Leumi

October 12, 2015

To
Stock Exchange
2 Ahuzat Bait St.
Tel Aviv 6525216

To
Securities Authority
22 Kanfei Nesharim St.
Jerusalem 95464

Dear Sir or Madame,

Re: **Report of the Non-Dependent Committee Appointed for Examination of the US Clients Affair**

Bank Leumi le-Israel Ltd. (**"the Bank**") is honored to report as follows:

1. On February 15, 2015, the Bank Board appointed a non-dependent claims Committee (hereinafter: **"the Committee"**) in order to examine the US Clients Affair and, in this respect, "to examine and recommend to the Bank Board as to the proper legal course of actions, considering all circumstances pertaining to the US Clients Affair".
   The Committee was headed by the former President of the Tel Aviv District Court, Justice (ret.) Uri Goren, and its other members were: the Hon. Justice of the Jerusalem District Court (ret.) Orit Efal-Gabbai; Dr. Leah Pesserman – Yozefov; Prof. Yedidia Stern (who serves as a director at the Bank); and Dr. Samer Haj-Yehia (who serves as a director at the Bank).
   For the sake of its activity, the Committee appointed a legal counsel on its own, who accompanied its work – Dr. Assaf Eckstein of Bar Ilan University.

2. On March 11, 2015, the Hon. Judge Haled Kabub, of the Tel Aviv District Court (Economic Department) decided to approve the appointment of the Committee and to suspend the claims submitted in connection with the US Clients Affair so that the Committee would be able to submit its recommendations.

3. On October 11, 2015, the Bank Board discussed the report submitted thereto by the Committee.

4. Below is a summary of the Committee's report, as included in the "Executive summary" chapter in the report submitted to the Board:

Executive Summary

From 2011 – 2014, Bank Leumi le-Israel Ltd. (hereinafter: **"the Bank"** or **"Bank Leumi"**) and its subsidiaries (hereinafter: "**the Subsidiaries**)" (the Bank and the Subsidiaries, hereinafter, collectively: "**the Group**") were investigated for allegedly assisting US clients to evade tax payments to the IRS (hereinafter: "**the US Clients Affair**"). The investigation was conducted by the US Department of Justice (hereinafter: "**DOJ**") and on the findings of the DOJ relied the New York Department of Financial Services (hereinafter: "**DFS**"). . On December 22, 2014, the Group, DOJ and DFS reached an agreement on agreed enforcement arrangements (hereinafter: "**the Agreed Arrangements**").

Pursuant to the Agreed Arrangements, the Group admitted assisting US clients evade taxes by forbidden use of products and various means (hereinafter: "**the Products**") including: Offshore accounts assisting US clients conceal their identity as beneficiaries of the accounts thereby evading the payment of taxes, as

required by law, in the US; opening accounts in the name of the Bank's trust company so as to add a layer of confidentiality and conceal the identity of US clients as beneficiaries of these accounts; grant of SBLC loans (back to back) where the information of the US clients is missing from the collateral documents issued by the Bank and the branches outside of the US to the US branch for securing the credit in this branch; providing Hold Mail services and coded/numbered accounts in order to mitigate the risk that the US authorities shall learn about the identity of the US tax payers holding undeclared accounts; and absorbing clients and assets of UBS Bank after an investigation was instituted against UBS Bank in 2008. In addition to admitting the use of the above products, the Group committed to pay the US authorities an aggregate amount of 400 million dollars.

Further to the investigations and the subsequent agreed arrangements, three shareholders in the Group filed various motions to approve derivative claims against the Group, office holders in the Group (most of whom had long since ended their tenure) and the Group's auditors. Two motions were filed with the Tel Aviv District court (the economic department) of which one motion was stricken *in limine* (an appeal was filed with the Supreme Court); an additional motion was filed with the New York State Supreme Court. Namely, there are two pending motions for derivative claims at present.

The Bank's Board has appointed us to act as an independent Committee to review the set of facts and legal status of the US Clients Affair and recommend for the Bank the best course of action to exhaust its rights, considering all circumstances arising from the affair. The target and purpose of the Committee throughout its entire work stages, was to **maximize the best interest of the Bank**. In order to better know the ways to achieve the best interests of the Bank under the circumstances, the Committee was required to perform an in –depth and broad factual analysis of the US Clients Affair, including **cross border activity** that took place in Israel, the US, Switzerland and Luxembourg, **during approximately one decade**. The Committee's work took seven months and included 36 hearings.

