2016 Risk Management Report

This translation of the financial statement is for convenience purposes only.
The only binding version of the financial statement is the Hebrew version

This report includes additional information to the Bank's financial statements and is compiled in conformity with directives of the Supervisor of Banks, which include disclosure requirements of Basel Pillar 3 and additional disclosure requirements of the Financial Stability Board (FSB).

The following reports are available on ISA's MAGNA website: The periodic report, actuarial assessment with regard to employee rights at the Bank, this Risk Management Report and other supervisory information about supervisory capital instruments issued by the Bank.

In conformity with directives by the Supervisor of Banks, the financial statements, this Risk Report and other supervisory information are also available on the Bank's website:

www.mizrahi-tefahot.co.il >> financial reports.

Main Table of Contents

Scope	8
Summary risk profile for the Bank	10
Corporate governance for risks management at the Bank Group	16
Risks management tools	20
Risk culture	22
Regulatory capital	23
Regulatory capital structure	23
Capital adequacy	24
Additional information about capital adequacy	29
Leverage ratio	30
Credit risk	32
Credit risk management	32
Credit risk analysis	43
Credit risk using the standard approach	53
Counter-party credit risk	56
Market risk and interest risk	59
Market and interest risk management in the bank portfolio	59
Market risk analysis	66
Analysis of interest risk in bank portfolio	67
Operating risk	69
Operating risk management	69
Operating risk mitigation	71
Business continuity	72
Information security and cyber security	73
Information technology risk	74
Legal risk	74
Liquidity and financing risk	76
Management of liquidity and financing risk	76
Liquidity coverage ratio	78
Other risks	81
Compliance and regulatory risk	81
Cross-border risk	82
Prohibition of money laundering	83
Reputation risk	83
Strategic risk	84
Remuneration	86
Appendix – Composition of supervisory capital	91
Glossary and index of terms included in the Risk Management Report	102

General mapping of quantitative and qualitative information included in the Risks Management Report

This Risks Report includes disclosure requirements made by the Basel Committee in conjunction with Pillar 3 and other disclosure requirements, based on other sources, in conformity with directives and instructions of the Supervisor of Banks.

Below is a general mapping table which specifically identifies information not required in conjunction with Pillar 3, but which is based on other sources –

primarily disclosure requirements of the Financial Stability Board ("FSB"). The table also provides a mapping of tables (schedules) included in this report.

Chapter	Other disclosure requirements (primarily FSB requirements)[(1)]	Quantitative information provided in this chapter
Forward-Looking Information		
Scope		
Summary risk profile for the Bank		
Corporate governance for risks management at the Bank Group		
Risk culture	- Description of the risk culture at the Bank	
Regulatory capital		- Composition of supervisory capital
		- Capital components included on the Bank's consolidated balance sheet
	- Movement in supervisory capital	- Movement in supervisory capital
Capital adequacy	- Capital planning	
		- Risk assets and capital requirements with respect to credit risk by exposure group
		- Risk assets and capital requirements with respect to market risk and operating risk
		- Tier I equity and total capital, tier I equity ratio and total capital ratio
	- Risk assets by operating segment	- Risk assets by operating segment
	- Movement in risk assets	- Movement in risk assets
Leverage ratio		- Comparison of assets on balance sheet and exposure measurement for leverage
		- Composition of exposures and leverage ratio
Credit risk		- Composition of credit exposure by exposure group
		- Composition of exposures by geographic region
		- Composition of credit exposures by contractual term to maturity
		- Impaired credit risk and credit risk for

Chapter	Other disclosure requirements (primarily FSB requirements)[1]	Quantitative information provided in this chapter
		credit in arrears but not impaired
		- Change in balance of provision for credit losses
		- Credit exposures before and after credit risk mitigation by risk weighting
		- Credit exposures by risk mitigation type
		- Credit exposure with respect to derivatives
Market risk and interest risk		- Capital requirements with respect to interest risk, equity risk and foreign currency exchange rate risk
	- Description of market risk to which the Bank is exposed	
	- Market risk management policy	
	- Means of supervision over and implementation of market risk policy	
	- Measurement of market and credit risk exposure and their management using models for risks management	
	- Nature of interest risk in Bank portfolio	
Operating risk		
Liquidity and financing risk		- Liquidity coverage ratio
	- Financing risk	
	- Description of the Bank's liquidity requirements	
Shares		- Fair value of investments in shares and capital requirements with respect there to
Other risks	- Description of other key risks	
Remuneration	- Details of remuneration of interested parties and senior officers	
		- Quantitative data for variable remuneration
		- Additional information about remuneration amount for the reported year

(1) All other information in this chapter is in conformity with disclosure requirements in conjunction with Basel Pillar 3.

Risks Report

This risks report includes additional information to the consolidated financial statements of Bank Mizrahi Tefahot Ltd. and its subsidiaries as of December 31, 2016. The financial statements and additional information to the financial statements, including the Report of the Board of Directors and Management, this Risk Management Report and other supervisory disclosures have been approved for publication by the Bank's Board of Directors at its meeting held on March 20, 2017.

The Risks Report and other supervisory disclosures are compiled in conformity with directives of the Supervisor of Banks, which include disclosure requirements of Basel Pillar 3 and other disclosure requirements of the Financial Stability Board (FSB).

All of these reports are also available on the Bank's website.

www.mizrahi-tefahot.co.il >> financial reports.

The disclosure in this report is designed to allow users to evaluate significant information included with regard to implementation of the framework for capital measurement and adequacy and to implementation of provisions of "Basel III: A global regulatory framework for more resilient banks and banking systems".

As directed by the Supervisor of Banks, additional information with regard to risk is provided in the Report of the Board of Directors and Management, in the following chapters:

– Chapter "Overview, targets and strategy" / major risks
– Chapter "Explanation and analysis of results and business standing" / risk events
– Chapter "Risks Overview"

Moshe Vidman	**Eldad Fresher**	**Doron Klauzner**
Chairman of the Board of Directors	President & CEO	Vice-president, Chief Risks Officer (CRO)

Approval date:
RAMAT GAN, March 20, 2017

Forward-Looking Information

Some of the information in the Risk Management Report, which does not relate to historical facts, constitutes “forward-looking information”, as defined in the Securities Law, 1968 (hereinafter: “the Law”).

Actual Bank results may materially differ from those provided in the forward-looking information due to multiple factors including, inter alia, changes in local and global capital markets, macro-economic changes, geo-political changes, changes in legislation and regulation and other changes outside the Bank's control, which may result in non-materialization of estimates and/or in changes to business plans.

Forward-looking information is characterized by the use of certain words or phrases, such as: "we believe", "expected", "forecasted", "estimating", "intending", "planning", "readying", "could change" and similar expressions, in addition to nouns, such as: "plan", "goals", "desire", "need", "could", "will be". These forward-looking information and expressions involve risks and lack of certainty, because they are based on current assessments by the Bank of future events which includes, inter alia: Forecasts of economic developments in Israel and worldwide, especially the state of the economy, including the effect of macroeconomic and geopolitical conditions; changes and developments in the inter-currency markets and the capital markets, and other factors affecting the exposure to financial risks, changes in the financial strength of borrowers, the public’s preferences, legislation, supervisory regulations, the behavior of competitors, aspects related to the Bank’s image, technological developments and human resources issues.

The information presented here relies, inter alia, on publications of the Central Bureau of Statistics and the Ministry of Finance, on data from the Bank of Israel data, the Ministry of Housing and others who issue data and assessments with regard to the capital market in Israel and overseas as well as forecasts and future assessments on various topics, so that there is a possibility that events or developments predicted to be reasonable would not material, in whole or in part.

Scope

The application scope refers to how the working framework specified by the Basel Committee for measurement and capital adequacy is applied, as well as other requirements specified by the Committee with regard to leverage ratio and liquidity coverage ratio.

Provisions of Proper Banking Conduct Directives 201-211 "Measurement and Capital Adequacy" apply to the Bank Group and in particular to the Bank – Bank Mizrahi Tefahot Ltd. – the parent company of the Group. Group companies to which the framework applies, in accordance with the supervisory consolidation basis, are the companies consolidated with the Bank's consolidated financial statements. There are no differences in the consolidation basis between accounting practices and the work framework.

Below are major Bank Group companies, how they are weighted and their lines of business:

	Operating sector
1) Fully-consolidated subsidiary	
Bank Yahav for Government Employees Ltd.	Commercial bank
Tefahot Insurance Agency (1989) Ltd.	Insurance agency
Mizrahi International Holding Company Ltd. (B.V. Holland)	International holding company
Etgar Investment Portfolio Management Company of the Mizrahi Tefahot Group Ltd.	Portfolio management company
Mizrahi Tefahot Issue Company Ltd.	Issuance company
Mizrahi Tefahot Trust Company Ltd.	Trust company
2) Associates (weighted by risk)	
Psagot Jerusalem Ltd. (“Psagot”)	Land for construction
Rosario Capital Ltd. ("Rosario")	Underwriting company
Mustang Mezzanine Fund Limited Partnership	Extending credit
Planus Technology Fund	Extending credit
3) Major subsidiary of a subsidiary (United Mizrahi Overseas International Holding Ltd. (BV Holland))	
United Mizrahi Bank (Switzerland) Ltd.	Commercial bank

To the best of the knowledge of Bank management, and relying on legal counsel, there are no prohibitions or significant restrictions on transfer of funds or supervisory capital between Bank Group companies.

Basel and capital requirements

The Basel Committee is an international body established in 1974 by the central banks of different countries. The Committee's decisions and recommendations, although they have no binding legal validity, prescribe the supervisory regulations acceptable to the supervisory bodies of the banking systems in a majority of countries throughout the world. On June 26, 2004, the Basel Committee published recommendations intended to assure proper regulation for arranging the rules of capital adequacy of banks in different countries (hereinafter: "Basel II"). These directives are governed in Israel by Proper Banking Conduct Directives 201-211. These directives are designed to address failures discovered in management and risk control processes during the global financial crisis, the Sub Prime crisis, which took place at the end of the first decade of this century. The directives include a set of amendments to the Basel II directive, including: Strengthening of capital base, Tier I capital, which is the primary loss absorption component, increase in minimum capital ratios, specification of new benchmarks and methodologies for handling liquidity risk, including the liquidity ratio under stress for one month (CCR) and Net Stable Funding Ratio (NSFR), reinforced methodology for handling counter-party risk (including capital allocation for this risk as part of Pillar 1), specification of the leverage ratio as a new ratio as part of risk management benchmarks, reinforcing processes for conducting stress testing and other processes designed to improve risks management and control capacity at financial institutions. According to the Committee-specified schedule, this directive would be gradually applied world-wide starting in 2013. Most of the Proper Banking Conduct Directive (201-211) were amended in 2013 in conformity with the Basel III directives and are applied as from January 1, 2014 (for more information see chapter "Capital Adequacy").

Key recommendations of the Basel Committee

The Basel directives consist of three pillars:

Pillar 1 – minimum capital – minimum capital allocation requirements with respect to market risk, credit risk and operating risk. Pursuant to the Supervisor of Banks' directives, capital allocations in Pillar 1 are calculated using statistical models specified in the directive.

Pillar 2 – Supervision and control process over capital adequacy – the Internal Capital Adequacy Assessment Process (ICAAP) conducted by the Bank, as well as the Supervisory Review and Evaluation Process (SREP) conducted by the Bank of Israel, designed to review the process and capital allocation conducted by the Bank. These processes are designed to ensure that the bank's total capital is in line with its risk profile, specified capital targets and its business targets according to the strategic plan, beyond the minimum capital requirements which the Bank should hold according to Pillar 1. This pillar also includes qualitative reviews of risk management processes, risk control and corporate governance related to risk management at the Bank.

Pillar 3 – "market discipline" – reporting and disclosure to the regulating authority and to the public. In this context, extensive, detailed and in-depth disclosure is provided with regard to the risk level and risk management processes at the Bank, so as to allow the public to better understand the risks, how they are managed and the capital buffer maintained by the Bank with respect there to.

The Bank applies these requirements and other disclosure requirements as noted in this Risk Report.

Summary risk profile for the Bank

Key data

Below is key data relevant for the Bank risk profile:

	2016	2015	2014	2013	2012
Key financial ratios (in percent), annual					
Performance benchmarks					
Net profit return on equity(1)	10.2	10.0	10.6	11.8	13.0
Net profit return on risk assets(2)	0.97	0.89	0.91	0.98	1.01
Ratio of Tier I capital to risk elements	10.10	9.50	9.05	8.94	8.55
Leverage ratio(3)	5.27	5.32	–	–	–
(Quarterly) liquidity coverage ratio(4)	117	91	–	–	–
Credit quality benchmarks					
Ratio of provision for credit losses to total loans to the public	0.83	0.87	0.90	0.94	1.22
Ratio of impaired debt or debt in arrears 90 days or longer to total loans to the public	0.98	1.14	1.20	1.70	2.55

Key data for 2016 show:

- In 2016, net profit return increased compared to 2015, to reach 10.2%.
  Return over the past 5 years was in double digits, given a 46% increase in capital (NIS 12.7 billion in 2016, compared to NIS 8.7 billion in 2012).
- The Bank is compliant with regulatory targets required for capital adequacy, liquidity and leverage.
- Credit quality benchmarks continue to improve, showing a low level of problematic debt and credit losses.

Items of profit and loss, balance sheet items and various financial ratios are analyzed in detail in the Report of the Board of Directors and Management, in chapter "Explanation and analysis of results and business standing" and in chapter "Risks overview", as the case may be.

(1) Net profit attributable to shareholders of the Bank.
(2) Net profit to average risk assets.
(3) Leverage Ratio – ratio of Tier I capital,(according to Basel rules) to total exposure. This ratio is calculated in conformity with Proper Banking Conduct Directive 218
(4) Liquidity Coverage Ratio – ratio of total High-Quality Liquid Assets to net cash outflow. This ratio is calculated in conformity with Proper Banking Conduct Directive 221, in terms of simple averages of daily observations during the reported quarter.

Below is capital for calculation of capital ratio after supervisory adjustments and deductions:

	December 31, 2016	December 31, 2015
Tier I capital	13,318	12,299
Tier II capital	4,888	4,916
Total capital	18,206	17,215

Total credit risk to the public[(1)]:

	December 31, 2016	December 31, 2015
Total credit risk to the public	252,489	217,469

(1) For more information about total credit risk to the public, see the chapter "Risk overview" in the Report by the Board of Directors and Management.

Risk assets and capital requirements with respect to credit risk, market risk, CVA risk[(3)] and operating risk are as follows (NIS in millions):

	December 31, 2016		December 31, 2015	
	Weighted risk asset balances	Capital requirement[(1)]	Weighted risk asset balances	Capital requirement[(2)]
Credit risk	121,969	16,173	120,136	15,377
Market risk	1,184	157	950	122
CVA risk with respect to derivatives[(3)]	636	84	657	84
Operating risk	8,113	1,076	7,743	991
Total risk assets	131,902	17,490	129,486	16,574

(1) The capital requirement was calculated at 13.26% of risk asset balances.

