half of 2008, so that the external auditors' audit will commence in June 2008 and will be completed by the date of the December 2008 Report.

The Management of the Bank has commenced preparations for the implementation of the directive, and the preliminary deployment to carry out the project at the Bank and the subsidiaries was completed by the date of publication of the report for the first quarter of 2006, with the cooperation of external consultants.

At the meeting of the Board of Directors held on 31 May 2006, it was decided to approve and publish the Group's condensed unaudited consolidated Financial Statements as at 31 March 2006 and for the period ending on that date.

During the period January - March 2006 the Board of Directors held 11 plenary meetings and 27 committee meetings.

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Eitan Raff  
Chairman of the Board of Directors

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Galia Maor  
President and Chief Executive Officer

**31 May 2006**

## **Certification**

I, Galia Maor, certify that:

1. I have reviewed the Quarterly Report of Bank Leumi le-Israel B.M. (the "Bank") for the quarter ended 31 March 2006 (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 prevent the statements included therein from being, in light of the circumstances under which such statements were made, misleading with respect to the period covered by the Report.
3. Based on my knowledge, the Quarterly 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 the Report.
4. I and the Bank's other certifying officers are responsible for establishing and maintaining the disclosure controls and procedures required for the Bank's Report and have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Bank, including its consolidated corporations, is made known to us by others within the Bank and those corporations, particularly during the period in which the Report is being prepared;
  - (b) evaluated the effectiveness of the Bank's disclosure controls and procedures and presented our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the Report, based on our 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. I and the Bank's other certifying officers have disclosed to the Joint External Auditors, the Board of Directors and the Audit Committee of the Board of Directors, based on our most recent evaluation of internal control over financial reporting:
  - (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.

The above does not prejudice my responsibility or the responsibility of any other person, pursuant to any law.

**31 May 2006**

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**Galia Maor**  
**President and Chief Executive Officer**

## **Certification**

I, Zeev Nahari, certify that:

1. I have reviewed the Quarterly Report of Bank Leumi le-Israel B.M. (the "Bank") for the quarter ended 31 March 2006 (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 prevent the statements included therein from being, in light of the circumstances under which such statements were made, misleading with respect to the period covered by the Report.
3. Based on my knowledge, the Quarterly 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 the Report.
4. I and the Bank's other certifying officers are responsible for establishing and maintaining the disclosure controls and procedures required for the Bank's Report and have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Bank, including its consolidated corporations, is made known to us by others within the Bank and those corporations, particularly during the period in which the Report is being prepared;
  - (b) evaluated the effectiveness of the Bank's disclosure controls and procedures and presented our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by the Report, based on our 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. I and the Bank's other certifying officers have disclosed to the Joint External Auditors, the Board of Directors and the Audit Committee of the Board of Directors, based on our most recent evaluation of internal control over financial reporting:
  - (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.

The above does not prejudice my responsibility or the responsibility of any other person, pursuant to any law.

**31 May 2006**

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**Zeev Nahari**  
**Deputy Chief Executive Officer**  
**Head of Finance and Accounting Division**

**Rates of Financing Income and Expenses (on a Consolidated Basis) (a)**  
**Reported Amounts**

	For the three months ended 31 March						
	2006			2005			
	Average balance (b)	Rate of income (expenses)			Average balance (b)	Rate of income (expenses)	
		Financing income (expenses)	Excluding the effect of derivatives	Including the effect of derivatives		Financing income (expenses)	Excluding the effect of derivatives
(NIS millions)		%	%	(NIS millions)	%	%	
<b>Israeli currency - unlinked</b>							
Assets (c) (d)	82,308	1,398	6.97	76,747	1,177	6.28	
Effect of embedded and ALM derivatives (e)	16,479	112		16,684	108		
<b>Total assets</b>	<b>98,787</b>	<b>1,510</b>		<b>93,431</b>	<b>1,285</b>		<b>5.62</b>
Liabilities (d)	81,024	(717)	(3.59)	78,253	(593)	(3.06)	
Effect of embedded and ALM derivatives (e)	7,327	(13)		5,730	(3)		
<b>Total liabilities</b>	<b>88,351</b>	<b>(730)</b>		<b>83,983</b>	<b>(596)</b>		<b>(2.86)</b>
<b>Interest margin</b>			<b>3.38</b>			<b>3.22</b>	<b>2.76</b>
<b>Israeli currency – linked to the CPI</b>							
Assets (c) (d)	54,867	770	5.73	53,723	636	4.82	
Effect of embedded and ALM derivatives (e)	226	3		153	2		
<b>Total assets</b>	<b>55,093</b>	<b>773</b>		<b>53,876</b>	<b>638</b>		<b>4.82</b>
Liabilities (d)	47,393	(558)	(4.79)	47,549	(432)	(3.68)	
Effect of embedded and ALM derivatives (e)	3,794	(56)		2,308	(24)		
<b>Total liabilities</b>	<b>51,187</b>	<b>(614)</b>		<b>49,857</b>	<b>(456)</b>		<b>(3.71)</b>
<b>Interest margin</b>			<b>0.94</b>			<b>1.14</b>	<b>1.11</b>
<b>Foreign currency – (including Israeli currency linked to foreign currency)</b>							
Assets (c) (d)	120,281	3,461	12.02	109,046	1,307	4.88	
Effect of derivatives: (e)							
Hedging derivatives	4,879	28		4,809	27		
Embedded derivatives and ALM	48,269	907		48,975	(397)		
<b>Total assets</b>	<b>173,429</b>	<b>4,396</b>		<b>162,830</b>	<b>937</b>		<b>2.32</b>
Liabilities (d)	114,845	(2,928)	(10.60)	100,280	(535)	(2.15)	
Effect of derivatives: (e)							
Hedging derivatives	4,789	(46)		4,753	(48)		
Embedded derivatives and ALM	53,660	(897)		57,249	178		
<b>Total liabilities</b>	<b>173,294</b>	<b>(3,871)</b>		<b>162,282</b>	<b>(405)</b>		<b>(1.00)</b>
<b>Interest margin</b>			<b>1.42</b>			<b>2.73</b>	<b>1.32</b>

See footnotes on page 66.

## Rates of Financing Income and Expenses (on a Consolidated Basis) (a) Reported Amounts

	For the three months ended 31 March							
	2006			2005				
	Average balance (b)	Financing income (expenses)	Rate of income (expenses)		Average balance (b)	Financing income (expenses)	Rate of income (expenses)	
			Excluding the effect of derivatives	Including the effect of derivatives			Excluding the effect of derivatives	Including the effect of derivatives
(NIS millions)		%	%	(NIS millions)		%	%	
Total monetary assets generating interest								
Income (d) (f)	257,456	5,629	9.04	239,516	3,120	5.31		
Effect of derivatives: (e)								
Hedging derivatives	4,879	28		4,809	27			
Embedded derivatives and ALM	64,974	1,022		65,812	(287)			
<b>Total assets</b>	<b>327,309</b>	<b>6,679</b>	<b>8.42</b>	<b>310,137</b>	<b>2,860</b>	<b>3.74</b>		
Total monetary liabilities generating interest								
expenses (d)	243,262	(4,203)	(7.09)	226,082	(1,560)	(2.79)		
Effect of derivatives: (e)								
Hedging derivatives	4,789	(46)		4,753	(48)			
Embedded derivatives and ALM	64,781	(966)		65,287	151			
<b>Total liabilities</b>	<b>312,832</b>	<b>(5,215)</b>	<b>(6.84)</b>	<b>296,122</b>	<b>(1,457)</b>	<b>(1.98)</b>		
<b>Interest margin</b>			<b>1.95</b>	<b>1.58</b>		<b>2.52</b>	<b>1.76</b>	
In respect of options		21			(11)			
In respect of other derivatives (excluding options, hedging derivative instruments, ALM derivatives and embedded derivatives which have been separated) (e)		1			8			
Financing commissions and other financing income (g)		187			186			
Other financing expenses		(28)			6			
Net interest income before provision for doubtful debts		1,645			1,592			
Provision for doubtful debts (including general and supplementary provision)		(201)			(445)			
Net interest income after provision for doubtful debts		1,444			1,147			
Monetary assets generating interest income (d) (f)	257,456			239,516				
Assets derived from derivative instruments (h)	3,266			3,547				
Other monetary assets (d)	3,568			3,286				
General provision and supplementary provision for doubtful debts	(1,037)			(1,038)				
<b>Total monetary assets</b>	<b>263,253</b>			<b>245,311</b>				
Monetary liabilities generating interest expenses								
(d)	243,262			226,082				
Liabilities derived from derivative instruments (h)	3,145			2,949				
Other monetary liabilities (d)	7,058			7,129				
<b>Total monetary liabilities</b>	<b>253,465</b>			<b>236,160</b>				
Total monetary assets exceed monetary liabilities	9,788			9,151				
Non-monetary assets	7,796			7,670				
Non-monetary liabilities	1,587			1,836				
<b>Total capital resources</b>	<b>15,997</b>			<b>14,985</b>				

See footnotes on page 66.

- (a) The data in this exhibit includes before and after the effect of derivative instruments (including the effect of off-balance sheet derivative instruments).
- (b) Based on monthly opening balances, and quarterly opening balances in foreign subsidiaries, except for the unlinked Israeli currency sector where the average balance is based on daily figures, and after deduction of the average balance sheet balance of the specific provision for doubtful debts.
- (c) The average balance of unrealized profits (losses) from adjustment to fair value of debentures held for trading and available for sale has been deducted from (added to ) the average balance of the assets as follows:  
 The unlinked Israeli currency sector for the three month period amounts to NIS 91 million.  
 The linked Israeli currency sector for the three month period amounts to NIS 5 million.  
 The foreign currency sector (which includes Israeli currency linked to foreign currency) for the three month period amounts to NIS (153) million.
- (d) Excluding derivative instruments.
- (e) Includes hedging derivative instruments (excluding options), embedded derivatives which have been separated, and ALM derivatives, which constitute part of the Bank's asset and liability management system.
- (f) The average balance of unrealized losses on adjustment to fair value of debentures held for trading and available for sale has been added to the average balance of the assets in the various sectors.  
 The three month period amounts to NIS 57 million.
- (g) This includes profits and losses on sales of investments in debentures and adjustments to fair value of debentures held for trading.
- (h) Includes the average balance for derivative instruments (does not include average of off-balance sheet derivative instruments).