As part of its work, the Committee analyzed a huge volume of documents submitted by the Bank, by the representatives of the parties in the motions for derivative claims and by experts that assisted the Committee. In addition, the Committee heard, at the request of the Committee and at the request of various parties, interested parties and professionals, from Israel and abroad and petitioners and respondents - in person or through their representatives. Furthermore, the Committee was assisted, when necessary, by the law firm of Meitar, Liquornik, Geva, Leshem, Tal & Co and the chief legal advisor of the Bank. Finally, the Committee summoned to appear before it representatives of the compliance risk audit unit in the Bank of Israel, who led the audit that was held at the Bank in connection with the US Clients Affair during October 2014 - April 2015. These representatives have decided not to appear before the Committee. In addition, alongside with the investigation of the facts, the Committee was required to discuss legal issues arising in connection with the findings of the investigation of the facts. At all stages of its work, the Committee was assisted by Dr. Assaf Eckstein of Bar-Ilan University who served as permanent legal advisor to the Committee.

The examination conducted by the Committee focused on the Group's use of products, while emphasizing the period that began after the commencement of the open investigation against UBS bank (May 2008) concluding at the end of 2010. The special focus on this period was required in light of the fact that this period has been the center of gravity in the investigations conducted by the US authorities and the audit conducted by the Bank of Israel in Bank Leumi as described above.

At the conclusion of the examination, the Committee decided that the argument raised in the motions for the derivate claims, regarding **breach of fiduciary duty** by office holders at the Bank, should be rejected. The facts presented indicate that the office holders did not prefer their personal benefit over that of the Bank. However, the Committee concluded **there was a reasonable cause to** assume that the Bank office holders had breached **the prudence duty** imposed thereupon, and that **there was reasonable cause** to assume the

existence of **negligence** in the behavior of other officials at the Group. The reason stems primarily from the manner by which the Bank responded to the change in the global banking scene that had derived from the UBS affair. The impression of the Committee was that the Bank had not sufficiently studied the agreed arrangement concluded between the US authorities and the UBS Bank in February 2009. Therefore, the Bank's treatment of some of the products, the use of which turned out to be forbidden, was hesitant and lacking.

The possibility of a probable violation of the prudent duty by any of the office holders and the negligence of other officials of the Bank, prompted the Committee to examine the options for instituting a claim by the Bank against them. A potential impediment for such claims could be the exemption and indemnification arrangements established by the Bank. However, the Committee found that the system of exemptions established by the Bank does not necessarily cover the entire relevant period of the US Clients Affair, nor does it cover the entirety of liabilities that can be incurred by the office holders towards the Bank and its subsidiaries in respect of their activities in this affair in Israel and abroad.

Consequently, the Committee was required to decide whether to recommend that the Bank shall direct the claim against the office holders and other officials personally, or direct it to the insurance companies, to the extent that insurance policies cover the conduct in question. At the end of the day, the Board decided that the exhaustion of rights of the insured office holders through the insurance companies, is preferable for the following reasons: first, in addition to the fact that some potential defendants have an exemption, it is clear that the means at their disposal are limited not only with respect to damage caused to the Bank but also with respect to the possible amount to be collected from the insurance. Second, conducting legal proceedings against a relatively high number of office holders and officers of the Bank may damage the reputation of the Bank and the work relations between the Bank and its managers and employees and its future ability to recruit talented managers and employees. It appears that overall, both monetary considerations and overall considerations indicate that it is in the Bank's best interest to prefer addressing the insurers over the option of addressing potential defendants.

In view of the above, the Committee held intensive discussions with the insurers, at the end of which an offer was accepted from the insurers such that for a final and complete settlement of all claims in connection with the US Clients Affair, insurers shall pay the Bank a total of $ 92 million, depending on the insurance structure of the Bank's insurance policy. The insurance structure includes insurance provided by the Leumi Re Corporation, a subsidiary fully controlled by the Bank, which covers part of the insurance risk contained in the insurance policy, in the amount of $ 26 million, where the remaining liability is covered by commercial insurers.

Beyond the compensation provided to the Bank for the probable violation of duties of conduct of office holders and other officers in the Bank by the insurers under the insurance policy, and in order to maximize the best interest of the Bank even further, the Committee found it proper to discuss the grants given to three senior executives of the Bank for their performance in the relevant years of the US Clients Affair: Eitan Raff, who served as Chairman of the Board of Directors and during the relevant period served as the Chairman of the Board of Leumi USA (BLUSA); Galia Maor, who has served as the CEO of the Bank and in the relevant years served as the chairman of Leumi Switzerland ((Leumi Private Banking), and Zvi Itskovitch who served as the head of private and international banking division and served as the Chairman of the Board of Leumi Luxembourg and as a director of Leumi Switzerland.

The grants of the senior office holders in the Bank mainly derive from the return on the Group's equity, namely from the Group's profitability. Upon distributing the grants, the Group's profits were predicted to be higher than what they actually were, given that, in retrospect it turned out to be that alongside the profits generated in those years, the Bank was required to pay the US authorities for its activities during those years

a very high amount. Therefore, the Committee believed that it is proper to demand from the three senior executives referred herein to return part of the bonus amounts paid to them in the relevant years. Such restitution, which is in addition to the responsibility the insurers took on their behalf, is appropriate in the circumstances. Our position is that the ratio between the amounts of the restitution to be demanded from senior officials and the total grants received by the three senior executives during the relevant period, should be the same as the ratio between the damage caused to the Bank as a result of the arrangements that were signed with US authorities and the profitability achieved by the Bank during the relevant period.