(2) The capital requirement was calculated at 12.80% of risk asset balances.

(3) Credit Value Adjustments – mark to market with respect to credit risk of counter-party, in conformity with Basel III provisions.

The change in risk assets in 2016 was primarily due to growth of the Bank's credit portfolio with respect to housing loans, due to continued increase in origination of housing loans. Furthermore, increased Bank business in the household segment and among micro, small and medium business clients resulted in increase in risk assets due to retail exposures.

Risk assessment

In its operations, the Bank is exposed to a succession of risks which may potentially impact its financial results and Bank reputation. These include financial risks, such as: credit risk and market risk, as well as non-financial risks, such as: compliance risk, operating, legal, reputation risks etc.

Risk is managed at the Bank using a uniform methodology and from a comprehensive viewpoint, in order to support achieving of the Group's strategic targets, while maintaining a risk profile in line with the risk appetite specified by the Bank and in conformity with regulatory requirements.

The Bank maps the key risks factors to which the Group is exposed and their potential impact on business operations over the coming year and appoints a Bank executive as risk owner for each risk.

The table below lists the risk factors and management assessment of the impact of each risk factor, on a scale of five severity levels: low, low-medium, medium, medium-high, high.

The Bank has defined the severity levels: low, medium and high based on the potential impact to Bank capital.

The risk level for each risk is assessed based on the outcome of monitoring the various quantitative risk benchmarks specified by the Bank, including the direction of their development over the past year, as well as based on a qualitative assessment of risks management and the effectiveness of control circles, in coordination with the ICAAP process conducted by the Bank and the results thereof.

As part of these processes, the Bank reviews the top risks, existing (or new) risks which may materialize over the coming 12 months which potentially may materially impact the Bank's financial results and stability, primarily credit risk and market risk. The Bank also identifies emerging risks, which may materialize over the longer term and subject to uncertainty with regard to their nature and impact on the organization. Among these risks are information security and cyber risk, IT risk, reputation risk and the group of compliance risks, including conduct risk, which is addressed within this framework.

Below is a mapping of risk factors, their potential impact on the Bank Group and executives appointed Risk Owners for each risk factor:

Risk factor[1]	Risk factor impact	Risk Owner
Overall effect of credit risk	Low-medium	Manager, Business Division
Risk from quality of borrowers and collateral	Low-medium	
Risk from industry concentration	Low-medium	
Risk from concentration of borrowers/ borrower groups	Low	
Risk with respect to mortgage portfolio	Low	
Overall effect of market risk	Low-medium	Manager, Financial Division
Interest risk	Low-medium	
Inflation risk	Low-medium	
Exchange rate risk	Low	
Share price risk	Low	
Liquidity risk	Low-medium	Manager, Financial Division
Overall effect of operating risk	Intermediate	Manager, Risks Control Division
Cyber and information security	Intermediate	Manager, Risks Control Division
Information technology risk	Intermediate	Manager, Mizrahi-Tefahot Technology Division Ltd.
Legal risk	Low-medium	Chief Legal Counsel
Compliance and regulatory risk	Intermediate	Manager, Risks Control Division
AML and cross-border risk	Low-medium	Manager, Risk Control Division
Reputation risk[2]	Low	Manager, Marketing, Promotion and Business Development Division
Strategic-business risk	Low	President & CEO

(1) Assessment of the effect of the aforementioned risk factors takes into account the risks associated with the US DOJ inquiry as well as all action taken by the Bank to defend its position with regard to that inquiry. For more information about the US DOJ inquiry with regard to Bank Group business with its US clients and for more information about a motion for approval of a derivative claim and motion for approval of a class action lawsuit on this matter, see Notes 26.C.10.J, 26.C.11.A and 26.C.12 to the financial statements.

(2) The risk of impairment of the Bank's results due to negative reports about the Bank.

Major developments in the Bank's risk profile

Review of the Bank's risk profile, as indicated by the risk documents and outcome of the ICAAP process, as well as analysis of the Bank's balance sheet resilience and key financial ratios under the uniform stress scenario specified by the Bank of Israel, indicate that the Bank's risk profile, at the end of 2016, is relatively low; the potential loss due to unexpected events, relative to the Bank's capital and profits, is low; Bank profitability is stable, i.e. the volatility of profitability is low; and the capital cushion available to the Bank is satisfactory under stress scenarios as well. These results are similar to the results in 2015.

The Bank's most recent capital planning, submitted to the Bank of Israel in January 2017, shows that the Bank has sufficient capital to achieve its total capital targets, including the core capital target specified for the most extreme stress test ("threat test", which is conducted under severe assumptions with regard to potential impact on the Bank). The Bank emphasizes, within capital planning, the stress testing conducted with respect to the Bank's mortgage portfolio by diverse methods, which analyze the portfolio under extreme macro-economic conditions specified by the Bank of Israel, assuming non-recovery by clients and assuming no management action to minimize the impact. Analysis of stress tests conducted by the Bank shows that, in spite of the strict and conservative assumptions made in these scenarios, the potential loss for the mortgage portfolio is low in relation to the Bank's core capital. Once a year, in conformity with Bank of Israel directives, the Bank submits the outcome of its Uniform Scenario, based on extreme macro-economic conditions, in the outline specified by the Bank of Israel for the banking system. The outcome of the Bank's most recent scenario (filed in February 2017) shows that the damage of this scenario to the Bank is low in relation to Bank capital and profit. These results are primarily due to the low credit risk level due to the Bank being oriented towards retail business with a significant mortgage component. It is also due to dynamic, flexible management of sources and uses, while maintaining a low risk appetite in exposures to counter parties, including banks and sovereigns, we well as management of a debenture portfolio, mostly for investment of excess liquidity, in high-quality assets with minimal credit risk.

In 2016, there were no deviations from the risk appetite set by the Bank Board of Directors for the various risks and at the end of the year, all benchmarks were at a safe distance from the risk appetite specified by the Board of Directors and in conformity with business operations, based on the strategic plan outline and on current work plans. In the fourth quarter of 2016, the Bank continued to make progress, in line with structured work plans, on handling liquidity risk, resulting in liquidity risk benchmarks showing a decrease in risk level. In 2016, the Bank acted to increase the liquidity coverage ratio (LCR), in conformity with the outline described in Proper Banking Conduct Directive 221, to achieve a minimum ratio of 80% in 2016 and a minimum ratio of 100% at the start of 2017. The average (consolidated) liquidity coverage ratio for the fourth quarter of 2016 was 117%, compared to 105% in the third quarter. The increase in the average ratio compared to the previous quarter is primarily due to continued increase in retail and other deposits and continued improvement in the structure of Bank resources, which resulted in increase in liquid assets. In 2016 there were no recorded deviations from the restrictions on this ratio.

Review of the Net Stable Funding Ratio (NSFR), which reflects the stability of the Bank's overall structure of sources and uses in terms of liquidity, using stress scenarios (based on the Uniform Scenario outline specified by the Bank of Israel) indicates that the Bank has a stable long-term source structure, which is resilient even in the face of stress events which impact liquidity.

The Bank regularly monitors the liquidity environment and conditions in various markets, with due attention to events which may impact the liquidity environment and the markets. In the first quarter of 2016, the Bank increased its liquidity state of alert to Elevated, following two stress events in financial markets in Israel and overseas. The state of alert was lowered shortly there after and in actual fact, there was no liquidity issue at the Bank nor in the Israeli banking system due to these stress events.

At the end of the second quarter of 2016, the Bank assumed a Higher Alert status, raising its readiness in liquidity and operating an emergency forum in order to closely monitor the effect of the Brexit referendum on its business operations and risk benchmarks. Action taken by the Bank with regard to this event showed that this event would not change the Bank's risk profile for market, interest, liquidity risk, nostro operations and client exposure – all of which remained at a relatively low risk level. In July, the Bank decided to return to business as usual. However, throughout the third and fourth quarters the Bank continued to monitor and follow any potential developments and implications of the Brexit implementation. During the fourth quarter, there were no market events in the Israeli or global banking system, which significantly impacted the Bank's business and risk profile.

Bank exposure to market and interest risks was essentially un-changed in 2016. Market risk in the negotiable portfolio is minimal, in conformity with Bank policy. The bank portfolio is primarily exposed to increase in the interest rate curve due to the relatively long-term structure of uses (the mortgage portfolio); it is monitored using diverse benchmarks, under the normal state of affairs and under stress scenarios and the risk profile is within a safe distance of the specified risk appetite.

In 2016, the Bank continued to deploy use of advanced models under development for analysis of the Bank's retail credit. A system for rating and underwriting individual and small business clients was deployed to all Bank branches and serves as an additional tool, beyond traditional Bank analysis, for management and regular monitoring of client risk by the Retail Division. In 2017, additional deployment and usability processes are planned. The credit risk profile of individual clients, based on the internal model, shows a relatively low risk level which is stable over time. For more information about loans to individuals, see the chapter "Credit risk" below.

Business loans are managed using a range of risk benchmarks and its risk level is low-medium. Exposure to concentration with respect to borrowers / borrower groups is very low and managed subject to strict restrictions, hence this risk level was classified as low.

The Bank has put in place the business, legal and operating infrastructure for selling of credit risk. In this regard, the Bank took steps over the past year to reduce credit risk by means of transactions for outright sale and transactions for sharing of risk. Note, in this context, the transaction involving insurance of Sale Act guarantees, which was completed at the end of the year, whereby the Bank acquired an insurance policy to cover credit exposure with respect to Sale Act guarantees. This coverage was obtained from international re-insurers with high international ratings. This insurance covers 80% of the guarantees amounting to NIS 15.5 billion and the reduction is valued, in terms of risk assets, at NIS 3.3 billion.

The risk level in the mortgage portfolio continues to be low, with leading benchmarks remaining stable or improving. The regular provision in this portfolio results in revenues for the Bank and the rate of troubled debt is constantly decreasing, including the rate of arrears in new loans, which is very low. In the mortgage segment, too, the Bank takes steps to reduce risk by selling it and has conducted multiple sales of mortgage portfolios during the year. For more information see chapter "Material events" in the Report of the Board of Directors and Management.

The Bank continues to upgrade the framework for handling "emerging" risks, such as compliance and regulatory risk, AML risk and cross-border risk – while allocating the required resources for addressing these risks. Note that the Bank has zero appetite for non-compliance with regulatory directives of the Bank of Israel. Bank operations with regard to these risks are primarily qualitative action designed to create the required framework for addressing these emerging risks. The Bank estimates that in the fourth quarter, too, the decreasing trend continued in these risk profiles and the Bank continues to prepare for the required action to address these risks, in order to ensure that their development trends continue in line with Bank strategy to reduce exposure to such risk.

The Bank's operating risk profile, including information security and cyber risk, is estimated to be medium. The Bank constantly strives to improve monitoring, management and control of these risks – which increase with technological advances and with the expansion of Bank business. In 2016, the Bank participated in a sector cyber drill, managed by the Bank of Israel, designed to exercise business aspects during a cyber event. Furthermore, the Bank regularly reviews attack events around the world, focusing on events at financial timings and regularly learns lessons and improves its cyber defenses.

The Bank is at a high state of readiness for business continuity in case of emergency. In late second quarter of 2016, the Bank conducted a comprehensive annual exercise to review business continuity at all Bank divisions, including its trading room. The exercise included a Red Team exercise entering a state of emergency, exercising the Management Forum and the Financial Forum in case of emergency. The Bank also conducted two exercises at the Technology Division's DRP site and in the fourth quarter, the Bank took place in an emergency exercise conducted by the Bank of Israel Currency Department. This exercise was designed to test the response in cash supply during emergency. All of these exercises were successfully completed, with assistance and control from the Risk Control Division, their results have been analyzed and lessons have been learned.

In accordance with the framework specified by the Bank for monitoring its risk profile, the Bank conducts another process as part of the ICAAP process. This is a qualitative process in which the different risks managers and controllers express their opinion as to the risk level, quality of its management and control as well as on the anticipated direction of development of various risks in the following year. The outcome of this process is discussed by Bank management, by the Board’s Risks Management Committee and by the Board plenum. The outcome of the most recent process, conducted in the final quarter of 2016, indicates that the quality of risks management at the Bank is good and that an appropriate framework exists for addressing all risks in 2017, given the business targets, current risk profile and regulatory requirements.

This information constitutes forward-looking information, as defined in the Securities Law, 1968, based on assumptions, facts and data (hereinafter jointly: "assumptions") brought to the attention of the Board of Directors. These assumptions may not materialize due to factors not all of which are under the Bank's control.

Corporate governance for risks management at the Bank Group

Risk exposure and management

The Bank complies with Proper Banking Conduct Directive 310 "Risk Management", which specifies the principles for risks management and control in the Israeli banking system and stipulates the standards required of the banks for creating their risks management framework to be in line with regulatory requirements, the Bank's risk profile and its business targets.

Corporate governance of risks management

The Bank's risk management setup consists of all management and control layers at the Bank, from the Bank Board of Directors, management and business units to control functions and Internal Audit. The Risks Control Division (headed by the Bank's CRO) is the overall entity tasked with risk management and control at the Bank.

The Bank has defined 3 lines of defense (LOD) in addition to the Board of Directors' lines of defense, which is responsible for specifying an appropriate culture and framework for handling risks and management, which is responsible for implementing the framework principles specified by the Board of Directors. These lines of defense are intended to ensure that the Bank has deployed an appropriate framework for risks management and control.

Lines of Defense

Line	Function	Reporting to	Role
First line	Lines of business	Line of business manager reports to the President & CEO	Unit management is fully responsible for risks management and for implementing an appropriate control environment for its operations
Second line	Risks Control Division	President & CEO	the Division, headed by the CRO, acts in concert with other divisions, including the Accounting and Financial Reporting Division, to assist management in promoting an integrated, cross-corporate vision of risks, plan and develop the risks management framework, challenge and ensure completeness and effectiveness of the risks management framework and internal controls and review of this framework in view of the strategic plan, annual work plan and the Bank's business targets.
Third line	Internal Audit	Bank’s Board of Directors	Review the effectiveness and efficiency (mostly in retrospect) of risks management processes and pointing out weaknesses in internal controls which may impact the effectiveness of control.

Different interfaces have been specified between the lines of defense, including forums and reporting channels deployed under normal and emergency conditions. Communication about risks between the different lines of defense is designed to ensure the information flow which allows the Bank to address the material risks for its operations, or the potential for development of such events, while achieving the Bank's business targets.

The functions involved in risks management and control at the Bank are as follows:

Bank's Board of Directors

The main roles of the Board of Directors are to set Bank strategy and to approve Bank policy, which would guide the Bank in its daily operations. The Board of Directors should supervise management actions and their consistency with Board policy, ensure that clear areas of responsibility and reporting paths are in place at the Bank, instill an organizational culture which demands implementation of high standards of professional behavior and integrity and ensure that the Bank is operating in compliance with the Law and regulation.

