August 27, 2015

Tel-Aviv Stock Exchange
2 Ahuzat Bayit St.
Tel Aviv 6525216

Israel Securities Authority
22 Kanfei Nesharim St.
Jerusalem

Dear Sir/Madam,

Re: **Audit Report performed by the Banking Supervision in the matter of: Risk Exposure Management in U.S. customers' cross-border activity**

On the 27th of August 2015, the Banking Supervision Department of Bank of Israel ("Bank of Israel") forwarded to the Leumi Le'Israel Bank Ltd. ("the Bank") an audit report on the above-mentioned subject, further to the audit conducted at the Bank during the months October 2014 up to April 2015.

In accordance with the Bank of Israel's instructions, the Bank was required to publish a summary of the audit report in its immediate report, as per the text attached to this immediate report. Furthermore the Bank of Israel notified the Bank that it has no objection that the Bank publish a summary of its response to the audit report alongside the summary of the Audit report and therefore the summary of the Bank's response is also attached to this immediate report.

The audit report refers to the period between January 2007 and April 2011 and in any event does not include a reference to activities performed by the Bank starting from 2011, when the risk involved in conducting activity vis-a-vis US customers became apparent.

Sincerely yours,

Bank Leumi Le'Israel Ltd.
By:
Prof. Danny Tsiddon, Deputy CEO
Hanan Friedman, Legal Counsel.

Bank of Israel
Banking Supervision
Tel Aviv, 11th Elul 5775

August 26, 2015

S1405L08

A summary of the Banking Supervision's Audit Report on the subject of risk exposure management in cross-border activity of U.S. customers

1. **Background**
   1.1 Bank Leumi Le'Israel Ltd. (hereinafter – Bank Leumi or the Bank) conducted private banking operations through three banking centers in the global private banking division as well as through its Swiss and Luxembourg offices, which specialized in provisioning private banking services. The private banking business model is based, inter alia, on provisioning services to customers, including foreign residents, exhibiting considerable financial wealth. Among others, these services were provided to customers defined by U.S. law as U.S. taxpayers (hereinafter – U.S. customers).
   1.2 Main risks involved in cross-border activity emanate both from the aspect of provisioning financial services to foreign customers and from provisioning financial services in foreign jurisdictions. The risks include legal risks stemming from the clash between laws, risks emanating from non-proficiency in foreign law, risks involving regulatory directives relating to anti-money laundering, etc.
   1.3 Israeli law does not consist of an explicit legal provision that binds the banking corporation to comply with the provisions of foreign law. However, the banking laws in Israel obligate the banking corporation to proper business management which includes complying with the law and regulations. In this

regard, the breaching of foreign law relevant to the banking activity may be considered a breach of the obligation to ensure the banking corporation's proper management. Proper banking management obligates the banking corporation to identify, understand, manage, minimize and monitor all risks, including legal and goodwill risks on the Group level. This obligation also refers to the banking corporation's cross-border activity.

1.4 The legal and goodwill risks involved in cross-border activity rose considerably starting from 2008, particularly with respect to U.S. customers. From 2008, U.S. authorities enhanced the enforcement of tax laws applying to U.S. taxpayers that hold accounts in offshore banks and in this context also to banks and bankers that operate outside the U.S., which according to U.S. law help U.S. taxpayers to evade taxes. In February 2008 a committee of the U.S Senate decided to investigate offshore tax haven banks and in July 2008, the investigation report[1] was published, with emphasis on monies held offshore in Lichtenstein and Switzerland. During that same period, the U.S. authorities investigated the UBS under the suspicion of assistance to U.S. taxpayers in tax evasion. Starting from 2009, several U.S. initiatives were introduced aimed at discovering undeclared funds and these included thousands of U.S. taxpayers holding offshore accounts. In some cases, taxpayers submitted information on bankers that assisted them in tax evasion. During this period, information on the proceedings conducted by the U.S. authorities was made known and in this connection indictments were filed against foreign banks and their employees for their cooperation and assistance in deceiving the U.S. authorities in identifying, calculating, assessing and collecting tax. In February 2009, the Swiss supervision authority (FINMA) published its audit report on cross-border activity of UBS relating to U.S. customers and in addition published the agreement that was signed between UBS and the U.S. authorities, in which UBS admitted to violation of Title 18, United States Code, Section 371 and was fined the sum of $780 million. Further ahead there were reports of Swiss Banks, including UBS, and other banks, discontinuing operations with U.S. customers.