The ratio between the amounts paid by the Bank in connection with the US Clients Affair and the Bank's total profit generated in the relevant period is approximately 11%. Based on the calculation forwarded to the Committee, the rate of 11% of the aggregate amount of the grants awarded to the three senior executives during the relevant period of the US Clients Affair (in terms of gross payments to executives), is approximately NIS 5.1 million (hereinafter: the "**Sum Required to be Returned**"). The three executives informed the Committee that they are willing to return the sum required,. so as to conclude their part in the affair.

Finally, the auditors of the Bank - Somekh Chaikin (KPMG) and Kost Forer Gabbay & (Ernst & Young) - serve in their positions for many years, including during the relevant years of the US Clients Affair. As part of its work, the Committee studied the audit functioning of the auditors. No adequate evidence was brought before the Committee that the auditors have taken independent tests following the reports about the UBS affair. These tests, had they been taken, would have allowed the auditors to warn the Bank in real time of the acts for which it is sued by the US authorities. The tight schedule of the Committee, would not allow it to deliberate thoroughly and entirely the set of facts regarding the functioning of auditors, as well as the normative framework applicable to auditors in these circumstances. Under these circumstances, we hoped that the auditors join the agreement formulating with the insurers and the three senior executives, so as to allow a fast and efficient completion of all procedures regarding the US client affair. However, the auditors have refused to be included in the arrangement. Instead, they proposed "to forward the discussion in the matter of auditors, including the completion of the argument and presenting their position to the audit Committee of the Bank".

Preferring the practical consideration of finality of proceedings in the US Clients Affair, we recommend to the Bank's Board of Directors to refrain from submitting a claim against the auditors, as this might, under the circumstances at hand, frustrate the finality of proceedings required, *inter alia*, in order to realize the arrangement with the insurers. However, we recommend to the Bank Board, whether by itself or through any of its Committees, to discuss the possibility that there were flaws in the work of the auditors, definitely before discussing an extension of the auditors' term. We believe that before the audit Committee solidifies a recommendation regarding the continued term of the auditors, first for the Bank Board and then for the general assembly of the Bank, it must consider the conduct of the auditors in the US Clients Affair and examine the steps that should be taken in light of the aforesaid.

Ultimately, the Committee was established in order to recommend to the Board of the Bank how to exhaust the rights of the Bank in relation to the US Clients Affair and its implications. The Committee recommends that the Board of Directors agree to the proposed arrangements;

- Proposed agreement with the insurers, under which the Bank shall receive from the insurers the amount of US $ 92,000,000 (equivalent to approximately NIS 360 million) for the settlement of possible range of the Bank's claims against office holders and other employees of the Bank, for violations of the duties of prudence and negligent conduct - respectively.

- Proposed agreement with three former executives in the Bank: Eitan Raff, Galia Maor and Zvi Itskovitch under which the Bank shall receive an aggregate amount of NIS 5.1 million for returning part of the grants awarded in the relevant period of the US Clients Affair.

5. Below are the conclusions and recommendations of the Committee, as written in the conclusions and recommendations chapter of the Committee report.

Conclusions and Recommendations of the Committee

The task of this Committee was defined by the Board of Directors of the Bank, in its decision of February 15, 2015, as follows:

> "The Claims Committee will examine the legal modus operandi, which the Bank should adopt in light of all the circumstances and proceedings relating to its clients who are assessed for tax in the United States ("**U.S. clients**"), this, inter alia, for the purpose of providing recommendations to the Board of Directors of the Bank on the question of whether the Bank is obliged to submit claims against office holders, employees and audit firms, and whether it should adopt other measures …
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> As part of its function, the Committee will examine, *inter alia*, the following questions:
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> Whether to submit, and on whose behalf, a lawsuit or monetary claims against any of the office holders and/or past or present employees of the Bank Group, in respect of damage incurred to the Bank because of the events which are the subject of the arrangements.
>
> Whether to strive for an arrangement or arrangements within the framework of pending proceedings in connection with clients of the Leumi Group who are assessed for tax in the United States, and if so – in whose name and under what conditions.
>
> Whether to submit, and on whose behalf, a lawsuit or monetary claims against any of the office holders and/or past or present employees of the Bank Group for the return of bonuses which were given on the basis of the profits which the Bank's corporations generated over the years from the clients in relation to which the Bank reached a settlement with the authorities in the United States".

In light of the definition of the Committee's function, as defined by the Board of Directors of the Bank, and as approved by the Hon. Justice Kabub of the Tel Aviv District Court (Economic Department) in his decision on March 11, 2015, this chapter of conclusions is limited only to the question of the existence of civil causes of the Bank towards any other entity and whether there are any grounds on the part of the Bank to act to realize them.