The Board of Directors operates multiple professional committees, tasked with conducting comprehensive and in-depth discussion of the various matters before they are brought for discussion and approval by the Board plenum.

Risks Management Committee

This committee discusses issues concerning risk management and control at the Bank, including capital planning and management.

The committee is responsible for approval of the Bank's risk mapping and approval of dedicated policy documents for each of the Bank's material risks. These document specify the nature of the risk and the risk appetite adjusted for strategic operations, as well as the risk management processes and methods applied by the Bank to mitigate it, including effective monitoring and control processes.

The committee conducts a quarterly discussion of the Bank's risk document, which presents an overview of all risks and their evolution over time, with emphasis on events in the reported quarter, on the quarterly risk document and on the annual ICAAP document and results of the Bank of Israel Uniform Scenario, as applied to Bank data and capital.

The committee regularly receives extended reviews on various topics. The committee also discusses new products subject to approval by the Board of Directors, new and revised regulatory directives and guidance with regard to risk management at the Bank, significant debriefs which took place with regard to risk management and any other topic of relevance to risk management.

Audit Committee

The Audit Committee is tasked with supervising the work of the Bank's Internal Auditor and that of the Bank's Independent Auditor. Thus, the committee discusses the Bank's financial statements and risks report and makes its recommendation to the Board of Directors with regard to approval thereof. The Audit Committee discusses audit reports of the Internal Auditor, the Independent Auditor as well as those of the Supervisor of Banks or any other competent authority. The Audit Committee points out faults in business management at the Bank, including those arising from organizational shortcomings, in consultation with the Internal Auditor or with the Independent Auditor and proposes to the Board of Directors ways to amend them.

Credit Committee

The committee is responsible for approval of the credit policy document. It is also tasked with approval of credit applications which deviate from limits specified in the credit policy. The committee also discusses credit control reports and current credit reports, as well as general credit-related topics.

Remuneration Committee

The committee discusses the remuneration policy and makes its recommendations to the Board of Directors. The committee also approves the terms and conditions of contracting with officers.

President & CEO

The Bank President & CEO is responsible for on-going management of Bank affairs, subject to policy set by the Board of Directors and subject to guidance there from, in particular with regard to implementing the Bank's strategy and business plans. In this regard, the President & CEO is responsible for management of all risk at the Bank and for leadership of management and risks owners in comprehensive and integrative management of risks and capital and implementation of an effective internal controls system.

The Bank President & CEO receives regular, current reviews and reports about the Bank's risk profile in such layout and timing as stipulated by Board resolutions and in conformity with Proper Banking Conduct Directives. The Bank President & CEO is responsible for reporting to the Board of Directors, in conformity with the outline specified in Bank procedures, including reporting concerning risk management by the Bank and, in particular, any unusual events and/or deviations from the risk appetite.

Bank management

Bank management is tasked with ensuring that Bank operations are in conformity with the business strategy and targets specified by the Board of Directors and within the specified risk appetite. In this context, Bank management is tasked with deploying an organizational risk management culture across the Bank and all its employees, as well as with acting to implement the systems and processes required for effective, efficient risk management.

The Bank's organizational structure is designed to support achieving the Bank's business targets while maintaining proper risk management and control processes.

Note that in similar fashion to business processes, risk management processes are not static, but rather change and evolve constantly, both due to local regulation and/or global practice and in conformity with business needs.

The Bank operates risks management committees at all management levels. These committees act as professional management forums, designed to foster discussion of issues related to risks management and control and to promote the necessary moves for on-going upgrade of the Bank's risks management framework.

Chief management committees include: The Supreme Credit Committee, the Asset and Liability Management Committee, the Overseas Affiliates Committee, the Management Committee for Operating Risks and Control, which also discusses the quarterly Risks Document. The Chief Risks Officer and other representatives of the Risks Control Division, as the case may be, are also members of these committees. The committees operate in normal times and during emergency, in conformity with detailed procedures.

Chief Risks Officer

The Risk Control Division Manager is also the Bank's Chief Risks Officer (CRO). The Risks Control Division operates independently of the risk-taking units and has direct access to information; the Division Manager has direct access to the Bank Board of Directors.

The CRO is responsible for ensuring that a process is in place for identification, measurement, control, mitigation and regular reporting of risks inherent across all business operations at the Bank and for ensuring that the Bank's risks profile is in line with the Bank's risk appetite.

The CRO is responsible for specifying the Bank's risk appetite framework, including challenging the various policy documents, challenging capital management and challenging the work plans. Also analysis of material failure events and a leadership role in conducting debriefs and lessons learned.

The CRO is directly responsible for multiple risks associated with internal control risks at the Bank. He is also responsible for control over credit risks and credit analysis, as an independent party to credit approval.

Internal Audit Division

Internal Audit is the third line of defense within corporate governance for risks management, for testing the effectiveness of internal controls at the Bank. This activity, typically in retrospect, uses diverse tools, including: The risk-focused work plan, based *inter alia* on the outcome of the ICAAP process, debriefs and ad-hoc reviews. The Audit findings and recommendations are sent to the Chairman of the Board of Directors, Chairman of the Audit Committee, Bank President & CEO and to relevant recipients at the Bank and implementation of these recommendations is monitored.

For more information about operations of the Internal Audit Division, see chapter "Corporate governance" on the financial statements.

Other forums for risks management and control operating at the Bank

As part of corporate governance for risks management and in line with Bank policy on stress testing, the Bank has other forums for risks and capital management and control, including:

- Internal controls forum – for integration of diverse Bank entities responsible for implementing an internal controls framework at the Bank.
- Capital planning and management forum – for monitoring development of Bank capital in view of Bank targets.
- Risks Monitoring Forum (RMF) – diverse forums, led by the Chief Risks Officer together with business unit managers, who engage in stress scenarios, model validation, operating risks and other various issues arising from risks management and internal controls of each business unit.
- Dedicated compliance-related forums, including cross-border risks management.
- The steering committee for operating and information security risks – discusses and makes decisions on enterprise-wide operating issues including: business continuity, physical security and cyber risks.

The Code of Ethics

Full transparency is a prerequisite of corporate governance, and in particular as relates to efficient risks management. Policies of proper disclosure of events, support processes and appropriate organizational structure create regular work interfaces which support the Board of Directors and allow it to discharge its duties. The Bank’s Board of Directors and management promote, throughout the organization, a high level of ethics and integrity. One of the key means for instilling ethics and integrity is the preparation of the Bank's Code of Ethics and deployment thereof across all Bank employees.

The Bank operates an Ethics Committee, headed by the Bank Secretary. The Ethics Committee convenes monthly, consisting of representatives from HQ units and branches, and acts to regularly deploy the Code of Ethics by publishing dilemmas to Bank staff, discussing dilemmas raised from the field and reviewing the deployment process of the Code of Ethics.

Values in the Bank's Code of Ethics include: reliability, loyalty, maintaining human dignity, excellence, integrity, fairness, transparency and commitment – are integrated in support of Bank strategy as a personal, human bank.

Bank remuneration policy

For more information about the Bank's remuneration policy, see the chapter Remuneration below.

Corporate governance of risks management at subsidiaries

As part of overall Group risks management at the Bank, risks management is coordinated with Bank subsidiaries. Supervision and control over subsidiaries is regular and reports are received from subsidiaries listing their exposure to various risks factors. Reports by Bank subsidiaries are incorporated into the Bank's quarterly risks document.

Risks management tools

The Bank has a risks management and control framework, adapted for market conditions, for the Bank's business targets and for Bank of Israel directives. This framework consists of multiple layers operating in tandem at Bank units, designed to ensure that the Bank can manage, measure and mitigate its risks during normal operation and in case of an internal or external stress event or emergency.

The key layers and principles put in place are as follows:

- Mapping and identification of risks to which the Bank is exposed – the risks identification process is a key, basic process designed to ensure proper mapping of the risks to which the Bank is exposed, with reference to dynamic changes in the business environment and in Bank operations. The Bank conducts a structure risks mapping and identification process, at least once per year, specifying for each risk whether it is material for Bank operations, based on a materiality threshold as percentage of the Bank's core capital. For every material risk mapped, the Bank appoints a member of Executive Management as Risk Owner.

- Setting the risk appetite – The risk appetite specified by the Bank's Board of Directors reflects the exposure limits which the Board is willing to assume, under normal circumstances and under stress conditions. The Bank's risk appetite includes many benchmarks specified for various risks to which the Bank is exposed in the course of its business operations. Risk appetite is specified for various portfolios and activities arising from the Bank's business operations, using a range of qualitative and quantitative risk benchmarks, results of stress tests, restrictions on scopes of operations etc. Bank management has zero appetite for deviation from Board restrictions, so that management has imposed its own restrictions for some risk benchmarks. Management restrictions were set lower than the Board restrictions. These restrictions serve to alert before reaching within range of the risk appetite specified by the Board of Directors.

- Policies documents for management of various risks – For each material risk, the Board of Directors issues a specific policy document, which sets out the risk appetite and required principles for addressing such risk, including the forums and functions responsible for management and control of such risk, how the risk is measured, business and regulatory requirements and ways to mitigate such risk. The policies documents are typically compiled using the Four Ms methodology, which the Bank specified to be the methodology for risk analysis and management, as follows:
    - Material – review whether the risk is material for Bank operations, under normal circumstances or in case of emergency.
    - Measured – mapping of key measurement methods, systems and models used by the Bank.
    - Managed – mapping and definition of management and control methods.
    - Mitigated – appropriate mitigation methods allow the Bank to minimize its risk exposure. Mitigation actions, whether financial or non-financial, include: training, debriefs, lesson learning processes and forums created to address risk evolution under normal conditions and in an emergency.

  Furthermore, Bank management specifies procedures, to ensure that the specified lines of defense properly implement the principles enshrined in policy.

- Risk profile – the risk profile reflects the Bank's actual exposure, subject to the specified risk appetite, in line with targets in the strategic plan and work plan and in line with development of macro-economic conditions, including the potential for realization of "reasonable" stress scenarios (other than threat scenarios). The Bank's quarterly risks document is the main reporting tool by Bank management with regard to the risk profile. This document also presents a qualitative and quantitative view over development of all risks benchmarks specified; in discussions, emphasis is placed on benchmarks which are getting close to the risk appetite, the implications of such closeness on the risk profile and action required in order to reduce the risk level.

- Stress testing – stress tests are a key tool, in addition to current risk benchmarks, as part of the Bank's risk management and control. The Bank has a diverse group of stress tests, applied to identify the potential impact of various risks to the Bank's business and financial targets. The major stress tests used by the Bank in its normal operations – and as part of capital planning within ICAAP – are applied at the portfolio level, at sub-portfolio level where relevant for Bank operations and at transaction level. The stress testing methodology applied by the Bank includes: Stress level scenarios, performed with variation in risk factors relevant for the operations being tested; stress tests based on past stress events in the local or global market with reconstruction of past events and review of their impact on the Bank's current portfolio; macro-economic scenarios, based on Bank assumptions or on changes issued by the Bank of Israel to the entire banking system under the uniform scenario, with development of equations which translate the effect of macro-economic factors on the portfolio (such as: equation which translates the effect of unemployment on default rates in the retail credit segment).

- Internal Capital Adequacy Assessment Process (ICAAP) – the document which describes this process is submitted annually to Bank management, to the Bank Board of Directors and to the Bank of Israel, presenting a summary of the internal process conducted by the Bank to evaluate its capital adequacy. The Bank's capital planning process, conducted over a three-year planning horizon, is designed to ensure that the Bank maintains adequate capital to support all risks associated with Bank operations, under normal conditions in line with the Bank's strategic plan and under stress events (for more detail see chapter "Capital adequacy"). In addition, review of the risks management and mitigation processes, which include self-assessment of risks, the quality of risks management and the direction of risks evolution by risk controllers and risk owners, as well as independent review by Internal Audit to assess the effectiveness of the Bank's internal controls framework.

- Model validation – the Risks Control Division maps and validates the material models at the Bank, based on their importance and on regulatory directives as to which models require revalidation at set frequencies. Each new model is put to use after undergoing a validation process.

- IT systems to support risks management and control – The Bank regularly reviews the quality of information in Bank systems and the needs for risks management and control, in order to ensure that vital, high-quality information is available to Bank units. In particular, the Bank has expanded its action to provide backup for its main systems, as part of the Bank's business continuity plan – and conducts regular exercises in order to ensure business continuity in case of emergency.

Risk culture

The Group constantly acts to develop and reinforce its risks management processes, to create a risks management culture in line with Bank operations and in support of achieving the Bank's business targets.

Risks management is an integral part of regular Bank operations and the Risks Control Division is involved in material processes at the Bank in all areas. This activity is reflected, *inter alia*, in these processes:

- Challenging of business and strategic processes – The Risks Control Division challenges the annual work plans, based on the Bank's strategic plan, as well as regular capital management planning. The Division, in co-ordination with business units, also monitors heat maps to identify major risks associated with operations of the various divisions, monitor and mitigate such risks and their impact on realization of business plans.
- Approval process for new product / activity – The launch of a new product or activity at the Bank (as well as revision of an existing one) in order to achieve business targets has the potential for deviating from the specified risk management and control framework and in particular, from the risk appetite. Therefore, the Bank's Board of Directors and management have issued a dedicated policy document, which sets out how the Bank addresses a new product or activity, used by the Bank to assess the impact of launching the new product or activity on the entire list of risks mapped by the Bank, the technology and accounting aspects associated with such launch. The effect of the new product / activity on the Bank's current risk profile determines how it would be approved: those having material effect on the Bank's risk profile are approved by the Board of Directors.
- Risks surveys – periodic processes whereby risks surveys are conducted in various areas: both in operating areas and related to compliance and internal control. These surveys are supporting tools for dynamic, active management of the risks map.
- Debriefs and ad-hoc tests – A continuous internal process maintained by the various lines of defense conducts debriefs and ad-hoc tests, following internal or external events, including events which occur in the global banking system. Learning lessons from these events, to be applied by the organization. Material debriefs conducted with regard to risks management are brought for discussion by the Bank's Board of Directors.
- Reporting chain – Risks communication is a key pillar of the Bank's capacity to manage its risks. The Bank has a reporting chain procedure which stipulates the required reports under normal conditions, in a state of alert and under stress (emergency) conditions between all lines of defense specified by the Bank, as needed and in conformity with potential situations.
- Emergency conduct – The Bank has policy documents and structured procedures to ensure business continuity in times of emergency, both systemic emergencies, such as: geo-political event, earthquake etc. and Bank-specific events, such as: failure of Bank systems. The Bank also has a procedure for business activity in case of a financial stress event in the market. Special emergency forums would be activated at the Bank by the risks managers in case of occurrence, or potential occurrence, of such events related to credit, market and interest risk in the bank portfolio and liquidity risk. Policy documents and procedures prepared by Bank units establish potential emergency plans which the Bank could activate should such events occur.
- Training – Maintaining a comprehensive training system, consisting of different means, including: remote eLearning kits, custom training with regard to risks management, emphasizing regulation and internal controls, dedicated seminars etc. In addition, constant contact is maintained between risk owners at headquarters and field units, in particular with representatives of each Bank unit appointed to be responsible for various risk areas, to disseminate operating principles and to communicate information to the various units.