**Rates of Financing Income and Expenses (on a Consolidated Basis) (a)**  
**Nominal U.S. \$**

	For the three months ended 31 March							
	2006				2005			
	Average balance (b) (\$ millions)	Financing income (expenses)	Rate of income (expenses)		Average balance (b) (\$ millions)	Financing income (expenses)	Rate of income (expenses)	
			Excluding the effect of derivatives	Including the effect of derivatives			Excluding the effect of derivatives	Including the effect of derivatives
		%	%			%	%	
<b>Foreign currency:</b>								
<b>Local operations (including Israeli currency linked to foreign currency)</b>								
Assets (c) (d)	16,577	189	4.63	16,488	143	3.51		
Effect of derivatives: (e)								
Hedging derivatives	1,051	6		1,106	6			
Embedded derivatives and ALM	10,354	5		11,187	3			
<b>Total assets</b>	<b>27,982</b>	<b>200</b>	<b>2.89</b>	<b>28,781</b>	<b>152</b>		<b>2.13</b>	
Liabilities (d)	15,954	(114)	(2.89)	14,931	(52)	(1.40)		
Effect of derivatives: (e)								
Hedging derivatives	1,032	(10)		1,093	(11)			
Embedded derivatives and ALM	11,489	(3)		13,064	(2)			
<b>Total liabilities</b>	<b>28,475</b>	<b>(127)</b>	<b>(1.80)</b>	<b>29,088</b>	<b>(65)</b>		<b>(0.91)</b>	
<b>Interest margin</b>			<b>1.74</b>			<b>2.11</b>	<b>1.22</b>	
<b>Foreign currency – Foreign operations (integrated operations)</b>								
Assets (c) (d)	9,415	114	4.92	8,663	86	4.03		
Effect of embedded and ALM derivatives (e)	43	1		80	2			
<b>Total assets</b>	<b>9,458</b>	<b>115</b>	<b>4.92</b>	<b>8,743</b>	<b>88</b>		<b>4.09</b>	
Liabilities (d)	8,852	(78)	(3.56)	8,199	(50)	(2.45)		
Effect of embedded and ALM derivatives (e)	71	(1)		107	-			
<b>Total liabilities</b>	<b>8,923</b>	<b>(79)</b>	<b>(3.56)</b>	<b>8,306</b>	<b>(50)</b>		<b>(2.43)</b>	
<b>Interest margin</b>			<b>1.36</b>			<b>1.58</b>	<b>1.66</b>	
<b>Total:</b>								
Monetary assets in foreign currency generating financing income (c) (d)	25,992	303	4.74	25,151	229	3.69		
Effect of derivatives: (e)								
Hedging derivatives	1,051	6		1,106	6			
Embedded derivatives and ALM	10,397	6		11,267	5			
<b>Total assets</b>	<b>37,440</b>	<b>315</b>	<b>3.40</b>	<b>37,524</b>	<b>240</b>		<b>2.58</b>	
Monetary liabilities in foreign currency generating financing expense (d)	24,806	(192)	(3.13)	23,130	(102)	(1.77)		
Effect of derivatives: (e)								
Hedging derivatives	1,032	(10)		1,093	(11)			
Embedded derivatives and ALM	11,560	(4)		13,171	(2)			
<b>Total liabilities</b>	<b>37,398</b>	<b>(206)</b>	<b>(2.22)</b>	<b>37,394</b>	<b>(115)</b>		<b>(1.24)</b>	
<b>Interest margin</b>			<b>1.61</b>			<b>1.92</b>	<b>1.34</b>	

See footnotes on page 68.

- (a) The data in this exhibit includes before and after the effect of derivative instruments (including the effect of off-balance sheet derivative instruments).
- (b) Based on monthly opening balances for the Bank and subsidiaries in Israel and on quarterly opening balances for foreign subsidiaries, and after deduction of the average balance sheet balance of the specific provision for doubtful debts.
- (c) The average balance of unrealized losses on adjustment to fair value of debentures held for trading and available for sale has been added to the average balance of the assets for local and foreign operations, in the amount of US\$ 33 million.
- (d) Excluding derivative instruments.
- (e) Includes hedging derivative instruments (excluding options), embedded derivatives which have been separated, and ALM derivatives, which constitute part of the Bank's asset and liability management system.



**Somekh Chaikin**



Kost Forer Gabbay & Kasierer  
3 Aminadav St.  
Tel-Aviv 67067, Israel

**To the Board of Directors of Bank Leumi le-Israel B.M.**

Dear Sirs,

**Re: Review of the Unaudited Condensed Interim Consolidated Financial Statements for the three month period ended 31 March 2006**

At your request, we have reviewed the condensed interim consolidated balance sheet of Bank Leumi le-Israel B.M. (the "Bank") and its subsidiaries (the "Group") as at 31 March 2006 and the condensed interim consolidated statements of profit and loss and the condensed interim statement of changes in shareholders' equity for the three month period then ended.

Our review was carried out in accordance with the procedures prescribed by the Institute of Certified Public Accountants in Israel. The procedures included, inter alia, reading the said financial statements, reading the minutes of the Shareholders' Meetings and the Meetings of the Board of Directors and its committees, as well as making inquiries of the persons responsible for financial and accounting matters at the Bank.

We were given reports issued by other auditors regarding their review of the interim financial statements of the foreign subsidiaries, whose assets constitute some 2% of the total consolidated assets in the condensed interim consolidated balance sheet as at 31 March 2006, and whose net interest income before provision for doubtful debts constitutes some 1% of the total consolidated net interest income before provision for doubtful debts included in the condensed consolidated statement of profit and loss for the three month period then ended.

Since our review was limited in scope and does not constitute an audit in accordance with generally accepted auditing standards, we do not express an opinion on the interim consolidated financial statements.

In carrying out our review, including reading the above mentioned reports of other auditors, nothing came to our attention to indicate that there is a need for any material modifications in the said condensed interim financial statements in order for them to be considered as interim financial statements that are drawn up in conformity with generally accepted accounting principles and with directives and guidelines of the Supervisor of Banks.

We draw attention to the contents of Notes 4 and 6 to the condensed interim financial statements regarding claims against the Bank and against a subsidiary, including applications for their approval as class actions. The Bank is unable to estimate the effect of the claims on the Bank, if any, on its financial position and operating results, and whether or not they will be material. Furthermore, we draw attention to the contents of Note 8 to the condensed interim financial statements regarding capital market reform legislation. The Note states, inter alia, that the implementation of the provisions of the legislation in their entirety is likely to have negative effects on the Group's businesses, the scope of which cannot at this stage be accurately evaluated in light of the uncertainties which still exist regarding various matters.

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**Somekh Chaikin**  
**Certified Public Accountants (Isr.)**

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**Kost Forer Gabbay & Kasierer**  
**Certified Public Accountants (Isr.)**

31 May 2006

**Condensed Consolidated Balance Sheet as at 31 March 2006**  
**Reported amounts**

	<b>31 March 2006</b>	31 March 2005	31 December 2005
	(Unaudited)	(Unaudited)	(Audited)
	(NIS millions)		
<b>Assets</b>			
Cash and deposits with banks	<b>35,568</b>	31,333	35,381
Securities	<b>48,365</b>	44,692	47,825
Credit to the public	<b>177,584</b>	168,921	177,255
Credit to governments	<b>808</b>	913	848
Investments in companies included on the equity basis	<b>1,255</b>	1,843	2,064
Buildings and equipment	<b>2,894</b>	2,710	2,843
Other assets	<b>6,525</b>	6,493	6,608
<b>Total assets</b>	<b>272,999</b>	256,905	272,824
<b>Liabilities and equity capital</b>			
Deposits of the public	<b>221,807</b>	210,109	221,828
Deposits from banks	<b>4,423</b>	5,986	4,347
Deposits from governments	<b>2,173</b>	3,070	2,225
Debentures, bonds and subordinated notes	<b>16,889</b>	12,673	17,253
Other liabilities	<b>10,272</b>	9,339	10,966
<b>Total liabilities</b>	<b>255,564</b>	241,177	256,619
Minority interest	<b>152</b>	267	205
Shareholders' equity	<b>17,283</b>	15,461	16,000
<b>Total liabilities and equity capital</b>	<b>272,999</b>	256,905	272,824

The accompanying notes are an integral part of these Financial Statements.

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**Eitan Raff**  
 Chairman of the  
 Board of Directors

\_\_\_\_\_  
**Galia Maor**  
 President and Chief  
 Executive Officer

\_\_\_\_\_  
**Zeev Nahari**  
 Deputy Chief Executive Officer  
 Head of Finance and Accounting Division

**Date of approval of the Financial Statements: 31 May 2006**

**Condensed Consolidated Statement of Profit and Loss  
For the Period Ended 31 March 2006  
Reported Amounts**

	For the Three Months Ended 31 March		For the Year Ended
	2006	2005	31 December
	(Unaudited)		(Audited)
	(NIS millions)		
Net interest income before provision for doubtful debts	1,645	1,592	6,628
Provision for doubtful debts	201	445	1,426
Net interest income after provision for doubtful debts	1,444	1,147	5,202
<b>Operating and other income</b>			
Operating commissions	742	693	2,810
Profits from investments in shares, net	4	7	43
Other income	194	187	865
Total operating and other income	940	887	3,718
<b>Operating and other expenses</b>			
Salaries and related expenses	1,189	864	3,627
Building and equipment maintenance and depreciation	287	277	1,168
Other expenses	345	279	1,275
Total operating and other expenses	1,821	1,420	6,070
Operating profit before taxes	563	614	2,850
Provision for taxes on operating profit	240	233	1,193
Operating profit after taxes	323	381	1,657
Equity in after-tax operating profit of companies included on the equity basis	78	141	378
Minority interest in after-tax operating losses (profits) of subsidiaries	(1)	9	24
Net operating profit	400	531	2,059
After-tax profit (loss) from extraordinary items	712	(3)	77
Net profit for the period	1,112	528	2,136
	(NIS)		
<b>Profit per share</b>			
Net operating profit	0.283	0.375	1.456
After-tax profit (loss) from extraordinary items	0.503	(0.002)	0.054
Total	0.786	0.373	1.510
	(Thousands)		
Number of shares for the purpose of the above calculation	1,414,233	1,414,233	1,414,233

The accompanying notes are an integral part of these Financial Statements.

**Condensed Consolidated Statement of Changes in Shareholders' Equity**  
**For the Period Ended 31 March 2006**  
**Reported Amounts**

	For the Three Months Ended 31 March					
	2006			2005		
	(Unaudited)					
	Capital and capital reserves	Retained earnings	Total shareholders' equity	Capital and capital reserves	Retained earnings	Total shareholders' equity
	(NIS millions)			(NIS millions)		
Balance at the beginning of the period	7,010	8,990	16,000	7,010	7,976	14,986
Net profit for the period	-	1,112	1,112	-	528	528
Benefit inherent in the allotment of share options to employees	-	33	33	-	-	-
Adjustments in respect of presentation of securities available for sale at fair value	-	245	245	-	(72)	(72)
Related tax effect	-	(100)	(100)	-	23	23
Translation adjustments for companies included on the equity basis	-	(12)	(12)	-	(8)	(8)
Loans to employees for purchase of Bank's shares	-	5	5	-	4	4
Balance at the end of the period	7,010	(a) 10,273	17,283	7,010	(a) 8,451	15,461

	For the Year Ended 31 December 2005 (Audited)		
	Capital and capital reserves	Retained earnings	Total shareholders' equity
	(NIS millions)		
Balance as at 1 January 2005	7,010	7,976	14,986
Net profit for the year	-	2,136	2,136
Proposed dividend	-	(1,103)	(1,103)
Adjustments in respect of presentation of securities available for sale at fair value	-	(83)	(83)
Related tax effect	-	35	35
Translation adjustments for companies included on the equity basis	-	25	25
Loans to employees for purchase of Bank's shares	-	4	4
Balance as at 31 December 2005	7,010	(a) 8,990	16,000

(a) The retained earnings at the end of the period include:

- Adjustments from translation of the financial statements of autonomous foreign investees in the amount of NIS (354) million (NIS (375) million as at 31 March 2005 and NIS (342) million as at 31 December 2005).
- Adjustments in respect of presentation of securities available for sale at fair value, less related taxation, in the amount of NIS 191 million (NIS 45 million as at 31 March 2005 and NIS 46 million as at 31 December 2005).

The accompanying notes are an integral part of these Financial Statements.

## NOTES

1. The Condensed Consolidated Interim Financial Statements to 31 March 2006 have been prepared in accordance with accounting principles adopted for the preparation of interim reports. The accounting principles used in preparing the interim report are consistent with those applied in the audited Financial Statements as at 31 December 2005, save as set forth in Note 2 below. These Statements should be read in conjunction with the Annual Financial Statements as at 31 December 2005 and for the year ended on that date, and their accompanying Notes.

2. **A. Application for the First Time of New Accounting Standards:**

1. **Accounting Standard No. 20 (Amended) – "Accounting Treatment of Goodwill and Intangible Assets on Acquisition of Investee Companies"**

As from 1 January 2006, the Bank has been applying Accounting Standard No. 20 (Amended) - "Accounting Treatment of Goodwill and Intangible Assets on Acquisition of Investee Companies" ("Standard No. 20") of the Israel Accounting Standards Board.

Standard No. 20 prescribes the accounting treatment of goodwill and intangible assets on the acquisition of a subsidiary and an investee company that is not a subsidiary, including a company under joint control.