The defining fact at the basis of the Committee's work is the Bank's admission within the context of the proceedings conducted in the United States by the U.S. authorities (the DOJ and the DFS), in respect to offenses of assisting U.S. clients to evade tax in the United States. The upshot of this admission was the payment of an aggregate amount of US$ 400 by the Bank to the U.S. authorities.

It should be emphasized that the Bank's admission does not include an admission by office holders or employees of the Bank in committing the said offenses. According to U.S. law, it is possible to impose criminal liability on a corporation not only in respect of the actions of senior officials serving therein as office holders, but also in respect of actions of any of the junior employees of the corporation. In addition, liability can also be imposed in circumstances in which the necessary elements for the formulation of an offense (the *actus reus* and the *mens rea*) do not exist in any one person, but the combination of the elements

together which do exist among a number of individuals, and complement one another, set up a liability at the level of the corporation as a whole.

As is made clear from this, the Bank's admission to the U.S. authorities contains nothing in of itself to establish similar liability of any of the office holders in the Bank or of any of its other employees. Accordingly, the Committee is unable to place any personal responsibility on office holders or employees in the Bank as a consequence of the Bank's admission. Hence, the independent examination which we conducted in regards to the actions which may give rise to liability vis-à-vis the Bank, of office holders in the Bank or of the other employees, in respect of the damage incurred to the Bank in the US Clients Affair.

Corporate laws in Israel provide a normative framework of the principles of behavior to which office holders are subject, including a fiduciary duty and the prudence duty. We examined the existence of liability in respect of these duties and our findings are set forth below.

Fiduciary Duty:

The fiduciary duty of office holders is enshrined in Section 254 of the Companies Law, which provides as follows:

> "(a) Any office holder owes a fiduciary duty to the company, they must act in good faith and in the company's best interest, including –
>
> (1) Refrain from any action which involves a conflict of interests between fulfilling their function in the company and fulfilling any other function of his or her personal interests;
>
> (2) Refrain from any action which constitutes competition with the company's business;
>
> (3) Refrain from utilizing a business opportunity of the company in order to obtain a benefit for themselves or for others;
>
> (4) Reveal to the company any information and furnish it with any document relating to its interests which comes into their possession by virtue of their position in the company.
>
> (b) There is nothing in the provisions of sub-section (a) above to prevent the existence of a fiduciary duty of an office holder vis-à-vis another person."

The main point of the fiduciary duty is an office holder's obligation to place the interest of the company above any other interest, including his personal interest. An office holder is a representative who is supposed to use the powers with which he is charged for the good of the company, without any extraneous or personal consideration whatsoever affecting his utilization of these powers.

In our case, we did not find any evidence that the office holders and other officials in the Bank Group acted in the US Clients Affair against the Bank's interest, as they understood it, or with an intention to promote an extraneous or personal interest at the expense of the Bank's interests. From the array of facts which was set before us, and from the evidence which we examined, it appears that the officials in the Group acted in real time on the basis of business considerations, and without the knowledge that this activity could adversely affect the Bank, even though, in hindsight, it became apparent otherwise.

In the motions for derivative claims, the plaintiffs claim a breach of the fiduciary duty on the part of the office holders, originating in the fact that the amount of the bonuses granted to them is derived from the Bank's performance and these were influenced favorably by prohibited activity with U.S. clients.[1] As far as

[1] See: the claim by Beeri Lanuel, in paragraphs 22, 59, 60, 148 – 156. And see, in addition, a summary in the context of remuneration derived from the Bank's performance, in relation to most of the office holders which are the subject of the claim: *id.*, paragraphs 163 – 178.

the plaintiffs are concerned, this situation has created "among office holders a conflict of interests between fulfilling their function in Leumi Group […] and their personal interest (the salary, bonuses and remuneration that they receive, increase as a result of illegal activity of the Group and as a derivative therefrom)".[2]

Our opinion is different: As explained in Chapter E of this report, the Group's activity vis-à-vis the U.S. clients was minimal in relation to the activity of Group as a whole, and its impact on the return on capital achieved by the Group in the years relevant to the Committee's examination was negligible. In fact, the bonuses of the senior office holders were derived from the Group's total activity, according to the consolidated financial statements, where the activity vis-à-vis the U.S. clients did not constitute a material part of the Group's activity. Accordingly, we found that there was nothing in the bonuses awarded to the office holders and other officials in the Bank to influence them to act against the Bank and its interest.[3]

On the basis of the aforesaid, we did not find any contradiction between this finding of the absence of personal responsibility of office holders in respect of a breach of the fiduciary duty and the Bank's admission to the authorities in the United States.

Prudence Duty:

An additional question which arises in examining the U.S. clients Affair is whether the office holders in the Bank breached the Prudence duty which they owe to the Bank.

This obligation of office holders is provided in Section 252 of the Companies Law.