For more information about remuneration at the Bank and its support for the risk culture, see chapter "Remuneration" below.

Regulatory capital

Regulatory capital structure

Supervisory capital is composed of two tiers: Tier I capital (including Tier I equity and Tier I additional capital) and Tier II capital.

Tier I equity includes equity attributable to equity holders of the Bank and the interest of external shareholders in equity of subsidiaries (excess capital at subsidiaries is not taken into account).

Tier I equity includes supervisory adjustments and deductions from capital – goodwill, investments in capital components of financial institutions, cumulative other comprehensive income with regard to cash flow hedges for items not presented at fair value on the balance sheet and adjustments with respect to liabilities for derivatives, due to change in the Bank's credit risk (DVA).

Additional Tier I capital consists of equity instruments which fulfill the specified requirements. As of December 31, 2016, the Bank had no equity instruments included in additional Tier I capital.

Tier II capital consists of a group provision for credit losses and equity instruments which fulfill the specified requirements.

Restrictions on capital structure:

- Tier II capital shall not exceed 100% of Tier I capital after required deductions from such capital.
- Capital instruments qualified for inclusion in Tier II capital shall not exceed 50% of Tier I capital after required deductions from such capital.

Below is a summary of supervisory capital components, capital ratios to risk components for the Group and minimum supervisory capital ratios specified by the Supervisor of Banks:

		2016		2015
	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III
				NIS in millions
Tier I equity before regulatory adjustments and deductions	13,420	142	12,397	216
Total regulatory adjustments to and deductions from Tier I equity	103	10	98	16
Tier I capital	13,318	153	12,299	232
Tier II capital	4,888	2,680	4,916	3,127
Total capital	18,206	2,832	17,215	3,359
Total risk weighted assets	131,902	–	129,486	–
Ratio of Tier I capital to risk elements	10.10%		9.50%	
Ratio of total capital to risk elements	13.80%		13.29%	
Minimum Tier I capital adequacy ratio required by Supervisor of Banks	9.76%		9.30%	
Minimum overall capital adequacy ratio required by Supervisor of Banks	13.26%		12.80%	

For more information and detailed composition of supervisory capital, in conformity with disclosure requirements of Basel Pillar 3, as of December 31, 2016 compared to December 31, 2015, see Appendix 1 below.

Report on movements in supervisory capital during the period, including changes to Tier I equity, Tier I capital and Tier II capital (NIS in millions):

	For the year ended December 31,	
	2016	2015
Tier I capital		
Balance as of January 1	12,299	11,273
Shares issued	12	27
Change in capital reserve from benefit from share-based payment transactions	(10)	1
Profit this year	1,266	1,134
Dividends	(186)	(86)
Movement in other comprehensive income	(47)	(62)
Of which: Translation differences	–	(1)
Of which: Capital reserve from securities available for sale	(15)	(17)
Of which: Capital reserve from cash flows hedging	(5)	(4)
Of which: Capital reserve with respect to employee rights	(27)	(40)
Others, including regulatory adjustments	(58)	(43)
Non-controlling interests	42	55
Balance as of December 31	13,318	12,299
Tier II capital		
Balance as of January 1	4,916	4,883
Deduction of equity instruments	(447)	(446)
Movement in group provision for credit losses	25	62
Issue of debentures with contingent conversion	394	417
Balance as of December 31	4,888	4,916

Capital adequacy

The Bank regularly monitors its capital adequacy and leverage ratio, in order to ensure compliance with requirements of the Supervisor of Banks, as well as to prepare in advance to respond to evolution of risk assets and capital requirements at the Bank. To this end, the Bank's Board of Directors has specified a document policy which sets the principles required for management of the capital adequacy ratio and the leverage ratio, as well as the Bank's capital targets ("risk appetite"), which provide a safety margin beyond the minimum regulatory requirements for capital and leverage. Also included are the required reports and actions to be taken should the capital ratio drop below the minimum required. Capital management and planning is conducted by a special forum headed by the Manager, Finance Division (CFO) and including the Manager, Risks Control Division (CRO), Manager, Accounting and Financial Reporting Division (Chief Accountant) and managers of business divisions at the Bank. On-going capital planning is based on the working assumptions in the Bank's five-year strategic plan, for growth targets in both risk assets and profitability, subject to capital and leverage targets and to the dividend distribution policy

The dividends policy for 2017 includes dividend distribution at 30% of net profit attributable to equity holders; the Board of Directors would monitor execution of the new strategic plan, in order to consider the possibility of increase in the aforementioned dividend rate by another step as from 2018.

As part of implementation of Basel II Pillar 2, the Bank annually files its ICAAR document – which is a report highlighting action taken by the Bank during the year as part of the ICAAP process, which is included in Basel II Pillar 2. On January 31, 2017, the Bank sent its ICAAP document for 2016 to the Bank of Israel. This document consists of several chapters which describe corporate governance for risks management at the Bank, the capital targets and targets of the strategic plan, as well as developments during the year in management of various risks identified and mapped by the Bank, as well as processes for improvement and usability planned for the coming year.

The core of this document is the internal capital planning process conducted over a three-year planning horizon and for the following quarter, based on September 30, 2016 and through 2019. This framework

was used to calculate the required capital allocation with respect to each of the risks, from the requirements specified in Pillar 1 with additional capital required with respect to Pillar 2. Pillar 2 includes capital allocation for risks not included in Pillar 1, such as: credit concentration risk and interest risk in the bank portfolio as well as additional capital allocation for risks included in Pillar 1, where the Bank believes the capital allocated is insufficient for the Bank's risk profile. The capital allocation is calculated both for normal conditions and for stress scenarios. Stress scenarios are applied in different ways, from single-risk scenarios through systemic scenarios to threat testing. These tests are designed to ensure that the Bank has sufficient capital buffers to survive even holistic scenarios which have minimum likelihood of materialization – stress events across all aspects of the Bank's risk profile, including effects with respect to risks for which no capital allocation was made in previous stages, such as: reputation and liquidity risk. The limit set for Tier I capital ratio under a threat scenario is a minimum of 6.5%. The Bank also applies Reverse Stress Tests

("RST") which review, based on the Bank's risk profile, which event is likely to bring the Bank closest to the Tier I capital limit under stress tests. At the end of this process, the Bank's expected capital is reviewed, based on the Bank's capital target management planning, against the capital required under all risks and under stress and threat scenarios, as estimated in the ICAAP process.

The outcome of this process for 2016 indicates that the Bank has available capital in excess of the required capital, even after applying stress and threat scenarios, meaning that the Bank has a sufficient capital absorption cushion to face the range of risks associated with Bank operations, even under stress events. The Bank's core capital, Tier I capital, is sufficient for capital requirements of Pillar 1 an additional capital allocations of Pillar 2 under normal conditions. The Tier I capital ratio under the threat scenario, for each year of the scenario period, does not drop below the minimum required ratio of 6.5%. Note that internal capital evaluation is highly conservative, so in actual fact the Bank would have additional capital buffers. The two main aspects of such conservatism are: Excess capital in the mortgage portfolio under the standard approach, compared to advanced approaches commonly used around the world, as well as calculation of the capital allocation, which does not take into account management's capacity to reduce risk through active management of operations. Such management includes stopping / reducing risk assets, operating streamlining measures and other activities permitted by other regulators.

Basel III

In late 2010, the Basel Committee adopted a new directive, known as Basel III. This directive, originated by the recent crisis in global markets, consists of multiple amendments to the Basel II directive, including: Strengthening of capital base, increase in minimum capital ratios, specification of new benchmarks and methodologies for handling liquidity risk, reinforced methodology for handling counter-party risk (including capital allocation for this risk as part of Pillar 1), specification of the leverage ratio as a new ratio as part of risks management benchmarks, reinforcing processes for conducting stress testing and other processes designed to improve risks management and control capacity at financial institutions. According to the Committee-specified schedule, this directive would be gradually applied world-wide starting in 2013.

As from January 1, 2014, the Bank applies provisions for capital measurement and adequacy, based on Basel III provisions, as published by the Supervisor of Banks and as incorporated in Proper Banking Conduct Directives 201-211.

Below are major updates and effects of application of the directives with regard to capital adequacy measurement:

- Stricter criteria for recognizing capital components to be included under Tier I capital.
- Additional capital allocation with respect to CVA losses (Credit Value Adjustments) – losses due to revaluation at market value with respect to counter-party credit risk – In addition to a capital requirement with respect to default risk arising from counter-party credit risk under the standard approach, an additional capital allocation is required to cover the risk of potential loss which may arise from marking to market value of OTC derivatives.
- Stricter, revised criteria for recognition of debt instruments as capital instruments included under additional Tier I capital and Tier II capital. CoCo capital instruments (Contingent convertible capital instrument) include loss absorption provisions, including discontinuation of interest payments to holders of such instruments (only exists in additional Tier I capital) and principal loss absorption provisions, whereby these would be converted to shares or principal reduction should the Tier I capital ratio drop below a quantitative trigger specified, or when notice is given by the Supervisor of Banks, whereby activation of principal loss

absorption provisions is required in order to maintain stability of the banking corporation, known as a Bank "non existence" event. The quantitative triggers specified for additional Tier I capital and Tier II capital are at 7% and 5%, respectively. As of December 31, 2016, the Bank had no equity instruments included in additional Tier I capital.

- Elimination of the distinction made by the previous directive, between Tier 2 capital types (lower Tier II and upper Tier II), so that Tier II capital is now uniform.
- Subordinated notes, recognized as Tier II capital instruments under the previous directives, no longer qualify as supervisory capital under the current directives, primarily due to lacking loss absorption provisions. Therefore, transitional provisions have been specified, whereby such instruments would be recognized as Tier II capital at 80% of their balance as of December 31, 2013, reduced annually by 10% through January 1, 2022.
- Group provision for credit losses – The amount of the group provision would be recognized as Tier II capital up to 1.25% of weighted risk assets for credit risk. On the other hand, the provision amount was added to the weighted risk assets for credit risk.
- Deferred taxes due to temporary differences – Deferred taxes due to temporary differences (and up to 10% of Tier I equity) – weighted at 250% risk weighting.

After the Supervisor of Banks issued its directives with regard to adoption of Basel III recommendations in Israel, the Bank's Board of Directors resolved, on August 14, 2013, to adopt a target for Tier I equity ratio to risk elements, as of December 31, 2014 of 9% or higher – while maintaining appropriate safety margins.

On September 28, 2014, the Supervisor of Banks issued a circular updating Proper Banking Conduct Directive 329, whereby the target Tier I equity ratio and the target ratio of total capital to risk elements ratio would include an addition equal to 1% of the housing loan portfolio balance. The equity targets would be increased by fixed quarterly steps from January 1, 2015 to January 1, 2017 (over eight quarters).

Following implementation of this directive, the target ratio of Tier I capital to risk elements increased gradually in each of the eight quarters as from the implementation date of this directive, for a total increase of 0.87% when implementation is complete. This target may change based on actual data for the housing loan portfolio and for total risk assets.

Accordingly, the minimum Tier I equity ratio and the minimum total equity ratio required by the Supervisor of Banks, as of January 1, 2017, on consolidated basis, in conformity with data as of the current reporting date, are 9.87% and 13.37%, respectively.

On November 22, 2016, the Bank's Board of Directors approved a new five-year strategic plan for 2017-2021 and resolved to approve a revised dividends policy as from 2017.

The revised dividend policy is subject to the Bank achieving a ratio of Tier I capital to risk elements as required by the Supervisor of Banks and maintaining appropriate safety margins.

Risk assets under Pillar 1 include risk assets with respect to credit risk, market risk, operating risk and counter-party CVA derivative risk. Credit risk is the material risk for the Bank and risk assets with respect to this risk account for 93% of all risk assets.

Composition of risk assets and capital requirements with respect to credit risk by exposure group are as follows (NIS in millions):

	As of December 31, 2016		As of December 31, 2015	
Exposure group	Weighted risk asset balances	Capital requirement(1)	Weighted risk asset balances	Capital requirement(2)
Sovereign debts	549	73	520	67
Public sector entity debts	640	85	378	48
Banking corporation debts	770	101	726	93
Corporate debts	35,119	4,657	39,938	5,112
Debts secured by commercial real estate	2,312	307	2,310	295
Retail exposure to individuals	13,180	1,748	12,027	1,539
Loans to small businesses	6,307	836	5,177	663
Residential mortgages	58,597	7,770	54,529	6,980
Other assets	4,495	596	4,531	580
Total	121,969	16,173	120,136	15,377

(1) The capital requirement was calculated at 13.26% of risk asset balances.

(2) The capital requirement was calculated at 12.80% of risk asset balances.

The primary exposure group consists of residential mortgages, the Bank's core activity. The residential mortgage portfolio accounts for 66% of the Bank's loan portfolio and the risk weighting is on average 50%, so that the risk asset weighting for residential mortgages is 44% of risk assets. This coefficient reflects the lower risk associated with this segment, compared to other debt, given the extensive borrower diversification as well as the solid collateral at high ratios compared to debt.

Risk assets and capital requirements with respect to market risk, CVA risk(3) and operating risk are as follows (NIS in millions):

	As of December 31, 2016		As of December 31, 2015	
	Weighted risk asset balances	Capital requirement(1)	Weighted risk asset balances	Capital requirement(2)
Market risk	1,184	157	950	122
CVA risk with respect to derivatives(3)	636	84	657	84
Operating Risk(4)	8,113	1,076	7,743	991
Total	9,933	1,317	9,350	1,197
Total risk assets	131,902	17,490	129,486	16,574

(1) The capital requirement was calculated at 13.26% of risk asset balances.

(2) The capital requirement was calculated at 12.80% of risk asset balances.

(3) Credit Value Adjustments – mark to market with respect to credit risk of counter-party, in conformity with Basel III provisions.

(4) Capital allocation with respect to operating risk was calculated using the standard approach.

Capital allocation with respect to market risk includes interest risk in the negotiable portfolio, calculated under the standard model using the effective duration method, risk with respect to currency exposure and risk in the option portfolio, calculated under the standard model using the Gamma Vega method, is low. This result reflects Bank policy on market risk management and the low risk appetite specified for such risks. Note that interest risk in the bank portfolio is addressed under Pillar 2.

Capital allocation with respect to CVA risk is very low, reflecting the Bank's conservative policy on transactions involving derivatives with counter-parties with low credit risk.