According to Standard No. 20, the excess of the cost of acquisition of an investment in an investee company over the part of the holding company in the fair value of its identifiable assets (including intangible assets) less the fair value of its identifiable liabilities (after relevant tax attribution) constitutes goodwill. The excess of the cost of acquisition of an intangible asset acquired will be attributed only in the event of fulfillment of the definition of intangible asset in accordance with the criteria fixed in Standard No. 20. According to Standard No. 20, in the event that negative goodwill (excess of fair value over acquisition cost) is derived as of acquisition, such negative goodwill will be recognized immediately as of acquisition date as a gain in the profit and loss statement and will not be amortized methodically. Positive goodwill and intangible assets with undefined lives will not be amortized, as opposed to the rules in effect until the starting date according to which goodwill and intangible assets are amortized over their useful lives, up to a maximum of 20 years for goodwill.

There are directives of the Supervisor of Banks in certain matters that relate to the treatment as aforesaid. Regarding amortization of goodwill over the period of the useful life, there is a limitation in the directives of the Supervisor of Banks of 10 years.

The application of Standard 20 for the first time did not have an effect on the Bank's Financial Statements.

2. **Accounting Standard No. 21 - "Earnings per Share"**

As from 1 January 2006 the Bank has been applying Accounting Standard No. 21, "Earnings per Share" ("Standard No. 21") of the Israel Accounting Standards Board. Standard No. 21 prescribes the principles for the computation and presentation of earnings (loss) per share in the financial statements and supersedes Opinion No. 55 of the Institute of Certified Public Accountants in Israel.

According to Standard No. 21, earnings per share are to be computed based on the number of ordinary shares (and not per NIS 1 par value of the shares as computed until the commencement date). Basic earnings per share are to include only the weighted average of the number of shares which are outstanding during the period whereas convertible securities (such as convertible debentures and options) are to be included only in the computation of diluted earnings per share,

in contrast to the principles applied until the commencement date, according to which in cases where a convertible security is likely to be converted, it is included in the computation of basic earnings per share. In addition, convertible securities which had been converted during the period are to be included in diluted earnings per share only up to the date of conversion and are to be included in basic earnings per share from that date. Pursuant to Standard No. 21, options will be included in diluted earnings when their exercise results in the issuance of shares for a consideration which is less than the market price of the shares. The amount of dilution is the market price of the shares minus the amount that would have been received as a result of the conversion of all the options into shares. This is in contrast to the method of computation prescribed by Opinion No. 55 of the Institute of Certified Public Accountants in Israel, which also includes adjustments to profits.

According to Standard No. 21, the provisions of the Standard should be implemented regarding comparative earnings per share data relating to previous periods.

The application of Standard 21 for the first time did not have an effect on the comparative figures of earnings per share.

### 3. **Accounting Standard No. 22 - "Financial Instruments – Disclosure and Presentation"**

As from 1 January 2006 the Bank has been applying Accounting Standard No. 22 – "Financial Instruments – Disclosure and Presentation" ("Standard No. 22") of the Israel Accounting Standards Board.

Standard 22 prescribes principles regarding the presentation of financial instruments and details the proper disclosure required in respect thereof in the financial statements. In addition, Standard 22 lays down principles for the classification of a financial instrument, or its constituent parts, upon its initial recognition as a financial liability, financial asset or equity instrument, the classification of transaction costs (net of any related tax benefit) arising from the financial instrument as a profit and loss item or capital item accordingly, and the conditions upon which a financial asset will be offset against a financial liability.

Adoption of the Standard is implemented according to the "from here onward" method. In certain matters relating to the presentation of financial instruments, the rules determined in the directives of the Supervisor of Banks apply to the Bank.

The application of Standard 22 for the first time did not have an effect on the Bank's Financial Statements.

### 4. **Accounting Standard No. 24 - "Share-Based Payment"**

As from 1 January 2006 the Bank has been applying Accounting Standard No. 24 - "Share-Based Payment" ("Standard 24") of the Israel Accounting Standards Board.

Standard 24 requires the recognition of share-based payment transactions in the financial statements. Such transactions include transactions with employees or other parties that are to be settled in the company's equity instruments or in cash, as well as transactions that provide the company or the supplier of the service or goods with a choice of settling in cash or in equity instruments. Concurrently with the recognition of the goods or services received, it is necessary to recognize an increase in shareholders' equity in the financial statements when the share-based payment transaction is settled in equity instruments, and the incurrence of a liability when this transaction is settled in cash.

Standard 24 prescribes the principles for the recognition, measurement and disclosure of the fair value of the goods or services provided in exchange for the equity instrument granted. In particular, measurement principles are prescribed with respect to transactions with employees

and others providing similar services, transactions with parties who are not employees and transactions that are measured by reference to the fair value of the equity instruments granted. In addition, requirements are prescribed for situations in which modifications are made to the conditions on which the equity instrument was granted.

The application of Standard 24 for the first time did not have an effect on the Bank's Financial Statements.

See Note 10 with regard to the grant of options and the sale of shares to the Bank's employees in 2006.

**B. Application for the first time of the Provisions of Proper Banking Management Directives relating to Provision for Doubtful Debts in respect of Housing Credit at Leumi Mortgage Bank**

As from 1 January 2006 Leumi Mortgage Bank has been applying the Bank of Israel's circular that deals with all matters relating to the manner of the calculation of the provision for doubtful debts regarding housing credit. The circular determines, *inter alia*, that a bank that elected to calculate the provisions in respect of loans in accordance with the depth of arrears method, even if it was not required to do so under the directives, is not entitled to reduce the provisions by means of a decision to make specific provisions. In addition, clarifications were given as to the manner of the calculation of the depth of arrears, directives as to the manner of the calculation of the provision in respect of arrangements and the re-organization of loans and also the manner of the calculation of the provision in respect of loans in which the principal is repaid in one payment. Further, the circular relate to the clearance of a debt in arrears after the balance sheet date and does not allow the reduction of the provision even if cash is received in respect of the arrears after the balance sheet date, including cash in respect of the sale of an apartment before the balance sheet date.

The effect of applying the circular to the provisions for doubtful debts at Leumi Mortgage Bank is a one-time addition in the amount of NIS 63.7 million, in respect of adjusting the opening balance for 2006.

3. In the regular course of business, legal claims were filed against the Bank and certain subsidiaries, including applications for approval of class actions. In the opinion of the Management of the Bank and the managements of the subsidiaries, based on legal opinions regarding the chances of the claims succeeding, including the applications for approval of class actions, appropriate provisions were recorded in the Financial Statements, insofar as required, to cover damages resulting from the said claims.

In the opinion of the Management of the Bank and the managements of the subsidiaries, the total additional exposure arising from legal claims filed against the Bank and against the subsidiaries as mentioned above on various subjects, the amount of each of which exceeds NIS 2 million, and where the chances of such claims succeeding are not remote, amounts to some NIS 110 million.

Following are details of claims in material amounts.

- A. On 24 August 1997 an application to approve the filing of a class action against the Bank and against Israel Credit Cards Ltd. ("ICC") was filed in the Tel Aviv District Court in connection with collection of fees for limitation of credit card holders' liability. The application is for approval of a monetary class action in the amount of some NIS 105 million as of the date of filing the claim and also for additional remedies. The request is in the stage of preparation of written summaries.
- B. In September 1997 a foreign company in the process of liquidation filed a claim against the Bank, a subsidiary of the Bank (Bartrade International Trade and Financing (83) Ltd.) and certain of their employees in the amount of NIS 153 million as of the date of filing the claim. The claim

relates to transfer of US\$ 43.4 million by the foreign company to an account with the Bank in the name of a manager of the foreign company. The liquidator of the foreign company claims, inter alia, that the defendants acted in such a way that enabled the manager of the foreign company to steal the said amount from it.

- C. On 15 June 2000 a claim was filed against the Bank in the Tel Aviv District Court, together with an application to approve the claim as a class action in the amount of NIS 1 billion.

The plaintiff alleges that the Bank, in its various publications, promised to depositors of shekel deposits made by self service through direct banking channels, a preferred annual interest rate of 1% over the accepted rate, and that the various publications and the information provided to the depositors at the time of the original deposit misled the depositors to think that the 1% additional interest is granted also in respect of the periods in which the deposit is automatically renewed and not only in respect of the original deposit period, as is the actual case.

Accordingly, the plaintiff is requesting that the Bank pay to it and all the relevant depositors being represented, the preferred interest also in respect of the periods in which the deposits were automatically renewed. In December 2003 the Court approved the claim as a class action. The Bank submitted an appeal on the decision to the Supreme Court, which has not yet rendered a ruling on the matter.

- D. On 19 June 2002 an application for approval of a class action was filed by the Ramle Municipality against the following respondents: the Bank, the Bank Clearing Center Ltd ("BCC"), Bank Hapoalim B.M. Israel Discount Bank Ltd., The First International Bank of Israel Ltd., United Mizrahi Bank Ltd. and Mercantile Discount Bank Ltd.. The applicant asserts that the respondent banks entered into a restrictive arrangement with regard to commissions they charge their customers that receive standing order clearing services and that, as a result of the restrictive arrangement to which the respondents are parties, the applicant, and all recipients of standing order clearing services, pay unfair and unreasonable amounts for these services. The class action was filed in the amount of NIS 967.5 million. On 11 December 2003 the application for approval of the class action was summarily dismissed. On 18 February 2004 the Ramle Municipality appealed the dismissal. On 28 November 2005 the Supreme Court dismissed the appeal. The Municipality submitted an application to the Supreme Court for an additional hearing on the decision and an application for exemption from deposit of a guarantee. The Supreme Court dismissed the application for exemption from deposit of a guarantee and the Municipality has filed an application to strike out its application for a further hearing.

- E. On 14 October 2004 an application to approve a claim as a class action in the amount of some NIS 2 billion was filed with the Tel Aviv-Jaffa District Court against the Bank on the basis of the Banking (Service to Customer) Law, 1981 and Regulation 29 of the Civil Procedure Regulations, 1984.

The subject of the claim was originally the allegations of the applicant that he and all the other customers of the Bank were charged fixed management fees, credit provision fees and securities deposit management fees illegally and contrary to the exemptions indicated beside the fees on the Bank's price list. The applicant maintains that the Bank misled its customers and breached the disclosure duties owed to them, and breached contractual obligations to them by charging them the fees, despite the fact that according to the Bank's price list they were entitled to exemptions from the payment of such fees. The applicant is also claiming that as such the Bank was unlawfully enriched.

On 19 December 2004 the Bank submitted to the Court its response to the application to approve the claim as a class action, and on 24 February 2005 the applicant's reply to the Bank's response to the application for approval of a class action was filed. On 20 September 2005 an application was filed with the Court to amend the statement of claim, pursuant to which the applicant requested to strike out all that part of the claim relating to commissions on securities deposit

management fees. The Court approved the request for such amendment and the amount of the claim was reduced to some NIS 1.12 billion. As a result of the amendment, on 19 December 2005 the Bank submitted an amended response to the amended application for approval of the claim as a class action. On 20 March 2006 an amended response of the applicant was filed.

- F. In June 2005, an application for the approval of the filing of a class action was filed in the Tel Aviv District Court against the Bank in the amount of NIS 576 million.

The applicant claims that the Bank did not stand by promises advertised on its internet site in the years 2002 to 2004 (inclusive), regarding interest benefits on certain deposits made through the internet. The applicant is demanding that the Bank pay him and all depositors through the internet who did not receive the promised benefits as advertised, the damages that they suffered as a result of non-receipt of such promised benefits.

4. In addition, there are legal claims pending against the Bank, including applications for approval of class actions, as detailed below. In the opinion of the Management of the Bank, based on legal opinions with regard to the chances of the claims, it is not possible at this stage to estimate the chances of the claims and therefore no provision was recorded in respect thereof.