[1]Tax haven banks and U.S. tax compliance – United States Senate – 17.7.2008

1.5 Since 2008, the Bank has taken measures to reduce risk exposure associated with its activities with U.S. customers, mainly in aspects relating to securities, including taxation of securities and offshore accounts. The Bank obtained a legal advice from US lawyers which led to updating procedures in this area. In 2008, travel procedures of delegates to the United States were updated; in 2009 guidelines were set that prohibited the provisioning of security services to US customers by means of the U.S. media, the opening of offshore accounts was prohibited and it was decided to close existing offshore accounts and furthermore delegates' travel to the U.S. was discontinued.

In 2011 a comprehensive procedure was established for dealing with U.S. customers and in the years 2013-2014 the Bank promoted a policy of "white money" and "declared monies" in order to minimize exposure to foreign resident customers' cross-border activities.

1.6 On December 22, 2014, Bank Leumi signed agreements with the US Department of Justice and with the Department of Financial Services in New York, in which it admitted committing the offenses pursuant to Title 26, United States Code, Section 7206 (2), all in violation of Title 18, United States Code, Section 371. These agreements were signed in compliance with and subject to U.S. law. In the framework of these agreements as aforementioned, the Leumi group was fined a considerable amount totaling $400 million and as of the date of the audit, negotiations with the U.S. Securities Authority (SEC) have not yet concluded. The fine imposed also covered activities from 2002 until 2010-2011[2], even though it was only in 2008 that the U.S. authorities declared their plan to wage war against banks that assist customers' tax evasion. It should be noted that the agreement with the U.S. Justice Department does not apply to individuals and to corporations in the Leumi group that were not mentioned in the agreement.[3]

[2] The agreement with the U.S. Justice Department refers to the period 2002-2010 and the agreement with the Department of Financial Services in New York refers to the period 2002-2011.

[3] At the end of the introduction to the DPA, the following was written: "This Agreement does not apply to any individual or entity other than the Bank Leumi Group Entities a set forth herein".

1.7 The agreement which Bank Leumi signed with the U.S. Justice Department as aforementioned, includes a statement of facts document (hereinafter- statement of facts). The statement of facts shows that Bank Leumi and its offices in the U.S., Switzerland and Luxembourg as well as the Bank's trustee company in Israel, conducted activities, from 2000 (at the least) and until 2010 (at the least), that constituted according to U.S. law aid and assistance in preparing and presenting various false reports and documents to the U.S. tax authorities ("…to willfully aid and assist in the preparation and presentation of false income tax returns and other documents to the Internal Revenue Service of Treasury Department"[4] .

1.8 According to the statement of facts , Bank Leumi and its offices in Switzerland and Luxembourg offered a range of services and products to U.S. taxpayers, which assisted them in opening and managing undeclared accounts [5] and this included: 1) the issuance of bank guarantees such as Standby Letters of Credit (hereinafter – SBLC) which served as collateral for credit provisioned to customers in the U.S. office; 2) the use of offshore entities and trustee accounts[6] ; 3) the use of hold mail, code accounts (assumed name accounts) and numbered accounts; as well as 4) the opening and managing of accounts on behalf of U.S. customers that left UBS and other Swiss banks after news of the investigation being held by the U.S. authorities against UBS became known to the public.

1.9 Scope of activities of the Group and the Bank with US customers and their contribution to profitability were limited.