> **"(a) An office holder owes a duty of prudence to the company as stated in Sections 35 and 36 of the Torts Ordinance [New Version].**
>
> **(b) There is nothing in subsection (a) to prevent the fulfillment of the duty of prudence by an office holder towards another person."**

In this context, the office holder is obliged to ensure the means of prudence and level of skill in accordance with Section 253 of the Companies Law:

> **"An office holder must act with a level of skill with which a reasonable office holder would act, in the same position and under these circumstances, whereas he should adopt, in consideration of the circumstances, reasonable means to obtain information regarding the economic feasibility of an action which is brought for his approval or of an action which is carried out by him by virtue of his duty, and to obtain any other information which is important for the purpose the aforesaid actions."**

After considering the full range of facts which were presented to us, some of which were reviewed in Chapter 5 of this report and relevant provisions of the law, we found that there was a reasonable possibility that the activity of office holders in the Group, after the UBS affair, constituted a breach of the prudence duty.

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[2] See: the claim by Beeri Lanuel, in paragraph 153.

[3] This basic notion that personal interests "should not influence [managers in the company] or attract their minds from the company and its best interests" was expressed re Orig. Summons 100/52 **Jerusalem Industry Company Ltd. v. Egyon**, PD 6 887, 889 (1952). For discussion on this matter, see Licht, "Fiduciary relations in a corporation", **Business and Law** 18 237, 257-258 (2014).

The Committee cautioned itself against being caught in a wrong mindset of "being wise after the fact". The Bank's modus operandi with regard to the U.S. clients was not perceived as wrong by many banks, including central banks, throughout the world, which adopted similar operating practices on a much larger scale, as detailed in Chapter 6 above. In addition, the regulatory environment in Israel also had not, until recently, waved a red flag against these practices. Furthermore, the report published by the Bank of Israel as a result of the audit conducted by Bank Leumi in connection with the matter of the U.S. clients did not consider it appropriate to highlight any flaw in the Bank's conduct in the years that preceded the revelation and publication of the UBS affair.

Nevertheless, we believe that there is a reasonable possibility of negligence on the part of office holders in the Group. This negligence is primarily due to the way in which the Bank responded (or refrained from responding) to the change in the global banking scene, in the wake of the UBS affair. Our impression is that the lack of sufficient attention to the DPA which the U.S. authorities signed with UBS; the lack of thorough investigation of the possible significance to the Bank and the possible implications of this affair, and the way in which the Bank dealt with some of the activities which turned out eventually to be prohibited, and placed at the center of the DPA which was signed with it, was neither quick nor decisive enough, as detailed in Chapter D of this report.

Alongside the office holders, others among the employees of the Bank Group were supposed to take more rapid and/or decisive measures for a necessary correction. In this context, the relevant normative framework is from the realm of tort laws. Here, too, we find that there is a reasonable possibility that the action of some of the Bank's employees over the years was negligent.

The existence of a reasonable possibility of negligent conduct on part of any of the office holders or employees of the Bank, as mentioned above, led the Committee to clarify the possibility of a claim of the Bank against them. This examination led us to address the insurance, exemption, indemnification arrangements applicable in the Bank.

According to Section 258 of the Companies Law, a company is entitled to exempt an office holder from liability due to a breach of the prudence duty towards it. It is not entitled to grant an exemption as aforesaid due to a breach of fiduciary duty. The restrictions regarding the grant of an exemption do not apply to employees who do not come within the definition of an office holder. In addition, pursuant to Section 263 of the Companies Law, a company is entitled to insure the liability of an office holder therein or to indemnify them due to a breach of a the prudence duty or a breach of the fiduciary duty, provided the breach has occurred in good faith, with the office holder having reasonable grounds for assuming that the action would not adversely affect the company's interests.

As of 2004, the Bank exempted office holders from responsibility towards it. In addition, over the years relevant to the Committee's examination, the Bank acquired an insurance policy to cover the liability of directors and office holders (D&O policy), following the receipt of the required approvals for this according to the Companies Law (including the approval of the general assembly). The policy is a collective policy which covers the liability of directors and office holders in all of the corporations of the Bank Group, both in Israel and abroad. The policy is of a "claims made" type (a policy in which the basis of coverage is according to the date of submitting the claim and not according to the occurrence of the event). A report was forwarded to the insurers regarding potential exposure in 2011, immediately after the beginning of the investigation by the U.S. authorities, and accordingly, the relevant policy is that of the year 2011.

The amount of insurance (the coverage cap per claim) according to the relevant policy regarding the U.S. clients is US$ 250 million. Due to the wide scope of coverage according to the policy, and pursuant to practices forwarded to us which are customary in insuring banking institutions at such high levels, the

insurance structure is through "Captive". The Captive is a wholly owned subsidiary company of the Bank which is incorporated abroad and acts as an internal quasi-insurer for the Bank, to cover a variety of banking risks (such as: embezzlement and fraud, loss of bank documents, loss or theft of notes, etc.), including risks such as those connected with the liability of office holders. It should be noted that the establishment of a Captive is executed with the approval of the Bank of Israel. In addition, in accordance with information which is included in the financial statements of banks in Israel, an insurance structure by means of a Captive exists in at least one other major bank.