Following are the details of the legal claims:

- A. In February 2006 an application for the approval of filing a class action was submitted by a customer of the Bank in the Tel Aviv District Court against the Bank, in an amount estimated by the applicant at some NIS 300 million.

According to the applicant, in the framework of the sale of "structured products" to Bank customers, the Bank does not disclose the full pricing and charges a hidden "commission" that is expressed in a financial margin which enures to the benefit of the Bank in the transaction, which in the applicant's view is in contradiction to the requirement for disclosure which applies to the Bank in accordance with the law.

The group to which the requested class action relates, according to the claim, is all Bank customers that invested in various "structured products" marketed by the Bank, from January 1999 until January 2006, where the Bank did not disclose to them what allegedly should have been disclosed.

The Bank has not yet submitted a response.

According to the Management of the Bank, based on the opinion of its legal advisers, the chances of the claim cannot be estimated at this time.

- B. On 7 August 2005, an application was filed against the Bank in the Tel Aviv District Court for the approval of an action as a class action. The claim being made is that up until January 2003, the Bank did not credit its customers with the relative part of the commission amounts paid by them in respect of bank guarantees issued at their request, where the amounts of the guarantees were reduced before the end of the guarantee period.

The applicants maintain that the value of the claim exceeds NIS 2.5 million. In the opinion of the Management of the Bank, based on the opinion of its legal advisers, the chances of the claim cannot be estimated at this time.

- C. On 23 April 2006 an application was filed in the Jerusalem District Court to approve a class action against the Bank on the assertion that in consequence of a change in the classification of accounts that were managed at the Bank as "debitory current accounts" to "private commercial debitory current accounts", on 25 April 1999 or thereabouts, according to the applicant's assertion, without due disclosure to customers and in breach of the provisions of the account

management terms and conditions agreement and the legal provisions in such regard, the Bank changed the interest rate (the risk supplement component) and additional costs relating to the management of the account.

The amount of the class action has been estimated by the applicant in an amount of some NIS 45 million.

In the opinion of the Management of the Bank, based on the opinion of its legal advisers, the chances of the application cannot be estimated at this time.

5. Following are details of requests for approval of class actions in material amounts that were submitted against Leumi Mortgage Bank Ltd. ("Leumi Mortgage Bank"). In the opinion of the Management of the Bank, based on the opinion of the Management of Leumi Mortgage Bank, which is based on the opinion of Leumi Mortgage Bank's legal advisers as to the chances of these proceedings, appropriate provisions have been included in the Financial Statements, insofar as required, to cover damages resulting from such claims:

A. On 21 June 2000 an application for approval of a class action was filed in the Tel Aviv District Court and against Leumi Mortgage Bank based on the Banking (Service to Customer) Law, 1981, Regulation 29 of the Civil Procedure Regulations, 1984, and the Supervision of Insurance Practices Law, 1981. The amount of the claim, whose approval as a class action was requested, is estimated by the applicants at some NIS 100 million.

The applicants who took out loans from Leumi Mortgage Bank, are making claims regarding the value of buildings for purposes of property insurance in the framework of loans taken out from Leumi Mortgage Bank. According to the applicants, Leumi Mortgage Bank or its representative prepared an excessive valuation of the buildings, resulting in overpayment of premiums by Leumi Mortgage Bank customers. The applicants contend that this was also done in their case. In accordance with the decision of the District Court, the hearing on the claim will be stayed until the appeals referred to in paragraph 6(A) below are decided – the application to the Court for approval of a class action in connection with collection of insurance commissions.

B. On 3 July 2001 an application was filed in the Tel Aviv District Court for approval of a class action based on the Banking (Service to Customer) Law, 1981, the Restrictive Trade Practices Law, 1988, and Regulation 29 of the Civil Procedure Regulations, 1984.

The amount of the class action whose approval is requested is estimated by the applicant at NIS 180 million as of the date of submission of the claim.

The subject of the claim is claims of alleged overcharging by Leumi Mortgage Bank from borrowers of Leumi Mortgage Bank who took out loans at variable interest. The applicant took out a loan from Leumi Mortgage Bank at variable interest. The applicant is claiming that the interest according to which Leumi Mortgage Bank updates loans at variable interest is excessive and collected illegally, due to it being based on misleading information which misled borrowers, the existence of a syndicate between the mortgage banks, which caused a limitation in the supply of loans at variable interest and their quality and diversity, and a series of other claims.

In addition to the monetary relief, additional relief was requested including declarative relief and determination of various rights for borrowers in accordance with the loan agreement.

On 3 June 2003 the Court dismissed the application for approval of the claim as a class action. On 23 September 2003 the applicant appealed the said decision to the Supreme Court. On 30 June 2004 the Supreme Court decided to stay the continuation of the hearing of the appeal in order to await a decision in the additional hearing regarding Regulation 29 of the Civil Procedure Regulations, 1984 (file no. 5161/03) that was meanwhile handed down on 1 September 2005. In short, the ruling states that although interpretive means may be utilized to convert Regulation 29

to an instrument for submission of class actions, such utilization is not appropriate as at this time, taking into consideration legislative procedures underway in the field of class actions. Accordingly, the parties agreed to strike off the appeal regarding Regulation 29 and a date for hearing of the appeal was fixed for 4 May 2006.

On 12 March 2006 the Class Actions Law, 2006 (the "Class Actions Law") was published. The object of the Law is to regulate uniform rules relating to the filing and conduct of class actions.

The Law provides that a class action shall not be filed other than a claim detailed in the schedule to the Law or pursuant to an express statutory provision. Among the matters in respect whereof a class action may be filed on the basis of the Law there include "a claim against a banking corporation in connection with a matter between it and a customer, irrespective of whether they entered into a transaction or not". The Law provides that in principle its provisions shall also apply to applications to approve a class action and to class actions that were pending before a court on the day the Law was published. At the same time, the Law repeals the provisions in the Banking Law (as well as in the Restrictive Trade Practices Law and in additional laws) that enable the filing of class actions. The Class Actions Law also prescribes provisions as to the prescription of causes of action, that had not been established in specific arrangements that enabled the filing of a class action prior to its enactment (such as arrangements pursuant to the Banking Law or the Restrictive Trade Practices Law) and that were included in applications to approve class actions that were submitted prior to the publication of the Law. On 24 April 2006 the Supreme Court ruled that the parties should submit their summations as to the applicability of the Class Actions Law to the proceeding before it, and if the Law in fact applies - what the implications of its application are. At the same time, the Court cancelled the date of hearing that had been fixed for 4 May 2006 and fixed it for 15 January 2007.

- C. On 7 July 2003 an application for approval of a class action was filed against Leumi Mortgage Bank and against the Director of Stamp Duty based on the Banking (Service to Customer) Law, 1981, and Regulation 29 of the Civil Procedure Regulations, 1984.

The applicant is claiming as follows: he received a loan from Leumi Mortgage Bank; according to the Law, Leumi Mortgage Bank was required to stamp to the loan documents; Leumi Mortgage Bank charged the applicant a higher amount than the legally required stamp duty, which was calculated according to the total amount of the loan repayments, including interest in respect thereof, over the entire loan period; the correct amount of stamp duty should be calculated according to the amount of the loan, without taking into account interest; Leumi Mortgage Bank presented misleading documents to the applicant, according to which the stamp duty that was required was the legally required amount.

The relief requested is for the refund by Leumi Mortgage Bank and the Director of Stamp Duty to the group of applicants of the difference between the actual stamp duty and the amount claimed by the applicants.

The amount of the class action whose approval is requested is estimated by the applicant at some NIS 100 million.

6. The applications for approval of class actions set out below are also pending against Leumi Mortgage Bank. In the opinion of the Management of the Bank, based on the opinion of management of Leumi Mortgage Bank, which is based on the opinion of the legal advisors of Leumi Mortgage Bank with regard to the chances of these legal proceedings, it is not possible at this stage to estimate their chances and therefore no provision was recorded. Following are details of the legal proceedings:

- A. On 17 July 1997 an application for approval of a class action in an amount exceeding NIS 1 billion was filed with the Tel Aviv-Jaffa District Court against Leumi Mortgage Bank and against other mortgage banks in connection with collection of borrowers' life insurance and property insurance commissions. Each of the applicants took out a loan from one of the

respondent mortgage banks. According to the applicants, in the framework of taking out the loan, the respondent banks included them in life insurance or property insurance policies implemented through the banks and, according to their assertions, part of the insurance premiums reached the respondent banks in contradiction of the law.

On 17 November 1997 the Court ruled that the claim could not be heard as a class action according to the Banking (Service to Customer) Law, 1981, and the Restrictive Trade Practices Law, 1988. Accordingly, the Court struck off the monetary claim.

Nevertheless, the Court decided that the claim could be heard in the framework of Regulation 29 of the Civil Procedure Regulations, 1984, only with regard to claims for declaratory relief relating to causes of action that had arisen before 10 May 1996. The Court ruled that the causes of action that could be heard in this framework related to the "restrictive arrangement and various insurance issues".

Appeals to the Supreme Court submitted against this decision by Leumi Mortgage Bank, all the other mortgage banks involved in the claim and the applicants are pending. According to the decision of the Supreme Court, the District Court's decision was stayed. Accordingly, the claim will not be determined until the Supreme Court rules with regard to all of the appeals.

On 1 September 2005 the Supreme Court gave judgement in which it was determined in short, that although it was possible to utilize interpretive means to convert Regulation 29 to an instrument for submission of class actions, such utilization is not appropriate at this time, taking into consideration legislative procedures underway in the field of class actions. On 12 March 2006 the Class Actions Law was published. For details of the Law, see Note 5B above.

In the opinion of the Management of the Bank, based on the opinion of management of Leumi Mortgage Bank, which is based on the opinion of its legal advisors, at this stage it is not possible to estimate the chances of the appeals.

- B. On 10 June 2003 an additional application for approval of a class action was filed against Leumi Mortgage Bank regarding alleged over-collection from borrowers who took out loans at variable interest. Although the application and the claim are stated unclearly, it appears that (at least partial) overlapping exists with the basic arguments raised in paragraph 5B above, the requested relief and the group of applicants.

The amount of the class action requested is estimated by the applicants at some NIS 90 million.

In light of the (at least partial) overlapping between the application for approval of the class action reviewed here and the application for approval of the class action reviewed in paragraph 5B above, it was agreed between the parties to stay the proceedings in the claim until after clarification of the appeal submitted in connection with paragraph 5B above. The Court was informed of this agreement and, accordingly, a response has not yet been submitted to the application for approval of a class action.

In the opinion of the Management of the Bank, based on the opinion of management of Leumi Mortgage Bank, which is based on the opinion of its legal advisors, in light of the preliminary stage of the process, the chances of the claim cannot be estimated at this time.

- C. On 27 March 2006 an application was filed in the Tel Aviv-Jaffa District Court against Leumi Mortgage Bank to approve a class action with regard to an alleged overcharging of stamp duty.

The estimated amount of the class action against Leumi Mortgage Bank is asserted in the application to be NIS 22 million.

The application was filed by a person who took a loan from Leumi Mortgage Bank and who contends that Leumi Mortgage Bank charged customers who had taken loans from it stamp duty in respect of the amount of the interest that is added to the loans. As is asserted in the application, the claim involves overcharging since Leumi Mortgage Bank should have only charged stamp duty in respect of the amount of the loan principal.

It should be noted that an application is pending against Leumi Mortgage Bank to approve a class action in an asserted amount of some NIS 100 million, that was filed against it and against the stamp duty authorities on 7 July 2003, in which overcharging of stamp duty is also asserted, which it is contended was effected by charging stamp duty in respect of the interest component of the loan (see Note 5C above for an expansion of the subject). It is contended in the present application that it relates to a charge period that is different from that asserted in the application to approve a class action with regard to stamp duty that is already pending against Leumi Mortgage Bank.