Capital allocation with respect to operating risk was calculated using the standard approach. According to this approach, the Bank was segmented into eight lines of business, as stipulated by the Bank of Israel, with a standard risk weighting assigned to each line of business, reflecting its sensitivity to loss with respect to operating risk. Risk weightings range from 12% for retail banking to 18% for corporate financing. Bank operations are mostly in the retail segment, hence most of the operating risk assets are with respect to this line of business; the Bank's overall average risk weighting is 12.5%.

Below is capital for calculation of capital ratio after supervisory adjustments and deductions:

	As of December 31, 2016	As of December 31, 2015
Tier I capital	13,318	12,299
Tier II capital	4,888	4,916
Total capital	**18,206**	**17,215**

Development of Group ratio of capital to risk elements is as follows (in %):

	Ratio of capital to risk elements	
	As of December 31, 2016	As of December 31, 2015
Ratio of Tier I capital to risk elements	10.10	9.50
Ratio of total capital to risk elements	13.80	13.29
Minimum Tier I capital ratio required by Supervisor of Banks[(1)]	9.76	9.30
Total minimum capital ratio required by the Supervisor of Banks[(1)]	13.26	12.80
Significant subsidiaries		
Bank Yahav for Government Employees Ltd. and subsidiaries thereof		
Ratio of Tier I capital to risk elements	9.41	9.97
Ratio of total capital to risk elements	13.27	13.23
Minimum Tier I capital ratio required by Supervisor of Banks	9.00	9.00
Total minimum capital ratio required by the Supervisor of Banks[(2)]	12.50	13.00

(1) Capital ratios required by the Supervisor of Banks as from January 1, 2015.

To these ratios, as from January 1, 2015, an additional capital requirement would be added expressed as 1% of the housing loan balance as of the reporting date. This requirement is applied gradually through January 1, 2017. Accordingly, the minimum Tier I capital ratio and the minimum total capital ratio required by the Supervisor of Banks, as of January 1, 2017, on a consolidated basis, in conformity with data as of the current reporting date, are 9.87% and 13.37%, respectively.

(2) In May 2016, the Bank of Israel reduced its capital requirement for Bank Yahav from 13.00% to 12.50%.

Additional information about capital adequacy

Below is information about risk weighted assets by supervisory operating segment (NIS in millions):

December 31, 2016	Households	Private banking	Micro businesses	Small businesses	Medium businesses	Large businesses	Institutional investors	Financial management	Overseas operations	Total amount	Total percentage
Credit risk (including CVA)	75,210	23	6,315	6,789	5,556	19,095	2,667	3,768	3,182	122,605	93%
Market risk	–	–	–	–	–	–	–	1,184	–	1,184	1%
Operating risk	4,929	1	414	445	364	1,251	175	325	209	8,113	6%
Total	80,139	24	6,729	7,234	5,920	20,346	2,842	5,277	3,391	131,902	100%
Total percentage	61%	1%	5%	5%	4%	15%	2%	4%	3%	100%	100%

December 31, 2015	Households	Private banking	Micro businesses	Small businesses	Medium businesses	Large businesses	Institutional investors	Financial management	Overseas operations	Total amount	Total percentage
Credit risk (including CVA)	69,438	29	5,633	5,806	5,720	23,756	2,994	4,105	3,312	120,793	92%
Market risk	–	–	–	–	–	–	–	950	1	951	1%
Operating risk	4,417	2	358	369	364	1,511	190	322	210	7,743	6%
Total	73,855	31	5,991	6,175	6,084	25,267	3,184	5,377	3,522	129,486	100%
Total percentage	55%	1%	5%	5%	5%	20%	2%	4%	3%	100%	100%

As noted above, operations are mostly in the retail segment (including housing loans); hence, the household segment accounts for 60% of risk assets at the Bank.

Below is the movement in weighted risk assets during the period, for each type of weighted risk asset:

	For the year ended December 31, 2016	2015
Movement in credit risk assets		
Balance as of January 1	120,793	116,159
Change in credit exposure risk assets	5,786	5,212
Change in securities exposure risk assets	(60)	(75)
Change in derivatives exposure risk assets	83	(696)
Change in off-balance sheet exposure risk assets	(3,939)	114
Change in CVA	(21)	(228)
Regulatory changes	–	–
Other effects	(36)	307
Credit risk assets as of December 31	122,606	120,793
Movement in operating risk assets		
Balance as of January 1	7,743	7,383
Change in revenues from financing operations (including commissions)	823	1,150
Change in non-interest financing revenues	(277)	(523)
Change in gross revenues of subsidiaries	28	(84)
Other effects[(1)]	(204)	(183)
Operating risk assets as of December 31	8,113	7,743
Movement in market risk assets		
Balance as of January 1	950	1,020
Change in basis risk	58	(155)
Change in interest risk – general market risk	175	84
Change in options risk	1	1
Market risk assets as of December 31	1,184	950

Leverage ratio

On April 28, 2015, the Supervisor of Banks issued a new Proper Banking Conduct Directive 218 concerning "Leverage ratio". This directive adopts the Basel Committee recommendations with regard to leverage ratio, stipulated in January 2014.

The leverage ratio is reflected in percent, defined as the ratio of Tier I capital to total exposure. Total exposure for the Bank is the sum of balance sheet exposures, exposures to derivatives and to securities financing transactions and off-balance sheet items.

According to the directive, banking corporations shall maintain a leverage ratio of 5% or higher on consolidated basis, as from January 1, 2018. Banking corporations which comply with the requirement upon publication of the directive may not drop below the threshold stated in the regulation. Any banking corporation which does not meet the requirements of this directive is required to increase its leverage ratio at fixed quarterly steps by January 1, 2018.

The Bank's leverage ratio, upon the issue date of this directive, was higher than 5% – hence this minimum leverage ratio applies to the Bank as from the issue date of this directive.

The leverage ratio is managed as part of capital management by the capital planning and management forum.

The Bank's leverage ratio as of December 31, 2016 is 5.27%, compared to 5.32% as of December 31, 2015.

Below is information about the Bank's leverage ratio:

Comparison of assets on balance sheet and exposure measurement for leverage ratio (NIS in millions)	December 31, 2016	December 31, 2015
Total assets in consolidated financial statements	230,455	209,158
Adjustments with respect to investments in banking, finance, insurance or commercial entities consolidated for accounting purposes but not within the scope of consolidation for supervisory purposes	–	–
Adjustments with respect to trust assets recognized on the balance sheet in conformity with Public Reporting provisions but not included in exposure measurement of leverage ratio	–	–
Adjustments with respect to financial derivative instruments	696	467
Adjustments with respect to securities financing transactions	–	–
Adjustments with respect to off-balance sheet items(1)	20,132	20,482
Other adjustments	1,206	1,184
Exposure for leverage ratio	252,489	231,291

(1) Conversion of off-balance sheet exposures to equivalent credit amounts, in conformity with Basel rules for capital adequacy measurement.

Composition of exposures and leverage ratio (NIS in millions)	December 31, 2016	December 31, 2015
Balance sheet exposure		
Assets on balance sheet[1]	227,824	206,590
Amounts with respect to assets deducted to determine Tier I capital	(87)	(87)
Total balance sheet exposure[1]	227,737	206,503
Exposure with respect to derivatives		
Cost of replacement with respect to all derivative transactions	1,455	1,539
Amounts added with respect to future potential exposure with respect to all derivative transactions	1,851	1,695
Gross-up of collateral provided with respect to derivatives, deducted from assets on the balance sheet in conformity with Public Reporting directives	–	–
Deduction of debtor assets with respect to variable cash collateral provided in conjunction with derivative transactions	–	–
Exempt central counter-party leg of commercial exposure settled by the client	–	–
Effective adjusted nominal amount of credit derivatives written	882	710
Adjusted effective nominal offsets and deduction of additions with respect to credit derivatives written	–	–
Total exposure with respect to derivatives	4,188	3,944
Exposure with respect to securities financing transactions		
Gross assets with respect to securities financing transactions (without offsets), after adjustment for transactions accounted for as an accounting sale	432	362
Offset amounts of cash payable and cash receivable from gross assets with respect to securities financing transactions	–	–
Credit risk exposure for central counter-party with respect to securities financing assets	–	–
Exposure with respect to transactions as agent	–	–
Total exposure with respect to securities financing transactions	432	362
Other off-balance-sheet exposures		
Off-balance sheet exposure at gross nominal value	59,729	62,343
Adjustments with respect to conversion to credit equivalent amounts	(39,597)	(41,861)
Off-balance sheet items	20,132	20,482
Capital and total exposure		
Tier I capital	13,318	12,299
Total exposure	252,489	231,291
Leverage ratio		
Leverage ratio in conformity with Proper Banking Conduct Directive 218	5.27%	5.32%

(1) Excluding derivatives and securities financing transactions, including collateral.

Credit risk

This chapter discusses credit risk, in conformity with disclosure requirements of the Basel Committee and the FSB; the chapter structure and topic order (adjusted for the nature of Bank operations) are also in conformity with said requirements.

Credit risk management	– qualitative disclosure
Housing loan risk management	– qualitative disclosure
Retail credit risk management (excluding housing loans)	– qualitative disclosure
Credit risk analysis	– quantitative disclosure
Credit risk mitigation using the standard approach	– qualitative disclosure
Housing loan risk mitigation	– qualitative disclosure
Credit risk mitigation using the standard approach	– quantitative disclosure
Credit risk mitigation using the standard approach (ratings)	– qualitative disclosure
Credit risk analysis using the standard approach (ratings)	– quantitative disclosure
Counter-party credit risk	

Credit risk management

Credit is at the core of banking operations and therefore, credit risk is the major risk addressed by the banking system. The lion's share of risk assets allocated by the Bank in Tier I are with respect to credit risk.

Mizrahi-Tefahot Group is a conservative, stable banking group thanks, *inter alia*, to the composition of its credit portfolio, which is oriented more towards retail and mortgage operations, which account for more than 75% of credit activity at the Bank Group. In conformity with principles of the Bank's five-year strategic plan, issued in November 2016, the Bank strives to maintain and establish its leadership position in the retail sector and to increase focus on and expand operations of the business segments.

Credit risk is the risk that a borrower or counter-party of the Bank would not fulfill its obligations towards the Bank. Credit risk is a material risk to Bank operations. This risk is affected by multiple factors: Business risk due to client activities, concentration risk due to over-exposure to a borrower / borrower group and to economic sectors, geographic concentration risk, risk due to exogenous changes which mostly involve changes to the borrower's macro-economic environment, overseas credit risk and operating risk which, should they materialize, would have implications for credit risk. Moreover, such risk is interrelated to multiple other risks, such as market and interest risk, liquidity risk, compliance risk etc.

The Bank's strategic plan has material effect on the nature of credit operations, risk level and business focus on various segments.

Group operations with regard to credit to the public are managed by client attributes and types of banking services these clients require:

For more information about client attributes in each segment, see chapter "Supervisory Operating Segments" on the Report by the Board of Directors and Management.

The Bank’s Board of Directors is responsible for setting the Bank’s credit policies, which prescribe principles and rules for making credit available and for the management and control over the loan portfolio, in order to preserve its quality and mitigate its inherent risk. These principles and rules enable controlled management of the risk involved in granting loans to borrowers, at the level of the individual borrower, group of borrowers and the level of economic and business sectors – to the level of the entire portfolio. The need to revise the policies is reviewed throughout the year, in view of developments in the business environment in which the Bank and Bank clients operate, given changes to the risk profile in view of the risk appetite specified and in view of regulatory changes, if any. The Manager, Business Division is the risks manager for credit risk, including credit concentration and environmental credit risk. The Manager, Risks Control Division (CRO) is responsible for the policy document on credit risk management. The Bank’s Board of Directors approves the Bank's credit policy at least once a year. The credit policy includes other policy documents which discuss the relevant risks to the Bank's credit operations, including: Credit concentration policy, which ensures that the credit concentration level at the Bank is regularly managed and monitored; derivatives policy, which stipulates the principles for management and monitoring of Bank clients with derivatives activity; collateral policy, which stipulates the principles required for management of client collateral, safety factors required by transaction type and risk factor; and the environmental risks policy.

Risk appetite consists of a long list of benchmarks and risk factors relevant to the Bank's credit operations, including: Economic sectors, borrower groups, risk factors in the mortgage portfolio, unique activity types, quality of credit portfolio, overseas operations etc. and other risk factors relevant for the Bank's credit risk profile and its business operations. Credit risk is also monitored using a range of stress tests, which estimate the potential impact of stress events on the Bank's credit portfolio. This is done, *inter alia*, in order to review Bank resilience to various stress events and as part of the ICAAP process.

The Board of Directors discharges its role with regard to credit through the Board of Directors' Credit Committee, the Audit Committee and the Risks Management Committee. The credit policy document is discussed by the Board Credit Committee and by the Board Risks Management Committee, prior to being approved by the Board plenum.

The Supreme Credit Committee is the most senior forum for credit approval at the Bank. This Committee, headed by the President & CEO, consists of managers of the Business Division, Finance Division, Retail Division, Risks Control Division and Legal Counsel Division, as well as sector managers in the Business Division.

First line of defense – credit-related business lines at the Bank

Credit at the Bank involves several key areas, supported by an organizational structure based on divisions and units with specific specializations, with credit extended to clients in various operating segments divided among different divisions (Retail, Business, Finance) and within those divisions, among different organizational units. Line of business management is fully responsible for risks management and for implementing an appropriate control environment for its operations The professional units in each of these client segments are responsible for regularly verification, monitoring and control of exposure to clients and operating segments for which they are responsible. This line of defense includes specific control units, such as division controllers and other control functions. A set of procedures ensures the actual implementation of policy guidelines.

Second line of defense – Risks Control Division

The Risks Control Division acts as the Bank's independent risks management function, thus serving as the second line of defense within corporate governance for risks management. Division operations and responsibilities include the following: With regard to credit risk management, the Division operates through multiple independent units:

- Credit risk control – *post-factum* assessment, independent of Bank entities which approve credit, of the borrower quality and quality of the Bank's credit portfolio.
- Analysis – a professional entity tasked with producing an independent opinion for credit to material clients, as part of the credit approval process.
- Control of client exposures in the capital market and development and deployment of advanced models. See more information below.

Second line of defense – Chief Accountant

In addition to the Risk Control Division, the second line also includes the Chief Accountant, in charge of appropriate credit classification and determination of provisions for credit losses.

Third line of defense – Internal Audit

Internal Audit serves as the third line of defense within corporate governance for risks management, conducting audits of credit risk management as part of its annual work plan.

As part of the credit granting process, transaction data is reviewed in accordance with criteria specified by the Bank. The decision making process for granting credit is hierarchical, from branch level to Board of Directors level. Each unit which provides credit monitors on a regular basis credit repayment in accordance with terms agreed as well as the financial status of the client, based on their level of indebtedness. Any findings requiring action are reported to the relevant credit entity. In addition, as noted above, the credit granting process involves the Analysis Department, which is part of the Bank's risk management function. This involvement includes (with regard to major credit exposures and to economic sectors, as stipulated by Bank of Israel directives and Bank procedures) independent analysis of credit applications and presentation of conclusions and recommendations in a written document attached to the credit application and brought for discussion by the appropriate credit committee.