According to the policy structure, the Captive covers liabilities in various amounts which are determined in accordance with the amount of damage in respect of which the policy is activated, where the maximum sum payable by the Captive is approx.US$ 26 million (this, where the damage amounts to tens of millions of dollars). In addition to the coverage provided by the Captive, the risks covered within the framework of the policy are secured by means of re-insurers in a pyramidal structure, the details of which exceed the framework of this report. In the event of a verdict or a settlement in a derivative claim (a claim submitted on behalf of the Bank), a problematic situation is created in which the Captive, which is a subsidiary of the Bank, pays the Bank a part of the damage (up to US$ 26 million). The Committee was told that this problematic situation was corrected as a lesson from the claim which was examined as part of the Committee's work, and commencing with the policy acquired in 2015, the Captive does not bear any insurance risk in respect of coverage for the liability of office holders in the Bank Group.

It is important to emphasize that the coverage for the liability of office holders is an insurance in which the insured entities are the office holders and not the Bank. Consequently, when the policy is activated according to the conditions, payments that are payable by the insurers are on their behalf and in place of the office holders or as indemnification to the office holders after they have borne the payments.

Finally, pursuant to the terms of the policy, it covers the liability of office holders vis-à-vis third parties and vis-à-vis the Bank. However, this is only in cases in which the exemption documents granted to the office holders do not exempt them from responsibility vis-à-vis the Bank.[4]

The Committee found that the system of exemptions established by the Bank does not necessarily cover the whole period relevant to the US Clients Affair or the entire liabilities that the office holders may have towards the Bank and its subsidiaries in respect of their activity in this matter. In this context, we would refer to the fact that this is a question of actions which spread over a number of countries, which occurred over a period of some ten years, and in which several figures fulfilling varied roles within the Bank Group were involved (with some of the figures carrying out duplicate functions). Given all of the above, we considered that there are grounds to optimize the benefits emanating from the rights of the insured office holders towards the insurance.

Before the Committee formulated its recommendations, it summoned the representatives of the insurers (who are not the Captive) in order to hear their position as regards the possibility that the insurance would recognize the liability of the office holders and reduce part of the Bank's damages. The decision to summon the insurers arose from wide-ranging considerations relating to the Bank's interest. These considerations led to recognition of the fact that the management of prolonged proceedings against a relatively large number of office holders (some of whom may have an exemption, and some may not have the means to sufficiently alter the picture of the total damage) may adversely affect the Bank's best interest, its reputation, the labor relations in the Bank and the Bank's future ability to recruit talented managers.

[4] This is in light of the fact that in case of an exemption, there is no possibility of collecting monies from the office holders, and accordingly, the insurance policy has no damage incurred by the insured (the officer holders) that is indemnifiable.

Following an intensive process with insurers, a proposal was received from them that for a final and decisive settlement of all the claims in connection with the U.S. customers affair, the insurers will pay the Bank a total of US$ 92,000,000,[5] under conditions as set forth in the insurers' proposal herewith attached as Appendix B, and in accordance with the Bank's insurance structure. The insurance structure includes coverage provided by Leumi-Re, which is a subsidiary under the full control of the Bank, which covers part of the insurance risk in the policy, in the amount of US$ 26 million, with the balance of the obligation being covered by commercial insurers.

The Committee balanced the various relevant considerations and its conclusion is that the Bank's interest for now is in utilizing to the full its rights with the insurers. What does this mean? As explained in Chapter C of this report, the Bank's best interest dictated that the Bank weighs broad considerations. In the context of these considerations, the Committee found, among other things, that the management of legal proceedings is expected to take several years with the conduct of the Bank itself in past years being at the center of proceedings. Continued occupation with the U.S. customers' affair is liable to have an effect on the Bank's reputation. In addition, the Bank's adoption of legal measures against its employees in respect of actions which they believed that were carried out in the Bank's best interest and not understood by them or by those who were in charge of them as criminal at the time they carried them out – is liable to inhibit positive initiatives and the taking of reasonable business risks, which are part and parcel of the Bank's operation.

In view of the above, and notwithstanding the fact that the insurance proceeds do not really make good the full amount of the damage incurred by the Bank, the arrangement proposed by the insurance does contain the possibility to bring the U.S. customers' affair to a speedy, effective and economical conclusion which will free the Bank to deal with the challenges of the future. Even though the insurance amount covers only part of the damage incurred by the Bank, this is an unprecedented amount in claims of this type in Israel.

It is important to mention in this context that the insurance policy insures the office holders and in any case covers the other employees of the Bank as well, in respect of their liability vis-à-vis the Bank and/or third parties (and it is not a policy which covers the Bank itself). Therefore, a payment received as part of an arrangement with the insurers is a payment made on behalf and in lieu of office holders and employees in the Group. Thus, the Bank's right to sue office holders and employees due to possible negligence in actions or the lack thereof in connection with the US Clients Affair has been exhausted.