2. **Summary and Conclusions**

2.1 A banking corporation involved in cross-border activity with foreign customers needs to analyze , as a matter of routine , the foreign law relevant to its banking operations, to identify potential risks involved and to adjust its policy to ensuing changes.

[4] Section 11 of the Statement of Facts.

[5] An "undeclared account" is defined in the statement of facts as a financial account owned by an individual subject to US tax laws and conducted outside the United States, which was not reported on by the account holder to the U.S. authorities.

[6] Despite that trust accounts mentioned in the statement of facts as a tool that assisted in concealing assets, the quantitative annex serving as the basis for establishing the amount of the fine by the U.S. authorities did not include reference to Trust Account (Annex B) .

2.2 In view of the developments in the U.S. administration's and enforcement agencies' attitude since 2008 , Bank Leumi who conducted cross-border activities with U.S. customers was called to perform a mapping of the overall services and operations that it provisions to U.S. customers and to examine what constitutes in the view of authorities aid and assistance to tax evasion, in order to assess the risks, including the legal risk, involved in this activity, prevailing during the audited period, both on the corporate and Group levels and to take measures to reduce the risks as mentioned.

2.3 Starting from 2008 until 2011, the Bank identified and acted to minimize some of the increased risks given the developments as mentioned. However, the Bank did not conduct mapping and examination as mentioned in section 4.2 and therefore did not identify and did not evaluate the overall risks that later materialized and as a result did not monitor and did not manage these risks as required. The fact that the Bank's cross-border activity with U.S. customers is negligible and has a marginal contribution to the Bank's profitability, does not detract from its obligation to conduct a thorough process of risk management also when operations are minimal as mentioned, since also negligible operations may create high exposure to risk on the part of the Bank.

2.4 According to Israeli law a tax offense does not constitute a source offense as prescribed by the anti-money laundering law. However even when there is no obligation to audit and report tax issues, this does not release the Bank from its duty of proper risk management and to not allow its banking services to be exploited for the purpose of tax evasion through the Bank. This obligation particularly applies in relation to the Bank's U.S. customers, after the U.S. authorities waged war against tax evasion of U.S. taxpayers by holding offshore accounts.

2.5 Primarily responsible for the failure to re-examine the policy with regard to cross-border activities with US customers, the non-mapping of activities and services offered to U.S. customers

and for the lack of examination of what is considered in terms of the U.S. authorities assisting tax evasion, including by seeking legal opinion on the matte , given the developments described in section 1.5, are the CEO and Director of the Global Private Banking Division. In addition, until January 2010 the CEO and Director of the Division did not sufficiently inundate information on developments and changes in the risk level arising from these developments before the Board of Directors.

2.6 Chairman of the Board of Directors[7] did not require that management divulge more detailed information on the latest developments as provided in section 1.5 above and their impact on the Bank's activities and did not place the issue on the Board of Directors' agenda until January 2010.

2.7 The Board of Directors was satisfied with the reports given to them in connection with the CEO's reports and even when discussions were actually held in the Board of Directors' meetings, the Board did not demand that a mapping of all the activities and services provisioned by the Bank to U.S. customers be carried out and that the Bank examine what constitutes in the view of the U.S. authorities aid and assistance in tax evasion, including by requesting a legal opinion in order to identify, monitor and deal with increasing risks in the Bank's and the Group's cross-border activities with U.S. customers. In this context it should be noted that during the audited period the Board of Directors employed a legal advisor to the Board of Directors on a regular basis.

2.8 The Board of Directors and the CEO did not arrange for a proper control and independent framework of the overseas offices. The supervision and control function of the offices reported to the Global Private Banking Division which harmed the autonomy of this function and the effectiveness of its operations. This prevented the conducting of an independent process of identifying the risks associated with its activities with US customers, as well as assessments and recommendations to reduce the exposure of the Global Private Banking Division and the offices. The reports submitted to the Board on the risk of the offices' exposure as required by Section10 (a) (4) of the Proper Banking Management Directive No. 301 (on the basis of the directive that has been in effect since June 1998 forward) did not show the Board of Directors the development of risk exposure

involved in cross-border activity, in general, and with regard to U.S. customers, in particular.