The Bank operates on multiple levels to monitor and mitigate credit risk in as much as possible, from the credit approval stage, required collateral and financial covenants specified in accordance with

procedures, authorization and diversification policies specified by the Bank, through to regular control by business units and dedicated control units. This is done with constant effort invested in improving the professional expertise of those involved with credit, by means of banking courses and training, as well as professional seminars at all levels. Concurrently, the Bank invests extensive resources in improving its control mechanisms and IT systems available to decision makers in the credit sector.

Key processes involved in credit risk management and control at the Bank:

Considerations in extending credit – The considerations involved in granting credit are based mainly on the quality of the client, his reliability, financial strength, liquidity, repayment ability, seniority in the industry, length of time with the Bank, behavior in the account and on the quality of the collateral. Likewise, the Bank works to match credit type and terms to client needs. In cases in which loans are issued based solely on the quality of the borrower, without requiring full or partial collateral coverage, the Bank may specify certain covenants, such as maintaining certain financial ratios.

Procedures – Procedures for granting credit and for processing credit and collateral, as well as the relevant IT systems there for, are regularly reviewed and updated to adapt them to the changing business environment, while learning lessons from different events. These procedures serve to implement the policy principles set by the Bank's Board of Directors.

Risks diversification – The Bank's credit policies have been based for years on diversification and controlled management of risks. Risks diversification is reflected in different ways: Diversification of the loan portfolio across economic sectors, including increased exposure to specific sectors, diversification across client size groups, diversification across different linkage bases, geographic diversification if applicable (construction sector).

Authority to grant credit – In order to streamline the decision-making process as it relates to granting credit while minimizing risk, a ranking of authority was determined for officers and credit committees at different levels, up to the level of the Board of Directors and its Credit Committee.

Credit-granting decisions, beginning from the region level, are made by credit committees in order to minimize the risk in relying on the judgment of a single individual. The credit authorizations include restrictions on credit limit as well as on the percentage of unsecured credit that each authorized official is permitted to approve, and other guidelines were prescribed relating to the prerogative to exercise authority in certain situations. These authorizations are reviewed from time to time and revised as needed.

Borrower rating – The Bank has developed a system for rating business borrowers, based on a computer-based model that combines quantitative and qualitative assessments of borrower, which has been adapted for a range of business borrowers in various economic sectors. The Bank regularly maintains the different existing models and develops new models, and acts to adapt, update and improve them in line with changes in the business environment.

The objective of the rating system is to provide for credit risks management and to support decision making processes. The system determines the rating of a borrower as a function of the quality of the client, the collateral furnished and the amount of credit received. Concurrently, the Bank has developed its ability to rate clients in the mortgage segment and in the retail segment using advanced models. Each of these segment clients is assigned a credit rating which reflects the theoretical likelihood of the client being in default. The borrower rating models are subject to periodic validation, in conformity with Bank of Israel directives, which are carried out by the Model Validation Department of the Risks Control Division.

In the first quarter of 2016, the Retail Division started using a new computer system which is being gradually put into use, designed to allow the Division to manage its clients by different criteria, including client rating, and to use the new rating models as a decision-support tool for underwriting and credit pricing for clients of the division. The Bank continues to deploy and expand use of this system while concurrently further developing and upgrading these models.

Credit in the construction and real estate sector – credit operations in this sector account for a significant component of credit operations of the Business Division. In financing the construction and real estate industry, specific analysis and monitoring tools are used to assist the Bank in reaching decisions on the granting of financial support to the various projects. Construction financing in this industry is focused mainly on residential construction in areas with strong demand and mid-level prices. In addition, the financing is allocated between geographic regions, based inter alia on relevant demand. In providing credit for construction, the Bank focuses on the financial support method (closed assistance). The application of this method is designed to reduce the exposure to risks in the granting of the loans, because it incorporates current and close monitoring of the progress of the financed project, both before the loans are provided, and as the project receives the financial support, while maintaining a distinction

between the financed projects and the business risk inherent in the other activities of the developer-borrower. The Bank is assisted by outside construction supervisors, and also relies on liens on the land in the project, to secure the loans. Loans are issued for financed projects only by branches with professional knowledge of the subject, and under the supervision of the construction and real estate sector. The Bank also sets policies and rules for financing other real estate transactions, such as financing for rental properties, purchase groups, National Zoning Plan 38 etc. In late 2016, the Business Division and the Retail Division created units aimed at providing a response to smaller-scale projects.

For more information about credit risk in the construction and real estate economic sector in Israel, see chapter "Credit risk" in the Report of the Board of Directors and Management.

Currency exposure in credit – Borrowers with currency exposure are offered means of safety and protection (hedging transactions) in order to reduce their exposure, in addition to other measures that the Bank adopts to minimize the risk of the Bank's exposure from the activities of these customers. Guidelines were prescribed to intensify the monitoring, control, and supervision of the activities of borrowers whose debts to the Bank are sensitive to exchange rate fluctuations, including the creation of simulations and future scenarios of changes in exchange rates. Special controls are also used for clients, when securities form a significant element of their collateral.

Learning lessons – credit control processes are conducted from extending credit to credit repayment. However, sometimes credit is not repaid as required and special treatment is necessary. Learning lessons is a process designed to identify inappropriate credit behavior in order to avoid repeating mistakes. The lesson learning process is incorporated into Bank procedures. Lessons are learned with regard to clients specified by a team which includes representatives from all Bank divisions and led by the Special Client Sector in the Business Division, as well as by designated teams in each Division. These findings are disseminated to relevant recipients at the Bank for implementation of the conclusions among those involved in extending credit at the Bank.

Monitoring and control – Control over credit operations is a key component in maintaining quality of credit extended by the Bank to clients, including maintaining the quality of collateral required to secure credit repayment. The Bank continuously acts to identify and locate, as soon as possible, any indications of impairment of borrowers' repayment capacity or any deterioration in the state of their collateral. The Bank applies different control mechanisms, including internal controls within the credit management chain – i.e. first line controls – which are regularly conducted by branches, regions, headquarters and specific units involved, and controls by entities external to the credit process, i.e. second-line controls. See more information below.

Integrated forums for credit risks management and control

The Bank has established various forums for credit risks management, which integrate the Bank's three lines of defense. The forums related to credit at the Bank are:

Risks Monitoring Forum for credit and credit concentration – managed by the Manager, Risks Control Division – which discusses aspects related to the overall framework for addressing risk, including rating aspects, methodologies for conducting stress testing, results of model validation for assessment of credit risk.

Watch List Forum – This forum is for each of the business divisions (Business Division, Retail Division and Finance Division), for the Risks Control Division and for the Accounting and Financial Reporting Division – and is convened quarterly. The client population discussed by this forum includes clients with high risk attributes, such as those with low rating or with other risk attributes (such as: restricted / AML suspects), failure to comply with financial covenants etc. including cases proactively placed on the list by credit handling entities. These discussions include an individual review of each client, their financial condition and the issue of credit risk to the Bank and the steps to be taken to mitigate such risk.

Emergency Credit Forum – This forum, headed by the Manager, Business Division and attended by representatives from the business divisions and from risks control, acts when unusual conditions evolve, providing a professional framework for addressing emergencies and realization of stress conditions.

Lessons Learned Forum – Includes representatives from the Special Client Sector, from headquarters of the Business Division, from headquarters of the Retail Division, representatives from the Risks Control Division and other relevant participants involved with specific credit. The team summarizes and analyzes material credit failure events, reaches conclusions and issues recommendations for implementation of the lessons learned – at client level and at Bank level.

Concurrently with the foregoing, both the Business Division and the Retail Division include division controllers. Control is also exercised by dedicated Bank units, including headquarter units of the

Business Division. The Business Credit Control Department of the Business Division uses computer systems to discover and alert to unusual accounts and clients, including based on information external to the Bank. Control is applied to banking operations in accounts flagged due to risk indications, based on criteria specified by the Bank for the population defined as under control, as well as for all Bank clients by means of IT systems which provide alerts. In the Real Estate sector, a dedicated control unit operates to control and review various aspects with regard to handling of real estate transactions by the Bank.

The Risks Control Division is a control entity for credit risk within the second defensive line. This Division includes two specialized departments, reporting directly to the Manager, Risk Control Division (the Bank's CRO): the Analysis Department and the Credit Risk Control Department. The Analysis Department conducts independent review of major credit applications (exposure in excess of NIS 25 million) and presents its recommendations as part of the credit approval process, as an independent party, to the Credit Committee of the Business Division, to the Supreme Credit Committee and to the Board of Directors' Credit Committee. The analysis recommendations include a recommendation as to actual approval of the application, and as to any further conditions or restrictions to be considered as a condition for approval of the credit application. The department representative regularly attends meetings of the aforementioned credit committees.

The Credit Risk Control Department operates in conformity with Proper Banking Conduct Directive 311, by rating borrower quality retroactively and by reviewing the quality of the Bank's loan portfolio, including stress testing, based on an annual work plan approved by the Board's Risks Management Committee and by the Board of Directors. The work plan of the Bank's Credit Control Department regularly includes the following:

- Monitoring low-rated borrowers.
- Credit control at London and Los Angeles branches via external entities which are professionally guided by the Credit Risks Control Department in Israel.
- Testing of reliability and quality of rating provided by the first line, with reference to quality of the model and rating results generated, and their implications for the Bank's loan portfolio.
- Analysis of the Bank's loan portfolio – and in particular, analysis of its mortgage portfolio – including evolution of housing loans granted and loan composition by various risk factors.
- Review of the Bank's loan portfolio in view of the credit policies and risk appetite restrictions adopted by the Bank.

Monitoring and control systems – the Bank Group regularly uses computer systems for management and control of credit risk. These computer systems provide control tools for personnel, including the specific unit assigned with identifying and controlling credit risks, to identify loans that exceed credit limits or are under-collateralized, as well as tools for identifying credit-risks developments resulting from the existence of various parameters in client-account development and management. There are several significant systems which play an important role in processes of credit management, risks management and control, including a system to calculate the required capital allocation with respect to credit risk, systems for identifying and alerting credit risks, for providing alert information, monitoring of financial covenants, automatic debt classification system and computer system for control and management of all accounts under legal proceedings.

In 2016, the Amot system was implemented, a new and improved system for management and monitoring of financial covenants. The system is connected to Bank infrastructure systems and supersedes an older system.

Environmental risks – Environmental risk to the Bank is the risk of loss which may be incurred due to deterioration in the borrower's financial position due to high costs incurred as a result of environmental hazard and regulation concerning environmental protection, or due to impairment of collateral exposed to environmental risk or to the Bank being indirectly liable for an environmental hazard caused by a project funded by the Bank. Environmental risk also includes other risks derived from this risk (goodwill, third party liability etc.) In recent years, global awareness of the potential financial exposure arising from regulations related to environmental protection has grown.

In conformity with directives of the Supervisor of Banks, banks are required to act to incorporate management of exposure to environmental risk within all risks at the Bank, including specification of work processes for identification of significant risk when granting significant credit and inclusion of risk assessment, if any, within periodic assessment of quality of credit extended. The Bank's policy documents include dedicated environmental risks policies, including methodology for identification, assessment and handling of environmental risk with material impact.

Handling of non-performing loans and collection of debts

The handling of problem loans requires special focus and professionalism, other than the level that approved or processed the credit extended and collateral received. Initial identification is typically computer-based by designated departments for identification and control in the Business Division and in the Retail Division. Identified clients are handled by the Special Client Sector of the Business Division (first line).

In order to identify credit risk materializing, or which may materialize, at the Bank, the Bank regularly conducts a process to review and identify debts, based on specified criteria. Some of these criteria require debt to be classified as problematic debt, while others provide a warning and allow the professional entity to exercise discretion. Debts are reviewed by a ranking of authorizations specified in Bank procedures. This authorization ranking includes individual authorizations, from branch and headquarters staff, to authorizations at higher levels with regard to classifications and provisions granted to committees headed by the Manager, Accounting and Financial Reporting Division and to the Bank management committee. The Chief Accountant forms a second line in the classification and provision setting process; they are responsible, in conformity with Proper Conduct of Banking Business Directive 311, for being the independent entity in charge of classification and setting the provision for credit losses.

A computer system which supports application of measurement and disclosure provisions for impaired debts, credit risk and provision for credit losses, including in identification and control processes, carries out logical, criteria-based testing and determines defaults for debts classification as debts under special supervision, inferior debt, impaired debt or debt in restructuring, as required.

Identification of housing loans (mortgages) with risk attributes is automated by identifying criteria for arrears and other qualitative criteria. In early stages of arrears, the Bank mostly applies automated collection processes. Later on, the Bank applies proactive processes, both internal and external, including legal proceedings, if needed.

Identification and classification of problematic debts – The Bank classifies all problematic debt and problematic off-balance sheet credit items under: special supervision, inferior or impaired. Debt under special supervision is debt with potential weaknesses, which require special attention by Bank management. Should these weaknesses not be addressed, the likelihood of debt repayment may deteriorate. Inferior debt is debt insufficiently secured by collateral or by debtor repayment capacity, and for which the Bank may incur a loss if faults are not corrected.

In conformity with Bank policy, debt in excess of NIS 700 thousand is classified as impaired when, based on current information and events, it is expected that the Bank would be unable to collect all amounts due pursuant to contractual terms of the debt contract. In any case, debt in excess of NIS 700 thousand is classified as impaired when its principal or interest is in arrears over 90 days, unless the debt is well secured and is in collection proceedings. Further, any debt whose terms and conditions have been changed in conjunction with restructuring of problematic debt would be classified as impaired debt, unless prior to and following such restructuring, a provision for credit losses by extent of arrears was made with respect to the debt pursuant to the appendix to Proper Banking Conduct Directive 314 on problematic debt in housing loans.

Debt under NIS 700 thousand in arrears 90 days is assessed on Group basis and in such case, is classified as inferior debt.

Decisions with regard to debt classification are made based, *inter alia*, on assessment of the borrower's financial standing and repayment capacity, any collateral and its status, the financial standing of guarantors, if any and their commitment to support the debt and the borrower's capacity to obtain financing from third parties.

Provision for credit losses – upon application of the directive for measurement and disclosure of impaired debts, credit risk and provision for credit losses on January 1, 2011, the Bank implemented a computer system for identification and classification of debts where risk of credit losses exists or may emerge. The system is connected to various infrastructure systems at the Bank, combining data to allow for debts review designed to assess their robustness and expected cash flows. The new system applies automated processes for identification, review, classification and determination of provisions, including process documentation and hierarchical approvals based on authorities specified in Bank procedures. The system also allows for handling problematic debts not identified by the automated identification processes, but rather using qualitative tests of the Bank's loan portfolio.