## **7. Sale of Two Non-banking Holding Corporations**

The Bank of Israel has advised the Bank that it is required to sell its holdings in two conglomerates (Africa Israel and/or Migdal Holdings and/or The Israel Corporation) as soon as possible and no later than 30 September 2006. Should one of the two corporations being sold be Migdal Holdings, the Bank would be entitled to sell its holdings in Migdal Holdings in stages by 31 March 2008 as follows: by 31 March 2007 the holdings of the Bank in Migdal Holdings would not exceed 10%, and by 31 March 2008, the Bank would be required to sell the balance of its holdings in Migdal Holdings (if until such time the Banking Law is not amended so that insurance companies are explicitly excepted from the provisions of Section 24 of the Banking Law).

On 18 January 2006 the Bank notified the Bank of Israel of its intention to sell its holdings in Africa Israel and in Migdal Holdings.

On 1 February 2006, the Board of Directors approved entering into a transaction for the sale of the Bank's entire holdings in Africa Israel to Mr. Lev Leviev (the controlling shareholder of Africa Israel) or a company controlled by him, at a price of NIS 150 per share, reflecting a company value of NIS 7,075 million. On 13 February 2006 an agreement was signed for the sale. The transaction was completed on 27 March 2006. The total consideration to the Bank for the transaction was some NIS 1,131 million. The net profit from the transaction is some NIS 476 million.

On 5 March 2006 an agreement was signed between the Bank and Leumi Real Holdings Ltd., a wholly owned subsidiary of the Bank ("Leumi Holdings") and Participatie Maatschappij Graafschap Holland N.V. (the "Purchaser"), a wholly owned subsidiary of Assicurazioni Generali S.p.A., for the sale of shares in Migdal Holdings constituting 10% of the issued and fully paid share capital of the company owned by the Bank and Leumi Holdings for a total consideration of some US\$ 142 million.

After receipt of the approval of the Supervisor of Insurance, the transaction was completed on 15 March 2006. The net profit from the transaction is some NIS 235 million.

Following the completion of the transaction, 9.98% of the issued and fully paid share capital of Migdal Holdings remains in the hands of the Bank, and is presented in the securities available for sale item.

## **8. Capital Market Reform Legislation**

On 9 November 2004 the team which was appointed by the Minister of Finance for the purpose of examining and recommending the steps required in order to intensify competition in the Israeli capital market, published its recommendations. The team's recommendations were approved by the government.

Following the team's recommendations, on 10 August 2005 three laws implementing a substantial reform of the capital market were published.

The laws that were published were:

The Intensification of Competition and Reduction of Concentration and Conflicts of Interest in the Israeli Capital Market (Legislative Amendments) Law, 2005;

The Financial Services (Control) (Engagement in Pension Counseling and Pension Marketing) Law, 2005;

The Financial Services (Control) (Provident Funds) Law, 2005.

The major matters dealt with in the laws are:

- A. A banking corporation that has material retail activity shall not hold any means of control in a provident fund management company or a mutual fund management company and shall not hold more than 10% of any means of control in a corporation that controls or holds more than 25% of such company.

Further, the controller of such a banking corporation will not hold more than 5% of any type of means of control in such a company or in a corporation whose business is the management of investment portfolios, as mentioned in paragraph 3 below, and will not hold more than 10% in another corporation which controls or holds more than 25% of one of these.

As an exception to these prohibitions on holdings, a bank is permitted to control and to be an interested person in a company which manages a central provident fund for severance pay whose only member is the bank, and to manage the same, and to manage a provident fund all of whose members are employees of such banking corporation or of a corporation controlled by it, and which on 1 July 2005 was closed to the joining of new members.

- B. The reduction in holdings in provident fund management companies and in mutual fund management companies will be effected as follows:

Each of the large banks (the Leumi and Poalim Groups) must reduce its holdings in provident funds so that after two years they will each have reduced their market share to no more than 18% and after three years will have no such holdings.

Each of the large banks must reduce its market share in mutual funds to no more than 25% after two years, to no more than 12.5% after three years and after four years they shall have no such holdings.

The other banks in the system were given longer periods to realize all their holdings.

By the date by which the banking corporations are required to have realized all their holdings in provident fund and mutual fund management companies, they are also required to reduce their holdings in corporations controlling or holding more than 25% in such companies, so as to reach holdings in the legally permitted percentages (as mentioned in paragraph A above).

Further, by the date by which the banking corporations are required to have no holdings in provident fund management companies, the banking corporations must reduce their holdings in portfolio management companies which manage investments for institutional entities, as set out in paragraph C below.

- C. Banking corporations as mentioned in paragraph A above will not control nor hold more than 5% of a corporation which manages portfolios, which include the assets of an insurer held on behalf of its insured, of provident funds (including pension funds) and of mutual funds.
- D. Pursuant to the team's recommendations, the laws defined two fields that require training and licensing and that are subject to regulation and supervision - counselling and marketing, of both

financial products and pension products, and the entities operating in the capital market are required to choose between them. Amendments for this purpose were made *inter alia*, to the Banking (Licensing) Law, 1981, the Regulation of Engagement in Investment Counselling and Investment Portfolio Management Law, 1995, which also regulates the profession of investment marketing, the Joint Investment Trusts Law, 1994 and the Insurance Business (Control) Law, 1981. In addition, a new law was enacted to deal with pension counselling and pension marketing, which applies to counselling with relation to provident funds, pension funds and insurance programs included in or connected to provident funds and pension funds.

- E. The possibility of choosing between the profession of investment counselling and pension counselling, and the profession of investment marketing and pension marketing was not made available to banking corporations with material retail activity or their controlling entities or entities controlled by them. These may engage in counselling only, except that they are permitted to market structured products, options and futures contracts issued by themselves only. In addition, provision of pension counselling by a banking corporation will require the receipt of a license from the Supervisor of the Capital Market, the receipt of which, as detailed below, has been made subject to various conditions.

Other entities have the option of choosing between these two professions; those that choose to receive a marketing license will be permitted (as opposed to the original recommendations of the team which recommended allowing the marketers to market the products of two institutional entities, including the marketer itself) to market products without limitation, on condition that they bring the fact that they are marketers and are interested persons in the products that they are marketing to the attention of their customers. The marketers are prohibited from using the word "counselling" in their name or publications.

Marketers, whether of financial products or pension products, are permitted to receive benefits both from the institutional entities whose products they are distributing and from the customers.

- F. Holders of investment counselling licenses, including banking corporations, are prohibited from counselling or executing transactions in respect of financial products in which an institutional entity (including its controlling entities or entities controlled by any of them) which holds 10% in the counsellor, has an interest (interest meaning management of the product, offering or issuing the product, or the receipt of a benefit other than from the purchaser or holder of the product, unless expressly permitted by law, hereafter: "interest"). Holders of investment counselling licenses and banking corporations are permitted to receive distribution commission from an institutional entity in connection with counselling and executing transactions in mutual funds and supplementary training funds.

In this regard, it was determined that the rate of commission that investment counsellors may charge a mutual fund manager or a supplementary training fund management company for executing transactions will not vary as a result of its being collected from various fund managers and it will not be dependent on the identity of the supplementary training management company. The Minister of Finance is authorized to issue regulations to determine the conditions for the payment of such commissions, their maximum rate and their manner of calculation. Regulations with regard to distribution commissions were issued in February 2006.

- G. Holders of investment counselling licenses or their related entities are prohibited from issuing exchange traded certificates.
- H. Pension counsellors will be under a duty, when choosing the type of pension product, to consider all the types of pension products, and when choosing the pension product of the relevant type, to consider all the pension products and the institutional entities.

Pension counsellors that are banking corporations are prohibited from counselling on pension products in which an institutional entity (including its controlling entities or entities controlled by

any of them), which is an interested person in the banking corporation, has an interest. Similarly, pension counsellors that are banking corporations are prohibited from counselling on pension products in which an institutional entity has an interest, where the controller of the banking corporation holds more than 10% or controls such institutional entity.

In addition, pension counselling provided by a banking corporation may only be given in a permanent branch building, which has been licensed as a branch under the Banking (Licensing) Law.

Pension counsellors may receive distribution commission from the management company in respect of a provident fund for savings, pension or severance pay, which is not an insurance fund, and in respect of a supplementary training fund, subject to limitations. The rules regarding distribution commissions to be paid by the management company were laid down in the distribution commissions regulations issued in February 2006.

These restrictions do not apply to pension marketers, who, as mentioned above, may counsel and sell, in accordance with the law and as opposed to the recommendations of the team, all pension products, and to receive benefits from the managers of such products.

A pension counsellor which is a banking corporation is forbidden to enter into an agreement with an employer or employers' organization regarding the provision of pension counseling to the employees of such employer or to the employees of an employer who is a member of such organization. In addition, a banking corporation is forbidden from entering into an agreement with an employees' organization regarding the provision of pension counselling to the employees it represents. This restriction does not apply to a pension marketer.

The law provides that a transaction in a pension product may only be carried out as part of and in pursuance to pension counselling or marketing.

- I. Investment counsellors in financial products and pension counsellors may not enter into agreements for the provision of services with institutional entities (provident fund managers, pension funds, insurers, mutual fund managers), which are not in the usual course of business of the counsellor, which are not on an arm's length basis or which may materially affect the profitability, assets or liabilities of the counsellor unless they have received the prior written approval of the Chairman of the Securities Authority or the Supervisor of the Capital Market, as appropriate, and with regard to banking corporations, also of the Supervisor of Banks and, until 2010, the Antitrust General Director.
- J. Banking corporations may receive a pension counselling licence where all the following conditions are fulfilled:

the banking corporation is permitted to carry-out pension counselling under the Banking (Licensing) Law; the bank does not hold more than 5% of an insurance company and does not hold more than 10% of a company that controls, or holds more than 25%, of an insurance company; the bank has reduced all its holdings in provident funds and mutual funds as required by the law so that it no longer holds provident fund and mutual fund management companies and holds no more than 10% of another company that controls or holds more than 25% of a provident fund or mutual fund management company; the Supervisor of the Capital Market is convinced that the bank's undertaking of pension counselling will not have a materially detrimental affect on the development of competition and prevention of concentration in Israel, in the field of pension counselling, in brokerage activities between customers and institutional entities and in the field of banking, such being after consultation with the Antitrust General Director and the Supervisor of Banks.

However, the Supervisor of the Capital Market may give a pension counselling licence to a banking corporation where its shareholders' equity and that of banking corporations controlling it

and controlled by it do not exceed NIS 10 billion, even before the completion of the sale of their holdings in provident funds and mutual funds.

- K. During the period determined in the law, and which is longer in the case of the Leumi and Poalim Groups than for other banks, the pension counselling licence of a banking corporation will be restricted and the banks will be permitted to counsel only in respect of some of the pension products, that is, provident funds for savings, pension or severance pay which are not insurance funds, but not in respect of insurance funds and life insurance products included in or connected to provident funds. The restricted counselling period for the Leumi and Poalim Groups will be 5 consecutive years from the date upon which each bank complies with the conditions for receiving a pension counselling licence (the first three conditions referred to in paragraph J above) while with regard to the other banks, the period will continue until the relevant bank has first complied with the said conditions for receiving a pension counselling licence, but no earlier than 31 December 2009.

During the restricted period, a bank must advise its customer that the pension counselling it gives is restricted to certain types of product, but nonetheless the law provides that when choosing the type of product which is most appropriate to the customer, the holder of the counselling licence will consider all the types of pension products, both those permitted and those forbidden to it, but the choice of the product most appropriate to the customer will be from the permitted products, on condition that the most appropriate product for the customer is in fact a permitted one.

- L. The supervision of and enforcement relating to provident funds have been laid down in a new law – the Financial Services (Control) (Provident Funds) Law, 2005. This law regulates for the first time provident funds managed personally by the individual members. The unique nature of such a fund is that it is intended for an individual member who is permitted to give instructions regarding the investment of the fund's moneys. The laws also determine that the control of and the holding of a specified percentage of the means of control in an institutional entity shall be conditional upon obtaining a permit. Obtaining a permit as aforesaid shall be conditional on the permit applicant's market share not exceeding 15% in the long-term savings sphere and 20% in the mutual funds sphere.