[7]Chairman of the Board of Directors terminated his tenure in June 2010

2.9 The Global Private Banking Division's activities with U.S. customers during the years 2008-2010 included recruiting U.S. customers of Swiss banks and the provisioning of SBLC backed loans which were guaranteed by "back to back " deposits held in Israel, Switzerland and Luxembourg, without specifying the particulars of the applicant requesting guarantee, and escalated the risk of exposure from cross-border activities of U.S. customers. The provisioning of SBLC guarantees, to guarantee "back to back" deposits also exposed the Bank to money laundering risks.

2.10 Management did not timely nor entirely involve the gatekeepers. Subsequent to the reports on the UBS affair, the Global Private Banking Division issued updated guidelines based on consultations held with U.S. lawyers without involving the in-house legal advisors, who actually rendered advice on the subject of U.S. customers only in May 2009. In addition, the compliance department was not fully involved in discussions held between the compliance officer in the U.S. office and business personnel in the Global Private Banking Division on the subject of marking the details of the applicant requesting the guarantee on the banking guarantee documents issued by the Group for provisioning "back to back" credit in the U.S. office.

2.11 Due to the nature of things, the bonuses paid by the Bank to office holders who served during the investigation period and in particular to the Chairman of the Board, to the CEO and to the Director of the Global Private Banking Division, during the years the object of the fine, did not take into account the damage caused to the Bank; our position is, that it would be appropriate that the Bank determine an outline for recalculating the bonus monies paid.

2.12. An examination of the number of "back to back" transactions shows that the bank allegedly violated section 9 of the anti-money laundering order (identification , reporting and record-keeping obligations of banking corporations) 5761 - 2001 – regarding the reporting of activities that appear to be irregular.

3. **Requirements**

3.1. In view of the findings detailed above, the Bank is required, among others, to appoint an independent committee to conduct a process of learning lessons from the incident. The learning process will include, among others, an examination of senior management's and the Board's conduct during the years 2008-2010 and, due to the considerable damage caused to the Bank, determine an outline to recalculate bonus monies paid to office holders based on the committee's findings and in particular to the Chairman of the Board, the CEO and the Director of the Global Private Banking Division.

In this respect, the Board of Directors is entitled to appoint an independent committee. In addition, the report includes other requirements with regard to strengthening risk management, including policy, procedures and controls relating to topics raised in the report.

Summary of the Bank's Response to the Audit Report

1. The Bank of Israel's audit report focuses on the fact that the Bank did not identify in time and in any event did not timely respond to the risk that, in retrospect, turned out to be involved in activity vis-a-vis tax evading U.S. customers. Most of the criticism is that the Bank did not identify the risk also when the UBS affair was made known to the public in 2008.
2. Since 2008 already, and also before the banking system in Israel and in the world internalized the prevailing risk, once the Bank understood the change in policy, in regulation and in enforcement, the Bank began correcting the deficiencies, in areas where it understood that its actions need to undergo a change, and this also when there were no regulatory instructions on this subject. This fact stands out also in the arrangement reached by the Bank with the U.S. Justice Department and also appears in the report.
3. The audit report refers to the years 2007 until 2011 and in any event does not include the massive activity carried out starting from 2011 when the risk was understood.
   The report does not deal with the correction measures taken by the Bank, at its initiative and before regulatory instructions were enacted. The correction of deficiencies which deepened in 2011, was performed when the Bank gained insights not previously clear to it. The correction of deficiencies is expressed among others in: (a) a change of business policy and the discontinuation of activities that created exposure; (b) gradual and orderly exit from banking operations in countries where the risk of offenses of assisting customers in evading tax is high; (c) the Bank in Israel led the way in dealing with foreign resident customers' monies suspicious of not been declared to the relevant tax authorities (declared money policy) (d) the Bank's activity in interfacing subjects such as: activities that are not permitted in securities according to the law of the account holder's country of residence (cross border policy). Concurrently, the Bank acted opposite regulatory authorities in order to change rules in a manner that will facilitate the banking system to implement the declared money policy. In actual fact only in March 2015, the Banking supervision published for the first time regulatory instructions on this subject, providing banks with the tools to enforce statements by customers on the source of their monies.