The decision about the amount of provision for credit losses is derived from the quality of credit and collateral, the financial and legal standing of the borrower and guarantors, as well as environmental and sector conditions in the client environment.

The Bank has put in place procedures for classification of credit and for measurement of provision for credit losses, in order to maintain an appropriate provision to cover expected credit losses with regard to the Bank's loan portfolio. Further, the Bank has put in place procedures to be followed, an appropriate provision to cover expected credit losses with regard to off-balance sheet credit instruments (such as: commitments to provide credit, unutilized credit facilities and guarantees).

The required provision to cover expected credit losses from the credit portfolio is estimated under one of the following tracks: "individual provision" or "group provision". Further, the Bank reviews the overall appropriateness of the provision for credit losses.

Such review of debts in order to determine the provision and debt handling is consistently applied to all debts in excess of NIS 700 thousand and in conformity with the Bank's credit management policy – and no transition is made, during the debt term, between the individual review track and the group-based review track – unless in case of restructuring of problematic debt, as noted above.

For more information about individual provision, group-based provision, provision with respect to housing loans and provision with respect to off-balance sheet credit, see Note 1 to the financial statements.

Credit risk management – housing

In conjunction with credit risks management, the Bank takes various actions to manage, control and mitigate risk associated with provision of housing loans. The Bank estimates the risk profile associated with provision of housing loans as low, due to the high level of client diversification, geographic diversification of borrowers, relatively low leverage, which recently has decreased even further due to Bank of Israel directives, intensive review procedures of borrower quality and their repayment capacity, and securing credit with property as collateral.

The Bank acts regularly to control and manage the risk associated with housing loans, for which the Retail Division, the Risks Control Division and other Bank entities are responsible. This activity includes portfolio analysis by inherent risk factors (LTV, repayment ratio, geographic location, loan age, income decile etc.) and carrying out a variety of stress tests to review the impact of macro-economic factors on portfolio risk – primarily the impact of unemployment and interest rates. The Bank has developed an advanced model for rating housing loans, which includes a rating for each loan and calculation of potential loss in case of failure. This model is in addition to the Bank's existing monitoring tools.

Risk appetite in mortgage segment

As part of its credit risk policies, the Bank has set various restrictions on housing loan operations, to account for major risk factors. These factors are reviewed from time to time and additional restrictions are imposed as needed, i.e. based on the actual risk profile of the mortgage portfolio and its trend, as well as on regulatory directives from the Bank of Israel.

The risk appetite for mortgages is defined using multiple risk benchmarks, which apply to credit risk and concentration risk aspects at regular performance level. These benchmarks include: differential risk premium (reflecting the risk of the mortgagee), the LTV ratio, property location (geographic risk), credit quality benchmark (see below under Credit Control), loan repayment to income ratio, loan purpose, loan term, loan track mix, property type, document quality, normative interest rate, financial wealth and cross restrictions on combinations of multiple parameters.

The Bank constantly monitors the risk profile of the mortgage portfolio and its development over time, in view of the specified risk appetite. In particular, this monitoring is conducted through the Bank's quarterly risks document which is presented to and approved by the Board of Directors and its Risk Management Committee. Such monitoring reveals that the leading risk benchmarks are relatively low and continuously improving. These benchmarks include: LTV ratios, repayment ratio, rate of obligo in default and, in particular, the rate of arrears for new loans (one year since origination), which is constantly dropping to very low rates, which is testimony to the high quality of underwriting at the Bank. Note that the average LTV ratio for the Bank's mortgage portfolio (at end of December 2016) was 54.7% (reflecting the LTV ratio upon loan origination). The Bank also estimates the "actual" LTV ratio for the portfolio, based on changes to property values, based on estimates by the Central Bureau of Statistics against the outstanding portfolio balances. This ratio is significantly lower than the original LTV ratio due to the constantly higher housing prices. These data support the Bank's estimate that the potential for loss due to the Bank's mortgage portfolio, even in scenarios involving material decline in housing prices, is low. In addition, the Bank regularly reviews its mortgage portfolio under stress conditions, including under

significant change in macro-economic conditions, using multiple methodologies. The outcome of stress testing indicates that portfolio risk has decreased and that the potential impact of a severe stress event in the market is low.

Means for risk management in housing loans

Underwriting process

Criteria for loan approval

The Bank has specified uniform, quantitative criteria for review and approval of housing loan applications. Along with the uniform criteria, decision makers at the Bank exercise their judgment. The guiding criteria for granting housing loans have been determined, inter alia, based on the following:

- Accumulated experience at the Bank with regard to housing loans, including lessons learned over time with regard to parameters which determine borrower quality and quality of loan collateral.
- Results of current credit reviews which include, inter alia, review of changes to credit quality in certain sectors.
- The loan portfolio is reviewed by a special-purpose nation-wide review center.
- Assessment of credit risks in different areas of the country, due to security-related and other events.
- During evaluation of the loan application, three key parameters are assessed: Borrower quality and repayment capacity, including future repayment capacity given higher interest rates, proposed property collateral and the nature of the transaction. For commercial banking, prime importance is usually assigned to the loan purpose. In the mortgage business, the main weighting in making credit decisions lies in assessment of borrower quality, because practically all of the loans are extended for purchase of real estate by households. However, for general-purpose loans, self-construction loans and non-standard loans, a weighting is assigned to the nature and quality of the transaction when making a decision.
- Collateral and guarantors form a safety net for the Bank in a specific transaction, in case the monthly repayment does not go according to plan.
- Decision making by the Bank involves a process of review of transaction data against predetermined criteria. Decision making with regard to credit is hierarchical and, to a large extent, corresponds to the Bank's management ranking. There are multiple approval levels and the application is routed to the required level based on application data.

These criteria are regularly updated in line with market developments and the portfolio's risk profile.

Credit authority

The Bank has created a ranking of authority for approval of housing loans (at branch, region and headquarters level). The authorized entity to approve the loan is determined based on data in the loan application and on its inherent risk (data about borrowers, LTV ratio, risk premium and nature of the transaction). To enhance control over approval of complex, high-risk loans and loans to specific populations (such as: large loans, transactions between family members, acquisition through a Trust, loans with pledged collateral being a property in high-risk locations etc.), such applications are sent for approval by the Underwriting and Control Department operating in the mortgage headquarters sector.

In addition, a major part of the loan origination process is conducted by the National Review Center. This Center controls the appropriateness of the loan origination process, including compliance with Bank procedures and various directives.

Model for determination of differential risk premium

The Bank has developed a model for calculation of differential risk premium, based on past empirical data, for rating transaction risk at the loan application stage. For each application, an individual risk premium is calculated based on all risk factors identifiable in client information and attributes of the desired transaction. The Bank is currently in a process of upgrading the model.

This premium reflects an estimate of overall transaction risk, allowing for assessment of client odds of being in arrears on the loan or becoming insolvent – at the outset of the application stage. This premium is used for both credit decision making and for pricing of client interest rate. The Bank is currently in the process of upgrading the model, expected to be deployed in 2017.

Built-in controls in loan origination system

The Bank manages its mortgage operations using a dedicated computer system developed for this purpose, which includes the following built-in real-time controls:

- Ensure information completeness required for loan and activities required in preparation of the material, review and approval of the loan.
- Rigid, real-time control over transactions by authorizations. Use of this preventive control methodology significantly reduces the need for discovery controls after loan origination.
- Work flow process with real-time control over execution of all required tasks at each stage of the loan origination process, sending the application to the authorized entity for performing the required actions at each stage of the loan approval process.

Use of this system has resulted in improved control in different stages of the loan origination process, while achieving uniformity among different Bank branches.

Mortgage-related training

The Bank's Training Center delivers courses for training, development and improvement of all those involved in provision of housing loans. Training content is determined in cooperation with the Mortgage Headquarters Sector, and staff at headquarters participates in training delivery to bankers. These courses include, inter alia, special emphasis on risks management. In addition, the mortgage operations are included within the Bank-specified framework for handling operating risk and staff at the mortgage headquarters take part in training designated for this area.

Professional conferences

The Retail Division regularly holds professional conferences for managers and bankers. In these conferences, extensive reviews of developments in the mortgage market are presented, along with steps to be taken to handle the risks associated with such developments.

Regular monitoring of borrower condition and of the housing loan portfolio

Credit control is a key factor in maintaining quality of credit provided by the Bank to its clients. Control over housing loans is exercised at the individual loan level as well as for the entire mortgage portfolio.

The Bank acts to identify as early as possible any symptoms indicating a decline in borrower repayment capacity, in order to identify as soon as possible any credit failure situation. The Bank applies multiple control types, including regular internal controls at branches, regions and headquarters.

The Bank maintains control over quality of new credit provided by branches, by means of a monthly Credit Quality report, which includes all loans originated by the Bank between 6-18 months prior to the reported date which are over 3 months in arrears. This report is designed to assist branches in reducing the extent of arrears, and to increase awareness of troubled loans by those originating and approving loans in order to learn lessons for future credit approval. Along with the individual report, listing loans, details of arrears etc., a statistical report is also produced, showing the extent of arrears at each branch, compared to the region and to the Bank as a whole, and compared to previous months. Management of the Retail Division regularly monitors handling of debts in arrears, using this report.

For the entire mortgage portfolio, control is maintained of restrictions imposed by the Bank's risk appetite, both at the Retail Division and at the Risks Control Department and Credit Control Department of the Risks Control Division.

In addition, a credit control report is produced semi-annually by the Risks Control Division, which extensively reviews the development of the housing loan portfolio's risk profile over the reviewed period. This review includes the risk appetite, credit quality, analysis of major risk attributes and risk factors, overview of arrears and debt collection, special populations, purchase groups and stress testing. This includes analysis of the development of housing loans extended, the Bank's share of the banking system and credit composition by various criteria. This report is discussed by the Supreme Credit Committee (a management committee) and by the Board of Directors' Risks Management Committee and is then presented to the Bank's Board of Directors.

Entities participating in risk management and control for housing loans

Mortgage Management Department of the Retail Division

This department handles different events which occur during the loan term, whether initiated by the Bank or by the borrower. One of the key tasks is monitoring of collateral provided. During loan origination, the Bank usually receives interim collateral, and the final collateral is expected to be received during the loan term. The department also monitors receipt of life and property insurance policies during the loan term.

The National Review Center of the Retail Division

Loan files are sent to this Center prior to origination. These files are reviewed by the Center, in order to verify that the branch did carry out the actions required according to Bank procedures, regulations and instructions of the loan approver.

Collection Department

The Bank operates a dedicated Collection Department, which handles debts collection from borrowers in arrears and realization of properties. Processing is automatically launched once the client fails to make a mortgage payment for the first time. If this failure is not resolved, processing continues by the Telephone Collection Center (prior to filing a law suit), designed to reach payment arrangements with clients. If such an arrangement with borrowers cannot be reached, the debt is processed by the Bank's Collection Department, which includes a dedicated department in the Special Client Sector, for handling mortgage debtors. If needed, legal action is brought against debtors.

Arrears Forum

The Arrears Forum convenes monthly, headed by the Manager, Business Division, and reviews the current state of affairs with regard to collection in the previous month, implications on the financial statements and on the provision for credit losses. The Forum specifies targets for debts processing and for reducing arrears.

Legal Division

As part of the underwriting process, collateral for non-standard loans (such as: transactions involving family members) and high-value loans are reviewed by the Mortgage Advisory Department, a dedicated department in the Legal Division. This test complements the loan approval and review conducted at the branch and the regional underwriting department.

Risks Control Division

The Risks Control Division monitors the quality of the Bank's loan portfolio and the evolution of the Bank portfolio's risk profile, in view of the specified risk appetite. The division is responsible for regular stress testing of the Bank's mortgage portfolio, in coordination with the Mortgage Headquarters sector, while challenging multiple risk factors in this portfolio. Some stress testing is conducted using advanced methods and using current data from advanced models developed by the Bank. The Bank's stress testing includes the Bank of Israel uniform scenario (a uniform macro-economic scenario for the entire banking system). In this scenario, the potential loss by the Bank due to extreme changes in the current macro-economic situation are calculated, accounting for a very high level of unemployment compared to the current situation as well as sharply lower housing prices. These stress tests indicate that the risk level of the portfolio is low.

Credit risk and credit concentration monitoring forum

The Bank operates a forum for monitoring credit risks, headed by the Manager, Risks Control Division, which promotes issues such as: review of credit policy and, in particular, changes to the risk appetite specified there, analysis of credit portfolio risk level, application of advanced modeling approaches, supervision of design and application process of stress testing, and monitoring of the risk profile of the Bank's loan portfolio.

Internal Audit

The work plan for Internal Audit with regard to loans includes, inter alia, reference to review of entities involved in loan approval, origination, administration and control.

Retail credit risk management (excluding housing loans)

Loans to individuals

The individual client segment is highly diversified – both by number of clients and by geographic location, with most clients in this segment being salaried employees with an individual account or a joint household. A recession in non-banking operations is a major risk factor for the individual client segment and higher unemployment has material impact on the likelihood of default.

Credit policy and work procedures at the Bank with regard to extending credit, including to individual clients, is based on several principles – both with regard to proper credit underwriting and adapting credit to client needs and repayment capacity. These include: review of credit objective, requested LTV ratio, loan term, analysis of the client's repayment capacity and repayment sources for all of their indebtedness, with review of various economic parameters of the client and based on the Bank's familiarity with the client and past experience working with them.

The Bank regularly monitors the risk level in the loan portfolio to individuals, including by using a model for credit rating of individual clients and by conducting various stress tests, including custom tests in conformity with Bank of Israel directives, which include scenarios such as: economic recession and significant increase in unemployment.

For further details see chapter "Credit risk" in the Report of the Board of Directors and Management.

Loans to small businesses

The micro and small business segment is highly diversified in terms of clients in various economic sectors, mostly in small industry, trade, business and financial services. Financing in the micro and small business segment is mostly provided for short terms, for current operations and for financing of working capital, covering gaps in cash flow, financing trade receivables, inventory and import activities. Such financing is provided against appropriate collateral, such as collateral checks / checks receivable, invoices, pledging of contracts and current liens.

As part of the credit underwriting process, the Bank analyzes the merchant's business activity, including by comparison to their economic sector. In this regard, and subject to review of repayment capacity and repayment sources, the credit amount and type are customized for the client needs.

Major risk factors in operations of the small business segment are: macro-economic deterioration which would result in recession, which would have across-the-board impact on businesses operating in this segment; dependence on key persons in the business (primarily owners and managers); dependence on individual suppliers / clients who may face default.

The Bank regularly monitors the risk level in the credit portfolio for micro and small businesses, including through custom credit rating models and by monitoring high-risk economic sectors and setting restrictions for activities and differential credit authorizations for different management levels.