This law makes basic changes to employee and employer rights in relation to provident funds, the principal ones being the freedom of choice allowed to employees with regard to provident funds and the freedom of movement between funds without the interference of the employer or employee organizations.

- M. The laws regulate subjects that did not arise from the team's recommendations, including, *inter alia*: an amendment to the Banking (Licensing) Law which permits a bank and a mortgage bank to control an insurance agent whose business is that of life insurance and household insurance connected with the granting of housing loans, an amendment to the Banking Ordinance that allows the Supervisor of Banks to publish Proper Banking Management Directives, and ratifies the existing Proper Banking Management Directives, an amendment to the Banking (Licensing) Law which will require the receipt of the consent of the Supervisor for the establishment of an auxiliary corporation by a banking corporation, civil penalties for breach of Proper Banking Management Directives and other breaches, including certain breaches of the Banking (Service to Customers) Law, the possibility of imposing civil fines for breaching various provisions of the Banking (Licensing) Law and breaches of various provisions of the Regulation of Engagement in Investment Counselling, Investment Marketing and Management of Investment Portfolios Law, and more.
- N. The laws include transitional provisions for the various amendments. So long as their entire holdings in provident funds and mutual funds have not been sold, the provisions of the Regulation of Engagement in Investment Counselling and Investment Portfolio Management Law, 1995 will apply to banking corporations, as they were prior to the amendments. However, with regard to counselling on provident funds for savings and personal provident funds for

severance pay, the said law will continue to apply until the earlier of either the end of three and a half years from the date the new legislation came into effect, that is 10 August 2005, or until the receipt of a pension counselling license.

### **The Team's Proposals regarding Underwriting Activity**

The team's recommendations included proposals to strengthen the restrictions on underwriting by corporations controlled by banks. On 12 February 2006, draft Securities (Underwriting) Regulations were published on the internet site of the Israel Securities Authority, the enactment of which, in the proposed form, would be likely significantly to damage the business activities of Leumi & Co. Underwriters Ltd., under its present control structure. The regulations require the approval of the Finance Committee of the Knesset before they become effective.

### **Regulation of Distribution Commissions**

On 26 February 2006, regulations were published in the Government Gazette ("Reshumot") regarding the payment of distribution commissions in respect of distribution of mutual funds and distribution commissions in respect of provident fund distribution. With regard to mutual funds, three levels of maximum rates of distribution commissions were determined, which are to be calculated in respect of the mutual fund units held through the distributor, according to type of mutual funds, being: 0.25% in respect of funds investing mainly in short-term, low risk investments, 0.8% in respect of funds investing mainly in equities and 0.4% in respect of other funds.

It was determined that a distributor will not be entitled to charge distribution commission in respect of mutual fund units as detailed below:

units purchased prior to the date when the regulations go into effect, except for mutual fund units that on 10 August 2005 were managed by a fund manager that was controlled at the time by the same distributor or by a company that controlled such distributor, and at the time of collection of the commission was managed by a fund manager who was connected to the distributor pursuant to a distribution agreement; units of a fund registered for trade on the Tel Aviv Stock Exchange; units purchased by portfolio managers on behalf of a customer whose portfolio is managed by it; although a distributor that does not have holdings in a corporation that is a mutual fund manager may charge distribution commission for units that were purchased by a portfolio manager controlled by the distributor on behalf of a customer of the portfolio manager.

In relation to provident funds, including supplementary training funds, and in relation to pension funds, the maximum distribution commission rate is 0.25% regarding new deposits made as from 1 January 2006, and 0.1% regarding deposits made up to and including 31 December 2005, excluding monies in a fund controlled by a banking corporation on 10 August 2005, and monies to be transferred, as from 1 April 2006, from a fund that was controlled by a banking corporation on 10 August 2005, to another fund. In both of these cases, monies deposited prior to 31 December 2005 will bear the maximum commission rate of 0.25%. The commission calculation will be made with regard to the value of the fund assets deposited, transferred or that remain in the fund following continuation of membership as a result of advice that will be given to the member, including profits accrued thereto, and in a provident fund for pension, the value of the assets standing against the obligations of the fund to the customer.

The regulations came into effect as from 1 April 2006.

### **Regulation of Operating Commissions**

In February 2006 the Supervisor of the Capital Market distributed a draft circular proposing restrictions on operating agreements between a pension counsellor and an institutional entity, including a maximum rate of commission of 0.1% for the provision of operating services to provident funds by a pension counsellor.

In addition, the proposed circular enables a management company acquired from a banking corporation, or that acquired a provident fund from such, to continue to provide various services through the banking corporation to members of a provident fund managed by it who are not included under the fund's operating agreement, and which are usually part of the service that the pension counsellor provides to its customers; and so long as the members are not receiving this service as part of the pension counselling given by the banking corporation, to pay commission for the above services at a maximum rate of 0.25% of the value of the total assets of the member managed by the fund.

According to the proposed circular, the above service and payment are to be laid down in an agreement between the management company and the banking corporation, and the agreement is to be presented for the approval of the Supervisor of the Capital Market, Insurance and Savings. Pursuant to the draft, the above arrangement will be in place for a limited period, namely, until the end of 2007, and it is proposed that the agreement lay down a mechanism to ensure that the management company does not pay for the service in respect of a member to whom the banking corporation does not intend providing pension counselling until the end of the above period or has not provided him in practice with pension counselling during such period. It is proposed that the management company not make the said payment to a banking corporation in respect of a member who received pension counselling from any pension counsellor, starting from the time of receipt of the counselling. On 21 March 2006, the Supervisor distributed an updated draft of the above circular, and gave notice that until the publication of a binding circular, he intends to approve agreements for the provision of services that comply with the conditions of the draft circular.

### **Actions taken by the Bank following the Legislation**

Following the legislation, the Bank has taken the following actions:

- On 15 September 2005 it was decided to sell the holdings in Leumi-Pia at a price of some NIS 535 million to Harel Insurance Investments Ltd., subject to the signature of an agreement between the parties and regulatory approvals.
- On 19 October 2005 the Bank sold its holdings in Direct Insurance – Financial Investments Ltd. to Tzur Shamir Holdings Ltd. at a price of some NIS 116 million.
- On 26 November 2005, the Bank decided to enter into agreements, together with Leumi Gemel Ltd., for the sale of the goodwill, activities, assets and liabilities relating to the provident funds managed by Leumi Gemel Ltd.

A group of five provident funds, the largest of which are the Otzma, Taoz and Rimon funds, and the investment activities of the provident funds, were sold to Harel Insurance Investments Ltd. at a price of NIS 675 million. The completion of the transaction is conditional upon the receipt of regulatory approvals and the signature of distribution and operating agreements. A group of ten provident funds, the largest of which are Sion, the Central Fund for Severance Pay, Tzur and Sagi were sold to A. Solomon Investments Ltd. (or a company under its control) at a price of some NIS 473 million. The completion of the transaction is conditional upon the receipt of regulatory approvals, and other conditions precedent on the fulfilment of which the Markstone Fund will become the controlling shareholder of A. Solomon Investments Ltd. The Leumi Group will continue to provide operating services in relation to all the provident funds that were sold, subject to the signing of operating agreements.

- On 28 November 2005, the Bank decided to enter into an agreement, together with Psagot Ofek Investment House Ltd. and its subsidiaries, including Psagot Managers of Mutual Funds - Leumi Ltd. (the "Psagot Ofek Group"), for the sale of the goodwill, activities, assets and liabilities relating to all the assets of the Psagot Ofek Group, with York Capital Management ("York") on behalf of entities managed by it, at the price of NIS 1,350 million. In addition, the Bank received an option to purchase from York half the means of control of the company that will manage the portfolio management

activities. The completion of the transaction is subject to receipt of regulatory approvals and other conditions precedent.

- Pursuant to the legislation, in March 2006 the Bank gave notice of a new commission to be charged in respect of holdings of customers in mutual funds, such being where there is no distribution agreement between the Bank and a fund manager, or where the customer does not agree to the Bank receiving distribution commission from the fund manager. With regard to managers of funds that were controlled by the Bank at the time of publication of the laws, the commission will be charged as of the date when such fund managers are no longer controlled by the Bank. The Bank has signed distribution agreements with the majority of the fund managers.
- On 26 May 2006, an agreement was signed between the Bank, Israel Discount Bank Ltd., Kahal Employees Supplementary Training Fund Ltd. ("Kahal"), Kahal Management of Study Funds (1996) Ltd. ("Kahal Management"), and between Migdal Capital Markets (1965) Ltd. on behalf of a company under its control and Migdal Insurance and Financial Holdings Ltd. on behalf of a company under its control (the "Purchaser"), for the sale of the goodwill, management rights, additional rights and means of control of the banks in Kahal, and for the sale of the goodwill, activities, assets and liabilities relating to the supplementary training funds managed by Kahal Management, for a consideration of NIS 260 million, to be adjusted in accordance with the volume of the supplementary training fund assets being sold as at the date of completion. The Bank's share of the consideration amount is NIS 149.5 million.

It has been agreed that the Bank will enter into an agreement with Kahal and the Purchaser to provide operating services to the funds sold, and also a distribution agreement, under which the Bank will distribute the funds.

Completion of the transaction is subject to the fulfillment of certain conditions and receipt of regulatory approvals.

- The Bank is examining, together with the employees' representatives, the preparations required for complying with the provisions of the permit given to the banks in the legislation, for the engagement in management of provident funds all the members of which are employees of the Bank or employees of a corporation controlled by it.
- The Bank is preparing to establish central funds for severance pay for its employees and employees of other Group companies.
- The Bank is examining the implications of the freedom of choice granted to employees with regard to provident funds, including freedom of movement between funds, on its liabilities towards employees on retirement.

### **Effect of the Reform on the Bank and the Group**

The reform will have a material effect on the Group's activities in the capital market. The Group has until now engaged both in managing assets on the capital market for the public, and in counselling, distribution and the provision of additional capital market services. Following the reform, the Group's activities in Israel will focus mainly on the provision of investment counselling, the provision of pension counselling (when the Bank receives a license to engage in such activities), the provision of operating services to entities active in the capital market, and additional activities.

The limits in the legislation, under which a banking corporation may not carry out marketing activities but only counselling (while other entities will be able to carry out marketing), the prohibition on holding material holdings in corporations which manage investment portfolios for institutional entities and the restrictions on carrying on pension counselling activities, will, in Management's estimation, lessen the ability of the Bank to compete in the most effective manner in the financial and pension markets.

Further, the disposal by the Bank of its holdings in mutual fund, provident fund and supplementary training fund management companies will cause a reduction in the Bank's current income from activity in these fields. On the other hand, the legislation allows, as mentioned above, the receipt of distribution commission from institutional entities, and the receipt of commission in respect of operating services to institutional entities, and these commissions will, to a partial extent, reduce the expected adverse effect.

The following table sets out details of income from management fees from mutual funds, provident funds and including supplementary training funds (in NIS millions):

	First Quarter		Year
	2006	2005	2005
From mutual funds	<b>118</b>	95	427
From provident funds	<b>54</b>	51	201
From supplementary training funds	<b>7</b>	7	32
<b>Total</b>	<b>179</b>	153	660

In the estimation of the Management of the Bank, based on the data and assumptions detailed below, in lieu of the income of the Bank and the Group arising from management fees as detailed above, which as of the completion of the disposal transactions will no longer arise, in 2006 the Bank may receive management fees, distribution commissions and commissions in respect of services to members, in amounts which will reduce the pre-tax profit by some NIS 176 million.

The bringing-forward/delay in the sale of all the mutual and provident funds by one month would reduce/increase Group profits by some NIS 20 million, before taxes.

The data and assumptions upon which the estimation is made are:

With regard to the first quarter of 2006, the actual income from mutual and provident funds, including supplementary training funds was taken into account.