4. This matter needs to be examined in a comprehensive context of norms according to which the entire banking system operated and which were well known to regulators in many countries. The insight of the global banking system and that of regulators was that the subject of customers reporting to tax authorities is the sole responsibility of the customer, and that this subject does not fall within the realm of their responsibility or the banks' involvement. This insight in Israel relies, among others, on the fact that the regulator decided (and has not yet changed his opinion on this subject) not to include tax offenses as source offenses in the anti-money laundering law. This insight even finds itself being supported over the years, in discussions in government offices. The subject of including tax offenses as source offenses in the anti-money laundering law has been raised time and again by policy makers, among others claiming, that these are undeclared funds of world Jewry, which Israeli governments have in past years fostered their deposit by the world Jewry in the Israeli banking system, in order to solidify Israel's economy.
5. The audit report reveals that there is no foundation to suspect that the Bank used irregular practices compared to the Israeli banking system. On the contrary, at a time when the Bank's change of policy resulted in the exit of undeclared monies of customers, other banks in Israel received some of these customers.
6. The report determines that the Bank did not understand the risk involved in activities opposite U.S. customers that exploit its services in order to evade tax, also when the UBS affair in 2008 was published. However, in examining the issues, the following facts should be taken into account:
    6.1 Bank Leumi was not the only one that did not understand in real time the risk involved in assisting U.S. customers in evading tax, but rather it was a misunderstanding that prevailed in most of the banking system and the regulatory system in Israel and around the world.
    6.2 During the period of reports on UBS, the services of a leading international law firm was hired who specializes in global financial regulations in order to analyze on the Bank's behalf the necessary conclusions to be reached. The mapping of the risks and the conclusions thereto did not include the subject of assistance to U.S. customers to evade tax. In other words,

also the lawyers whose services were hired did not understand the full extent of the risk, which as time passed actually materialized. The lawyers pointed to certain actions that need to be taken and the Bank carried these out in a short time schedule.

6.3 Additionally, the Bank received advice from another law firm, a well-known and leading firm in the U.S. that accompanies the Bank's business, as well as other financial institutions in Israel for many years. This law firm also submitted a list of recommendations to the Bank and the Bank swiftly and intentionally acted to carry out the changes as per the recommendations. Retrospectively and unfortunately for everyone, the recommendations were neither sufficient nor complete.

6.4 The various reports on the UBS affair focused on a number of actions, which the Bank understood as not being Bank Leumi's common practices. Therefore the prevailing understanding at the Bank, as well as of many other banks, was that the UBS affair is not relevant to the activities carried out in the Bank.

7. Besides the actions taken over the years, starting from 2008, the Bank not for a moment underestimated the severity of the outcome of the US customers' affair and did not attempt to brush off the issue without thorough handling of this matter and drawing the required conclusions. Among the actions taken by the Bank, worthy of note is that already in March 2015, the Bank appointed an independent committee, in order to examine the issue. Most members of the independent committee (three of the five) are external to the Bank. The committee is headed by the retired President of the Tel Aviv District Court, the Honorable Judge Uri Goren and also a member in the committee is the retired Senior Judge of the Jerusalem District Court - Judge Orit Efal-Gabai . Another member of the committee is Dr. Leah Paserman, a reputable expert on corporate law and securities.