Return of bonuses:

Beyond the obligations of conduct prescribed in the Companies Law, to which the office holders in the Bank are subject, and in the best interests of the Bank, the Committee found it appropriate to discuss the bonuses awarded to three senior office holders in the Bank for their functioning in the relevant years: Eitan Raff who served as President and Chief Executive Officer, and in the relevant years served as Chairman of the Board of Directors of Bank Leumi USA; Galia Maor, who served as President and Chief Executive Officer and in the relevant years, as Chairman of Leumi Switzerland (Leumi Private Banking), and Zvi Itzkovitz, who served as Manager of the International Private Banking Division. The former two were at the head of the Group and Mr. Itzkovitz was, during the relevant period, at the head of the division in which the activity under discussion took place, and he served as a member of the board of directors of Leumi Switzerland and as the chairman of Leumi Luxembourg.

The bonuses of the senior office holders in the Bank are derived principally from the returns on the Group's capital, namely, from the Group's profitability. When awarding bonuses, the Group's profits were forecast to be high, but in actual fact, information not known at the time when the bonuses were approved by the Board of Directors, became apparent in retrospect, that along these profits, the Bank was required to pay over to

[5] Including the share of the Captive amounting to US$ 26 million.

U.S. authorities a very large sum which could change the picture. Accordingly, we considered it appropriate to require the three abovementioned senior officials to reimburse a part of the amount of the bonuses which were paid to them in the relevant years. Such a repayment, which is in addition to the liability placed on their behalf, is appropriate in the circumstances. Our position is that the repayment as aforesaid should reflect the relationship between the profits achieved by the Bank in the relevant transactions and the damage which transpired following the agreements the Bank signed with the U.S. authorities.

The potential causes for claim of the Bank have been exhausted in the arrangement with the insurers. This arrangement includes a condition set by the insurers for finality of all claims and proceedings in connection with the US Clients Affair and clarification that they would not pay the significant amount they had agreed to as part of the arrangement, without achieving finality of the various claims. In addition, since the insurance policy is for the office holders and not for the Bank, the insurers conditioned payment of the amount according to the arrangement upon the senior executives' consent and their wavier of any additional demand towards the insurers. Under these circumstances, the ability to demand restitution of significant amounts from the senior executives from the grants paid thereto, beyond those as determined, is limited. The Committee is of the opinion that there is great importance to determination of the principle of restitution of part of the grants paid in cases such as this, even though a condition of restitution was not included at the time of granting the bonuses to the senior executives.[6] Even though apparently the absolute amount of restitution is not high, then due to the overall considerations, especially the need to obtain finality for the realization of the arrangement with the insurers, and considering the amounts of grants received by the senior executives, the Committee believes that this is a proper and reasonable amount. The relationship between the amounts paid by the Bank in connection with the U.S. customers' affair and the total profit generated by the Bank in the relevant period is approximately 11%. The amount of the bonuses paid to the three office holders in the relevant period is some NIS 45.7 million (at the rate of the U.S. dollar at the date of each payment). Accordingly, the required amount of the repayment from the three senior officials is NIS 5.1 million. This amount constitutes approximately 22% of the net grants received by the senior executives and approximately 11% in gross terms. The calculation of the abovementioned amount which was prepared by Cognum Financial Consultation Ltd. (formerly Yitzhak Suari Ltd.) is herein attached as Appendix C.

The three senior officials have informed the Committee that, in order to finish the affair as far as they were concerned, they were willing to repay the amount required from the bonuses which they had received.

The auditors:

The Bank's auditors - Somech Chaikin (KPMG) and Kost, Forer Gabbai & Kassierer (Ernst & Young) – have served in their capacity for many years, including the years which are relevant to the U.S. customers' affair. These two firms audit the consolidated financial statements of the Bank Group, including the financial statements of the subsidiaries. Therefore, they are subject to the obligations in connection with the financial statements of the subsidiaries.

The Committee examined the possibility of claims against the independent auditors and also heard their representatives and received from them documents and presentations that includes an expert opinion. The auditors argued that their work was flawless.

In a professional review of the accounting and auditing standards which were presented to us, the claim arose that in view of an event of such a global scale as UBS, the auditors of the Bank should make a

[6] It is noted that Proper Banking Administration Regulation 301A, which deals with remuneration policy at a banking corporation, was only recently amended and now includes provisions, having future applications, regarding inclusion of a clause of restitution of grants, though only in extreme cases.

profound examination of whether the type of events and risks which exposed UBS to criminal proceedings and the payment of heavy fines in the United States, applied also to Bank Leumi, *mutatis mutandis*. It was argued that, within the framework of the aforesaid examination, the auditors should not settle for the general explanations of the Bank management, but rather, to investigate and delve into the matter thoroughly, including by obtaining independent opinions from experts in the field.