With regard to the second quarter, an income estimate according to actual first quarter performance was used, since the sales have not yet been completed, with the exception of one company in relation to which only distribution commissions were taken into account. In the figures of the Annual Report, the calculation was made on the assumption that the sales would be completed by 31 March 2006.

With regard to the following quarters, the distribution commission and commission in respect of services to members were calculated as follows:

The calculation of distribution commission in respect of mutual funds is based on the balance of the holdings of customers of the Bank or the Group, as the case may be, as they were on 31 March 2006, and weighted commission rates, according to the types of the total fund assets managed by Leumi Pia and Psagot on 31 March 2006, without assuming any changes in the holdings, which might affect the amount of commissions to be received by the Bank, both due to changes in the classification of funds and to changes in the scope and make-up of customers' holdings.

The calculation of the distribution commission is based on the maximum rates determined in the regulations.

The calculation of the distribution commission in respect of provident funds also includes commission in respect of services to members that are usually part of the service provided by a pension counsellor, for as long as pension counselling is not provided. The calculation is also based on the balances of the holdings of members of provident funds managed by the Group, as they were as of 31 March 2006, assuming that the commissions will be paid on these total balances. It is clarified that if this assumption does not materialize, the decrease in pre-tax profit as detailed above will increase by up to some NIS 33 million. In addition, this calculation was made without any assumption as to changes in holdings, which might affect the amount of commissions that the Bank will receive.

Operating commission that the Bank may receive from operating services was not taken into account in the calculation, in light of the significant expenses involved in providing these services.

In the above amounts, the use that the Bank is likely to make of the consideration of the sales of holdings carried out in consequence of the legislation was not taken into account.

The transactions carried out by the Bank (with the exception of the sale of Direct Insurance which was completed in 2005) are expected to be completed during 2006, and consequently the Bank anticipates in 2006 capital gains of some NIS 2.0 billion.

In the Bank's assessment, in addition to the estimated decrease in income shown above, the implementation of the provisions of the legislation in their entirety is likely to have additional negative affects on the Group's business, the scope of which cannot at this stage be accurately evaluated, in light of the uncertainties which still exist with regard to various matters.

## **9. Changes in Mortality Tables**

In November 2005 the Supervisor of Banks announced that he was adopting the letter of the Chief Actuary of the Capital Market, Insurance and Savings Department at the Ministry of Finance to the insurance companies, pursuant whereto as from the first quarter of 2006 an insurer must assess the reserves for life insurance policies on the basis of the mortality tables as presented in the position paper sent by the Commissioner of Insurance for the observations of the insurance and pension fund companies in April 2005.

In the opinion of the Bank's actuary, in reliance on the revision of the mortality assumptions in accordance with the said position paper, for the purpose of assessing the actuarial liabilities, the Bank recorded an additional provision of NIS 136 million before taxes (some NIS 86 million after taxes) in the first quarter of 2006 to revise the pension and jubilee reserves.

## **10. A. Issue of Options to Employees**

On 2 February 2006, the Bank's General Meeting approved a plan for the issue of options to the Bank's employees and to various employees of the Leumi Group, as determined in the outline published by the Bank on 24 January 2006 (the "Outline"). In accordance with this program, on 14 February 2006, 84,853,960 options, exercisable into 84,853,960 ordinary shares of the Bank, were allotted. The said options are subject to all the terms of the Outline, including:

1. The options will be exercisable in two equal annual tranches, the first tranche at the end of two years from the date of the allotment of the options and the second tranche as from the end of the second year from the date of the allotment of the options and up to the end of the third year from the date of the allotment of the options.
2. The options were issued to the employees free of consideration.
3. The exercise price per share will be NIS 13.465 and will be linked to the CPI (commencing from September 2005). The price will be adjusted for the distribution of dividends (whose amounts will be linked to the CPI), bonus shares and the bonus element of rights issues, if such issues take place.

In respect of the issue of the said options, the Bank will record salary expenses in accordance with the fair value of the options with the addition of salaries tax and national insurance. This expense will be recorded in the Bank's Financial Statements over a period of two years from the date of allotment.

The estimate of the fair value of the options, as of the date of allotment, which was prepared by an external valuer in accordance with the Black & Scholes model, is some NIS 422 million. The calculation of the fair value is based upon the following principal criteria:

- standard deviation of the annual yield: 25%;
- risk free linked interest rate: 3.5%;
- price per share – the closing rate of NIS 17.30 per share on 14 February 2006;
- dividend distribution policy: 50% of the net profit;
- rate at which employees leave during the course of the vesting of the options: 2%;

The Bank received approval from the tax authority for the operation of the plan as a "plan for the allotment of shares by means of a trustee" within the context of section 102 of the Income Tax Ordinance, on the capital gains taxation path. The profit benefit portion (which will be considered to be income from work in the hands of the employees) at the time of the granting of the options is some NIS 368 million. In respect of this portion, the Bank will pay salary tax and national insurance contributions in the amount of some NIS 83 million, and as against this the Bank will save companies tax and profits tax in the amount of some NIS 163 million. This saving will be recorded in the Bank's books over the period of two years from the date of the allotment, in parallel with the recording of the expense. The amount of the expense in respect of the fair value will be recorded against capital account. In the first quarter of the year, the Bank recorded some NIS 40 million as salary expenses in the statement of profit and loss.

## **B. Sale of Shares to Employees**

In March 2006, agreement was reached with the Accountant-General regarding the offer of ordinary shares of the Bank by the State to the employees of the Bank, and this in accordance with the agreements in respect of the privatization of the Bank and decisions of the Finance Committee of the Knesset. According to the above agreement, the shares will be offered to the employees in two stages, in respect of the first of which, in which 2.873% of the share capital (40,630,905 shares) will be offered, an outline was published on 9 May 2006 (and amended on 10 and 25 May 2006). The second stage, in which a further 1% of the share capital will be offered, will be carried out after completion of the privatization process. The base purchase price per share was set at NIS 16.10 per share (the average price of the shares as agreed in the sale to Barnea). The shares will be offered to the employees at a discount of 25% below the base price, the price being linked to the CPI for September 2005 up to the date of exercise of the offer with the addition of interest of 2% per annum from 24 November 2005 (the "Exercise Price"). The Exercise Price will be adjusted for the dividend distribution on 28 February 2006 (NIS 0.78 per share).

The benefit granted to the employees in respect of the said purchase (according to the price per share on 25 May 2006) will be recorded as a salary expense in the sum of NIS 155 million against the capital account when the shares are allotted, which is expected to occur in the second quarter of 2006. In addition, there will be additional taxation costs of some NIS 57 million, with the overall cost to the Bank amounting to some NIS 212 million. In order to finance the purchase of the shares, the employees will be granted the right to receive loans, which will be repayable at the end of the lock-up period of the shares, which is four years. The loans will be linked to the CPI, will not bear interest and will not be granted on non-recourse conditions. The granting of the loans has been approved by the Supervisor of Banks, who noted in his approval that when determining the repayment terms, the Bank is requested to take into account the fact that approval will not be given for the extension of the repayment period of the loans beyond the end of the lock-up period. The maximum amount of the loans in respect of all of the shares being offered is estimated at some NIS 473 million and the actual amount of the loans will be deducted from the Bank's capital.

Further, total costs of NIS 69 million will be recorded in salary expenses in respect of the interest benefit related to the said loans.

The Bank has received from the tax authority draft confirmation that the provisions of section 102 of the Income Tax Ordinance will be applied to the program.

The above figures, including the price per share, are estimates only and the final figures will be determined on the date when the shares are transferred to the employees against payment.

**Net Interest Income Before Provision for Doubtful Debts (on a Consolidated Basis)  
Reported amounts (Unaudited)**

	For the three months ended 31 March	
	2006	2005
	(NIS millions)	
<b>A. Income on assets (a)</b>		
Credit to the public	3,820	2,352
Credit to governments	24	20
Deposits with Bank of Israel and cash	34	23
Deposits with banks	735	164
Debentures	1,035	579
<b>Total income on assets</b>	<b>5,648</b>	<b>3,138</b>
<b>B. Expenses on liabilities (a)</b>		
Deposits of the public	(3,816)	(1,381)
Deposits from governments	(32)	(35)
Deposits from Bank of Israel	(11)	(2)
Deposits from banks	(101)	(18)
Debentures, bonds and subordinated notes	(272)	(156)
<b>Total expense on liabilities</b>	<b>(4,232)</b>	<b>(1,592)</b>
<b>C. From derivative instruments and hedging activities</b>		
Ineffective portion of hedge relationships (b)	(8)	(7)
Net income (expenses) from ALM derivative instruments (c)	77	(147)
Net income from other derivative instruments	1	8
<b>Total income from derivative instruments and hedging activities</b>	<b>70</b>	<b>(146)</b>
<b>D. Other income and expenses</b>		
Financing commissions	69	61
Profit from sale of debentures available for sale, net	3	17
Profit (losses) realized and not yet realized in respect of fair value adjustments of trading debentures, net	(16)	19
Other financing income	131	89
Other financing expenses	(28)	6
<b>Total other income and expenses</b>	<b>159</b>	<b>192</b>
<b>Total net interest income before provision for doubtful debts</b>	<b>1,645</b>	<b>1,592</b>
<b>E. Detail of net effect of hedging derivative instruments on net interest income</b>		
Financing income (expenses) on assets	19	18
Financing income (expenses) on liabilities	(29)	(32)
<b>Including: net exchange rate linkage differences</b>	<b>3</b>	<b>(12)</b>

- (a) Including effective portion of hedge relationships.
- (b) Excluding effective portion of hedge relationships.
- (c) Derivative instruments that are included in the Bank's asset and liability management system which are not designated for hedging relationships.

**Provision for Doubtful Debts (on a Consolidated Basis)**  
**Reported amounts (Unaudited)**

	For the three months ended 31 March					
	2006			2005		
	Specific Provision (a)	Supplementary Provision (b)	Total	Specific Provision (a)	Supplementary Provision (b)	Total
(NIS millions)			(NIS millions)			
Balance of the provision at the beginning of the period	<b>8,212</b>	<b>1,040</b>	<b>9,252</b>	7,275	1,041	8,316
Provisions during the period	<b>416</b>	<b>36</b>	<b>452</b>	664	20	684
Decrease in provisions	<b>(235)</b>	<b>(2)</b>	<b>(237)</b>	(223)	(7)	(230)
Collection of past years' write-offs	<b>(14)</b>	-	<b>(14)</b>	(9)	-	(9)
Net amount charged to statement of profit and loss	<b>167</b>	<b>34</b>	<b>201</b>	432	13	445
Write-offs	<b>(42)</b>	-	<b>(42)</b>	(203)	-	(203)
Balance of provision at end of period	<b>(c) 8,337</b>	<b>1,074</b>	<b>9,411</b>	(c)7,504	1,054	8,558
Including balance of provision not deducted from credit to the public	<b>32</b>	<b>126</b>	<b>158</b>	36	130	166

- (a) Not including provision for interest in respect of the period after the loans were determined to be doubtful. With respect to loans in arrears for which a provision was established to the extent of the arrears, no accrual for interest was recorded thereon.
- (b) Including the general and special provision for doubtful debts.
- (c) The specific provisions according to the period of arrears are NIS 442 million on a consolidated basis (31 March 2005 – NIS 362 million).