Despite their general argument that their work had been flawless, we were not presented with sufficient evidence that the auditors had properly examined the UBS affair following the publications, and its implications on the financial statements of the Bank and the subsidiaries, the statements of which had been consolidated with those of the Bank. It appears that the auditors sufficed themselves with general reliance on the understanding of office holders in the Bank, whereby the UBS was not relevant to Bank Leumi's and the subsidiaries' operations in view of the different way in which it operated, this, without the auditors conducting independent research into the question.

Due to the tight schedule the Committee was faced with when it became clear that there are many question marks requiring an examination of the auditors' liability, it was not possible to clarify the relevant factual situation in its entirety.

In these circumstances, we hoped that the auditors would see fit to join the emerging settlement with the insurers and with the three senior officials, in order to allow for a rapid and effective conclusion of all the proceedings. However, the auditors refused to take part in the settlement. Instead, they offered "to transfer the discussion on the matter of the auditors, including the completion of the plea and the presentation of their position to the Bank's Audit Committee".

The best interest of the Bank in the present circumstances is to conclude the proposed arrangement with the insurers, as part of which the Bank will receive US$ 92,000,000, a precedential amount in Israel, for the full and absolute discharge of all possible claims of the Bank due to the affair. Therefore, leaving the matter of the liability of the auditors outstanding will prevent the achievement of finality (as the auditors are likely to involve additional parties and office holders of the Bank in any claim against them, if at all), whereas finality is a condition the insurers placed in order to finalize the settlement agreement with the Bank. Thus, preferring the practical consideration, we recommend to the Bank Board to avoid submission of a claim against the auditors.

However, we do not believe that it is appropriate to shelve the question of the functioning of the auditors in this affair at this stage. We recommend that the Board of Directors, either itself or through any of its Committees, discuss the possibility of the existence of flaws which allegedly occurred in the work of the independent auditors, this, definitely before discussing the extension of the engagement with the independent auditors. We believe that before the Audit Committee formulates a recommendation for the Board of Directors of the Bank, and further, for the General Meeting of the Bank's Shareholders, regarding the continuation of the term of office of the independent auditors, it must take this matter into account and examine what measures should be adopted in view thereof.

Conclusion

In 2008, the U.S. authorities began adopting a stringent policy of enforcement of the U.S. tax laws and related legislation, and subjecting the global financial system to this policy. This step exposed a large number of banks throughout the world to claims without precedence in the previous years. Bank Leumi was one of the first 11 banks to which this policy change was implemented. The broad factual scene which became apparent in the course of the Committee's discussions revealed the tension between the commercial behavior which was generally acceptable and a legislative system which was forced upon it for the first time.

The practical consequence for Bank Leumi was the payment of an unprecedented sum of US$ 400 million to the U.S. authorities.

The Committee, the task of which was to recommend to the Board of Directors how to make the most of the Bank's rights, recommends it to accept the following arrangements:

The receipt of the sum of US$ 92,000,000 (which, as of the date of this report, is equivalent to NIS 360 million) from the insurance companies, for absolute and final settlement of all of the Bank's claims in respect of negligence of the office holders and employees in the Group.

The repayment of NIS 5.1 million from three senior office holders in the Bank in respect of the bonuses which were awarded to them in regard of the relevant period.

Two comments before the conclusion:

We would like to point out the extensive cooperation of the Bank with the Committee, which assisted its work in every possible way, including supplying all of the required information, giving the Committee access to experts from Israel and abroad, and throughout, strictly maintaining the Committee's independence. The Committee enjoyed the services of the Committee's legal advisor, Dr. Asaf Eckstein from Bar Ilan University.

The Committee thanks the Board of Directors of the Bank and Justice Khaled Kabub from the Tel Aviv District Court (Economic Department) for their trust in placing the discussion on the possible claims of the Bank in respect of the U.S. customers' affair in its hands. It should be noted that the uniqueness of the Committee is in its composition. Contrary to accepted practice until now in special litigation Committees in which the members of the Committee are members of the board of directors, in this case, most of the members of the Committee (three out of the five members) are not members of the Board of Directors of the Bank. At the head of the Committee is the former President of the Tel Aviv District Court, the Hon. Justice (ret.) Uri Goren and the members included Ret. Justice Orit Efal Gabbai and Dr. Leah Pesserman – Yozefov; those three are not members of the Bank's Board of Directors. A claims Committee of such composition is unprecedented in Israel.

6. **The Bank Board decided unanimously, at its meeting on October 11, 2015, to adopt the Committee report and the recommendations included in the report, in their entirety.**

7. The Bank intends to submit a notice regarding the Committee report to the Tel Aviv District Court, today, along with the Committee report, which spreads over 110 pages, and to request from the Court a relatively short period of time in order to reach specific arrangement with all relevant persons, to realize the Committee's recommendations and to submit to the Honorable Court a motion for approval of these arrangements..

Sincerely,

Bank Leumi le-Israel Ltd.

By:

Prof. Danny Zidon, Deputy CEO
Hanan Friedman, Legal Counsel