**Assets and Liabilities Classified According to Linkage Basis (on a Consolidated Basis)  
as at 31 March 2006 (Unaudited)  
Reported amounts**

	Israeli currency		Foreign currency (a)			Non-monetary items (c)	Total
	Unlinked	Linked to the CPI	In U.S. dollars	In Euro	In other currencies		
<b>Assets</b>							
Cash and deposits with banks	4,512	470	21,479	4,571	4,536	-	35,568
Securities	13,843	3,366	22,035	5,930	645	2,546	48,365
Credit to the public (b)	63,165	52,438	45,158	5,558	10,879	386	177,584
Credit to governments	-	33	775	-	-	-	808
Investments in affiliated companies	9	-	-	-	-	1,246	1,255
Buildings and equipment	-	-	-	-	-	2,894	2,894
Other assets	1,539	25	2,309	445	1,007	1,200	6,525
<b>Total assets</b>	<b>83,068</b>	<b>56,332</b>	<b>91,756</b>	<b>16,504</b>	<b>17,067</b>	<b>8,272</b>	<b>272,999</b>
<b>Liabilities</b>							
Deposits of the public	78,731	33,136	80,042	18,271	10,936	691	221,807
Deposits from banks	653	1,223	1,438	433	676	-	4,423
Deposits from governments	489	1,015	652	16	1	-	2,173
Debentures, bonds and subordinated notes	773	11,775	4,159	182	-	-	16,889
Other liabilities	2,814	2,565	1,681	454	1,172	1,586	10,272
<b>Total liabilities</b>	<b>83,460</b>	<b>49,714</b>	<b>87,972</b>	<b>19,356</b>	<b>12,785</b>	<b>2,277</b>	<b>255,564</b>
Difference	(392)	6,618	3,784	(2,852)	4,282	5,995	17,435
<b>Effect of hedging derivative instruments:</b>							
Derivative instruments (excluding options)	-	-	87	(50)	(37)	-	-
<b>Effect of derivative instruments that are not hedging derivatives:</b>							
Derivative instruments (excluding options)	8,716	(3,502)	(4,412)	2,908	(3,710)	-	-
Options in the money, net (in terms of underlying asset)	186	-	5	(249)	58	-	-
Options out of the money, net (in terms of underlying asset)	(227)	(2)	66	224	(61)	-	-
<b>Total</b>	<b>8,283</b>	<b>3,114</b>	<b>(470)</b>	<b>(19)</b>	<b>532</b>	<b>5,995</b>	<b>17,435</b>
<b>Effect of derivative instruments that are not hedging derivatives:</b>							
Options in the money, net (discounted par value)	(68)	-	403	(402)	67	-	-
Options out of the money, net (discounted par value)	448	(9)	(545)	243	(137)	-	-

(a) Including linked to foreign currency.

(b) The general and supplementary provisions for doubtful debts have been deducted proportionately from the different linkage bases.

(c) Including derivative instruments that their basis is applicable for a non-monetary item.

**Assets and Liabilities Classified According to Linkage Basis (on a Consolidated Basis) (cont'd)**  
**as at 31 March 2005 (Unaudited)**  
**Reported amounts**

	Israeli currency		Foreign currency (a)			Non-monetary items (c)	Total
	Unlinked	Linked to the CPI	In U.S. dollars	In Euro	In other currencies		
<b>Assets</b>							
Cash and deposits with banks	5,820	526	15,826	5,537	3,624	-	31,333
Securities	14,744	3,140	21,289	2,661	799	2,059	44,692
Credit to the public (b)	55,145	51,430	46,228	5,314	10,725	79	168,921
Credit to governments	-	52	857	4	-	-	913
Investments in affiliated companies	-	-	-	-	-	1,843	1,843
Buildings and equipment	-	-	-	-	-	2,710	2,710
Other assets	1,976	35	2,215	431	780	1,056	6,493
<b>Total assets</b>	<b>77,685</b>	<b>55,183</b>	<b>86,415</b>	<b>13,947</b>	<b>15,928</b>	<b>7,747</b>	<b>256,905</b>
<b>Liabilities</b>							
Deposits of the public	77,921	36,456	(d) 68,760	(d) 16,695	(d) 10,065	212	210,109
Deposits from banks	760	2,255	(d) 1,829	347	(d) 795	-	5,986
Deposits from governments	625	1,155	1,278	11	1	-	3,070
Debentures, bonds and subordinated notes	121	8,766	3,575	211	-	-	12,673
Other liabilities	2,451	2,163	1,796	450	899	1,580	9,339
<b>Total liabilities</b>	<b>81,878</b>	<b>50,795</b>	<b>77,238</b>	<b>17,714</b>	<b>11,760</b>	<b>1,792</b>	<b>241,177</b>
<b>Difference</b>	<b>(4,193)</b>	<b>4,388</b>	<b>9,177</b>	<b>(3,767)</b>	<b>4,168</b>	<b>5,955</b>	<b>15,728</b>
<b>Effect of hedging derivative instruments:</b>							
Derivative instruments (excluding options)	-	-	66	(37)	(29)	-	-
<b>Effect of derivative instruments that are not hedging derivatives:</b>							
Derivative instruments (excluding options)	11,419	(1,903)	(9,517)	3,748	(3,747)	-	-
Options in the money, net (in terms of underlying asset)	(105)	-	(201)	259	47	-	-
Options out of the money, net (in terms of underlying asset)	146	-	22	(163)	(5)	-	-
<b>Total</b>	<b>7,267</b>	<b>2,485</b>	<b>(453)</b>	<b>40</b>	<b>434</b>	<b>5,955</b>	<b>15,728</b>
<b>Effect of derivative instruments that are not hedging derivatives:</b>							
Options in the money, net (discounted par value)	(245)	-	(221)	356	110	-	-
Options out of the money, net (discounted par value)	(330)	(3)	302	121	(90)	-	-

(a) Including linked to foreign currency.

(b) The general and supplementary provisions for doubtful debts have been deducted proportionately from the different linkage bases.

(c) Including derivative instruments that their basis is applicable for a non-monetary item.

(d) Reclassified

**Assets and Liabilities Classified According to Linkage Basis (on a Consolidated Basis) (cont'd)**  
**as at 31 December 2005 (Audited)**  
**Reported amounts**

	Israeli currency		Foreign currency (a)			Non-monetary items (c)	Total
	Unlinked (NIS millions)	Linked to the CPI	In U.S. dollars	In Euro	In other currencies		
<b>Assets</b>							
Cash and deposits with banks	5,863	507	19,331	5,559	4,121	-	35,381
Securities	15,440	1,842	22,423	5,332	828	1,960	47,825
Credit to the public (b)	62,289	52,569	47,550	4,663	10,110	74	177,255
Credit to governments	-	42	806	-	-	-	848
Investments in affiliated companies	9	-	-	-	-	2,055	2,064
Buildings and equipment	-	-	-	-	-	2,843	2,843
Other assets	1,537	9	2,511	401	1,140	1,010	6,608
<b>Total assets</b>	<b>85,138</b>	<b>54,969</b>	<b>92,621</b>	<b>15,955</b>	<b>16,199</b>	<b>7,942</b>	<b>272,824</b>
<b>Liabilities</b>							
Deposits of the public	81,777	33,783	78,376	16,603	10,991	298	221,828
Deposits from banks	517	1,345	1,356	452	677	-	4,347
Deposits from governments	430	1,062	721	11	1	-	2,225
Debentures, bonds and subordinated notes	762	11,720	4,606	165	-	-	17,253
Other liabilities	3,349	2,435	2,034	445	1,334	1,369	10,966
<b>Total liabilities</b>	<b>86,835</b>	<b>50,345</b>	<b>87,093</b>	<b>17,676</b>	<b>13,003</b>	<b>1,667</b>	<b>256,619</b>
<b>Difference</b>	<b>(1,697)</b>	<b>4,624</b>	<b>5,528</b>	<b>(1,721)</b>	<b>3,196</b>	<b>6,275</b>	<b>16,205</b>
<b>Effect of hedging derivative instruments:</b>							
Derivative instruments (excluding options)	-	-	86	(50)	(36)	-	-
<b>Effect of derivative instruments that are not hedging derivatives:</b>							
Derivative instruments (excluding options)	10,711	(3,453)	(5,990)	1,872	(3,140)	-	-
Options in the money, net (in terms of underlying asset)	(560)	265	152	(56)	199	-	-
Options out of the money, net (in terms of underlying asset)	(65)	(174)	209	56	(26)	-	-
<b>Total</b>	<b>8,389</b>	<b>1,262</b>	<b>(15)</b>	<b>101</b>	<b>193</b>	<b>6,275</b>	<b>16,205</b>
<b>Effect of derivative instruments that are not hedging derivatives:</b>							
Options in the money, net (discounted par value)	(1,033)	518	269	(47)	293	-	-
Options out of the money, net (discounted par value)	(146)	(526)	398	370	(96)	-	-

(a) Including linked to foreign currency.

(b) The general and supplementary provisions for doubtful debts have been deducted proportionately from the different linkage bases.

(c) Including derivative instruments that their basis is applicable for a non-monetary item.

**Information on activity by banking sectors**  
**Reported amounts**

Statement of profit and loss for the Three Months Ended 31 March 2006 (Unaudited)									
	Household banking	Private banking	Small business banking	Commercial banking	Corporate banking	Construction and real estate	Financial management	Other	Total consolidated
	(NIS millions)								
<b>Net interest income before provision for doubtful debts</b>	<b>519</b>	<b>92</b>	<b>209</b>	<b>279</b>	<b>390</b>	<b>167</b>	<b>(12)</b>	<b>1</b>	<b>1,645</b>
<b>Operating and other income:</b>									
From outside entities -	308	94	116	101	91	14	6	210	940
Intercompany operations -	133	8	(3)	-	(20)	-	-	(118)	-
Total	441	102	113	101	71	14	6	92	940
Total income	960	194	322	380	461	181	(6)	93	2,585
Provision for doubtful debts	101	-	9	29	8	51	3	-	201
Net profit (loss)	88	4	52	113	169	62	(131)	755	1,112

Statement of profit and loss for the Three Months Ended 31 March 2005 (Unaudited) (a)									
	Household banking	Private banking	Small business banking	Commercial banking	Corporate banking	Construction and real estate	Financial management	Other	Total consolidated
	(NIS millions)								
<b>Net interest income before provision for doubtful debts</b>	<b>453</b>	<b>70</b>	<b>187</b>	<b>250</b>	<b>338</b>	<b>150</b>	<b>140</b>	<b>4</b>	<b>1,592</b>
<b>Operating and other income:</b>									
From outside entities -	296	90	116	82	70	12	(4)	225	887
Intercompany operations -	115	7	(5)	4	(10)	-	-	(111)	-
Total	411	97	111	86	60	12	(4)	114	887
Total income	864	167	298	336	398	162	136	118	2,479
Provision for doubtful debts	37	-	6	60	241	102	(1)	-	445
Net profit	118	11	54	67	10	22	35	211	528

**Information on activity by banking sectors (cont'd)**  
**Reported amounts**

Statement of profit and loss for the Year Ended 31 December 2005 (Audited) (a)									
	Household banking	Private banking	Small business banking	Commercial banking	Corporate banking	Construction and real estate	Financial management	Other	Total consolidated
	(NIS millions)								
<b>Net interest income before provision for doubtful debts</b>	<b>1,877</b>	<b>317</b>	<b>779</b>	<b>1,036</b>	<b>1,569</b>	<b>650</b>	<b>354</b>	<b>46</b>	<b>6,628</b>
<b>Operating and other income:</b>									
From outside entities -	1,221	355	473	340	286	38	144	861	3,718
Intercompany operations -	504	29	(24)	14	(53)	-	-	(470)	-
<b>Total</b>	<b>1,725</b>	<b>384</b>	<b>449</b>	<b>354</b>	<b>233</b>	<b>38</b>	<b>144</b>	<b>391</b>	<b>3,718</b>
<b>Total income</b>	<b>3,602</b>	<b>701</b>	<b>1,228</b>	<b>1,390</b>	<b>1,802</b>	<b>688</b>	<b>498</b>	<b>437</b>	<b>10,346</b>
Provision for doubtful debts	172	2	75	188	818	157	14	-	1,426
<b>Net profit</b>	<b>466</b>	<b>28</b>	<b>172</b>	<b>330</b>	<b>226</b>	<b>251</b>	<b>129</b>	<b>534</b>	<b>2,136</b>

(a) Reclassified.