Credit risk analysis

Below is the composition of credit exposure by exposure group and by balance sheet item, before provision for credit losses (NIS in millions)[(1)]:

	December 31, 2016										
	Sovereigns	Public sector	Banking corporations	Corporations	Secured by commercial real estate	Retail for individuals	Small businesses	Housing loans	Others	Gross credit exposure[(2)]	Average gross credit exposure
Loans[(3)]	39,442	749	1,794	27,050	2,289	17,781	9,449	114,620	–	213,174	202,821
Securities[(4)]	9,680	–	113	19	–	–	–	–	–	9,812	9,397
Derivatives[(5)]	37	369	986	1,896	–	13	5	–	–	3,306	3,272
Other off-balance-sheet exposures	–	588	81	40,688	568	10,387	3,092	4,231	–	59,635	61,743
Other assets[(6)]	–	–	–	–	–	–	–	–	4,585	4,585	4,557
Total	49,159	1,706	2,974	69,653	2,857	28,181	12,546	118,851	4,585	290,512	281,790

	December 31, 2015										
	Sovereigns	Public sector	Banking corporations	Corporations	Secured by commercial real estate	Retail for individuals	Small businesses	Housing loans	Others	Gross credit exposure[(2)]	Average gross credit exposure
Loans[(3)]	27,845	280	1,064	27,696	2,465	16,258	8,059	105,656	–	189,323	179,820
Securities[(4)]	11,234	–	274	18	–	–	–	–	–	11,526	12,701
Derivatives[(5)]	41	373	776	2,023	–	18	4	–	–	3,235	4,040
Other off-balance-sheet exposures	16	273	43	40,339	377	10,954	2,990	7,352	–	62,344	63,217
Other assets[(6)]	–	–	–	–	–	–	–	–	4,637	4,637	4,535
Total	39,136	926	2,157	70,076	2,842	27,230	11,053	113,008	4,637	271,065	264,313

(1) After deduction of accounting write-offs and before provision for credit losses on individual and group basis.
(2) Balance of on– and off-balance sheet balances, after on– and off-balance-sheet offsets, excluding impact of credit risk mitigation, conversion factors and risk weighting factors, as defined under Basel rules.
(3) Includes loans to the public, loans to governments, deposits with banks and borrowed securities.
(4) Excludes balances deducted from the capital basis and investment in securities in the negotiable portfolio.
(5) Includes face value of derivatives (including credit derivatives), after effect of add-on factors and positive fair value of derivatives.
(6) Excludes derivatives and balances deducted from the capital basis, including cash, investment in shares, fixed assets and investment in investees.

Composition of exposures by geographic region and – for significant regions – by major type of credit exposure (NIS in millions); This information lists total exposure to foreign countries and exposure to countries for which total exposure to each country exceeds 1% of total consolidated assets or 20% of capital, whichever is lower:

	Balance sheet exposure	Off-balance sheet exposure[1]	Impaired debts
December 31, 2016			
USA	4,281	1,268	–
UK	1,008	3,411	–
France	1,430	916	–
Other	2,758	3,054	–
Total exposure to foreign countries	9,477	8,649	–
Of which: Total exposure to LDC countries	510	151	–

	Balance sheet exposure	Off-balance sheet exposure	Impaired debts
December 31, 2015			
USA	4,877	407	1
Other	5,174	1,012	1
Total exposure to foreign countries	10,051	1,419	2
Of which: Total exposure to LDC countries	557	80	–

(1) The off-balance sheet exposure includes NIS 6,111 million with respect to acquiring insurance for the portfolio of Sales Act guarantees from international r-insurers.

The exposure presented above represents, in accordance with directives of the Supervisor of Banks, exposure based on final risk. The party bearing the final risk is an individual, business, institution or instrument which provides "credit reinforcement" to the Bank, such as guarantees, collateral, insurance contracts or credit derivatives. When no "credit reinforcement" exists, the party bearing the final risk is the debtor.

For more information see "Exposure to Foreign Countries" in the Report by the Board of Directors and Management.

Composition of credit exposure before provision for credit losses, by contractual term to maturity, by major gross credit exposure type, is as follows:

Gross credit (NIS in millions)[(1)]:

					December 31, 2016
	Up to 1 year	1-5 years	Over five years	Without maturity	Total[(2)]
Loans[(3)]	71,728	28,166	113,122	158	213,174
Securities[(4)]	66	7,532	2,214	–	9,812
Derivatives[(5)]	2,106	993	207	–	3,306
Other off-balance-sheet exposures	50,444	7,510	1,681	–	59,635
Other assets[(6)]	4,435	–	116	34	4,585
Total	128,779	44,201	117,340	192	290,512

					December 31, 2015
	Up to 1 year	1-5 years	Over five years	Without maturity	Total[(2)]
Loans[(3)]	56,242	28,605	104,338	138	189,323
Securities[(4)]	533	8,181	2,812	–	11,526
Derivatives[(5)]	2,014	1,038	183	–	3,235
Other off-balance-sheet exposures	54,579	5,833	1,932	–	62,344
Other assets[(6)]	2,905	–	112	1,620	4,637
Total	116,273	43,657	109,377	1,758	271,065

(1) After deduction of accounting write-offs and before provision for credit losses on individual and group basis.

(2) Balance of on– and off-balance sheet balances, after on– and off-balance-sheet offsets, excluding impact of credit risk mitigation, conversion factors and risk weighting factors, as defined under Basel rules.

(3) Includes loans to the public, loans to governments, deposits with banks and borrowed securities.

(4) Excludes balances deducted from the capital basis and investment in securities in the negotiable portfolio.

(5) Includes face value of derivatives (including credit derivatives), after effect of add-on factors and positive fair value of derivatives.

(6) Excludes derivatives and balances deducted from the capital basis, including cash, investment in shares, fixed assets and investment in investees.

Below is a summary of impaired credit risk and un-impaired credit risk by major sector (NIS in millions):

			December 31, 2016
	Impaired debts[1]		Non impaired debts
		In arrears 90 days or longer[3]	In arrears 30 to 89 days[4]
Borrower activity in Israel			
Total commercial[7]	580	79	102
Private individuals – housing loans	27	[6]853	[5]407
Private individuals – other	70	26	64
Total public – activity in Israel	677	958	573
Total public – activity overseas	4	–	–
Banks and governments	–	–	–
Total	681	958	573

			December 31, 2015
	Impaired debts[1]		Non impaired debts
		In arrears 90 days or longer[3]	In arrears 30 to 89 days[4]
Borrower activity in Israel			
Total commercial[7]	698	38	156
Private individuals – housing loans	24	[6]956	[5]347
Private individuals – other	81	17	81
Total public – activity in Israel	803	1,011	584
Total public – activity overseas	14	1	–
Banks and governments	–	–	–
Total	817	1,012	584

(1) Loans to the public, loans to governments, deposits with banks and other debts, except for debentures and securities borrowed or acquired in conjunction with resale agreements, except for deposits with Bank of Israel.

(2) Generally, impaired debts do not accrue interest revenues. For information about certain impaired debts restructured using problematic debt restructuring, see Note 30.B.2.c. to the financial statements.

(3) Classified as problematic non-impaired debts. Accruing interest revenues.

(4) Accruing interest revenues. Debt in arrears 30 to 89 days amounting to NIS 31 million was classified as problematic non-impaired debt (as of December 31, 2015: NIS 20 million).

(5) In conformity with Public Reporting Directives, excludes the balance of housing loans in arrears up to 2 months.

(6) Includes balance of housing loans amounting to NIS 125 million provided for by extent of arrears of borrower, for which an agreement has been signed for repayment of arrears by the borrower, where a change was made to the repayment schedule for the outstanding loan balance not yet due (as of December 31, 2015: NIS 161 million).

(7) Includes debt amounting to NIS 1,544 million, extended to certain purchase groups which are in the process of construction (as of December 31, 2015: NIS 1,285 million).

Provision by extent of arrears

Below are details of the provision for credit losses with respect to housing loans for which a minimum provision for credit losses was made by extent of arrears, in accordance with appendix to Proper Banking Conduct Directive 314, as of December 31, 2016 (NIS in millions):

								Extent of arrears
			In arrears 90 days or longer				Balance with respect to refinanced loans in arrears[4]	Total
	In arrears 30 to 89 days[3]	90 days to 6 months	6-15 months	15-33 months	Over 33 months	Total over 90 days		
Amount in arrears	6	10	10	10	200	230	53	289
Of which: Balance of provision for interest[1]	–	–	–	–	101	101	6	107
Recorded debt balance	407	357	165	58	138	718	138	1,263
Balance of provision for credit losses [2]	–	–	24	31	101	156	64	220
Debt balance, net	407	357	141	27	37	562	74	1,043

(1) With respect to interest on amounts in arrears.
(2) Excludes balance of provision for interest.
(3) In conformity with Public Reporting Directives, excludes the balance of housing loans in arrears up to 2 months.
(4) Loans for which an agreement was signed for repayment of arrears by borrower, where a change was made in the repayment schedule for the loan balance not yet due.

Below is a summary of movement in provision for credit losses for the year ended December 31 (NIS in millions):

	December 31, 2016					
	Provision for credit losses					
	Loans to the public					
	Commercial	Housing	Individual – other	Total	Banks and governments	Total
Balance of provision for credit losses at start of period	700	614	192	1,506	3	1,509
Expenses with respect to credit losses	96	13	92	201	(1)	200
Net accounting write-offs	(72)	(12)	(76)	(160)	–	(160)
Balance of provision for credit losses at end of period	724	615	208	1,547	2	1,549
Of which: Individual provisions	132	2	10	144	–	144
Of which: With respect to off balance sheet credit instruments	98	–	11	109	–	109

	December 31, 2015					
	Provision for credit losses					
	Loans to the public					
	Commercial	Housing	Individual – other	Total	Banks and governments	Total
Balance of provision for credit losses at start of period	635	624	186	1,445	5	1,450
Expenses with respect to credit losses	149	9	55	213	(2)	211
Net accounting write-offs	(84)	(19)	(49)	(152)	–	(152)
Balance of provision for credit losses at end of period	697	614	195	1,506	3	1,509
Of which: Individual provisions	118	1	10	129	–	129
Of which: With respect to off balance sheet credit instruments	97	–	9	106	–	106

	December 31, 2014					
	Provision for credit losses					
	Loans to the public					
	Commercial	Housing	Individual – other	Total	Banks and governments	Total
Balance of provision for credit losses at start of period	633	640	145	1,418	10	1,428
Expenses with respect to credit losses	83	6	93	182	(9)	173
Net accounting write-offs	(81)	(22)	(52)	(155)	4	(151)
Balance of provision for credit losses at end of period	635	624	186	1,445	5	1,450
Of which: Individual provisions	125	–	8	133	–	133
Of which: With respect to off balance sheet credit instruments	92	–	10	102	–	102

For more information about movement in the provision for credit losses see Notes 13 and 30 to the financial statements.

Credit risk mitigation using the standard approach

The Bank Group takes different actions to mitigate risks associated with extending credit and with credit concentration. Below is a description of major tools used to mitigate risk in conjunction with the Bank's credit policies.

Collateral – Collateral received by the Bank is designed to secure repayment of credit extended by the Bank to the client, in case of insolvency. The quality and extent of collateral required from the client is determined based on the basic borrower attributes, transaction attributes and materiality of the risk of the client being unable to repay the credit. The higher the risk, the larger and more liquid collateral required by the Bank.

Bank policies and procedures specify the asset types which may be recognized as collateral for providing credit. The commonly used collateral types at the Bank are: Deposits, securities, liens on real estate, vehicles, , credit vouchers, checks, bank guarantees and institutional, corporate or individual guarantees. As part of the collateral policies, rules and principles were prescribed as to the level of reliance on each type of collateral, with regard to its character, marketability, price volatility, promptness of realization and legal status, in addition to assessing the repayment ability of a client as a criterion for issuing the loans.

There are also other collateral types, such as a floating lien, receivables and/or financial and operating covenants imposed on the client to secure their capacity to repay their debt to the Bank.

The collateral is matched, as far as possible, to the type of credit that it secures, while taking into account the period of time, types of linkage, character of loans and their purpose, as well as how quickly it can be realized. Collateral coefficients determine the extent to which the Bank is willing to rely on specific collateral to secure credit. The value of the collateral, with the use of safety factors, is, as far as possible, calculated automatically by the IT systems. The safety factors for different types of collateral are examined once a year and are approved by the Board of Directors' Credit Committee, by the Risks Management Committee and by the Board of Directors. There is also collateral in place which is not accounted for in calculating safety factors, but only used to reinforce existing collateral. The Bank also approves, on a limited, case-by-case basis, the granting of credit solely on the basis of the borrower's obligation.

Bank procedures specify rules for ongoing collateral management, including updates to the value of collateral: Deposits and bank guarantees are regularly updated based on the terms and conditions thereof; collateral consisting of negotiable securities is regularly updated based on their market value ; with regard to collateral consisting of real estate, the procedure determines the date for valuation by a licensed assessor in accordance with the type of credit secured by the property. This assessment is validated in cases specified in Bank policies, by the Bank's internal assessment unit. Valuation is also carried out in case of concern regarding material impairment of the collateral, which may cause the Bank to face shortage of collateral.

As stated above, including in the chapter on Basel Committee Recommendations, the Bank makes extensive use of collateral not recognized under credit mitigation rules of Basel II (real estate, liens on automobiles, personal guarantees) in order to mitigate credit risk.

Guarantors – Sometimes, the Bank requires clients to provide guarantees or guarantors to secure credit. There are different types of guarantees, such as personal guarantees, various bank guarantees, State guarantees, insurance policies or letters of indemnification.

Credit syndication – The Bank participates in syndication and in the last three years has established a professional department which allows the Bank to lead syndications of significant credit volumes. Syndicated financing allows the risk to be diversified among multiple financing providers in large credit transactions.

Debts sharing / sale – Another tool used to mitigate credit risk is sharing / selling parts of the Bank's credit portfolio in certain segments to financial institutions. Over the past two years, the Bank has established the business, legal and operational infrastructure for selling of credit risk. Selling / sharing risk is possible by way of outright sale or by way of sharing the risk. This operation is spearheaded by the Syndication Department of the Corporate Sector in the Business Division.

Furthermore, in late 2016, the Bank acquired an insurance policy for credit exposures with respect to guarantees provided by the Bank pursuant to the Sale Act. The insurance policy covers 80% of the guarantees amounting to NIS 15.5 billion, out of total Sale Act guarantees issued by the Bank and is effective as from December 31, 2016.

The aforementioned transaction was made through an insurance company which is a wholly-owned subsidiary of the Bank which, concurrently, has contracted with international reinsurers with a high international rating to allow for the reduction of risk assets, as set forth below. The insurance policy covers the Bank should the Bank be required to pay due to forfeiture of the guarantees, pursuant to terms and conditions of the insurance policy.

The insurance policy was primarily acquired in order to reduce risk assets with respect to credit exposure arising from such guarantees, in conformity with Proper Banking Conduct Directive 203 "Capital measurement and adequacy".

According to preliminary estimates, acquiring this insurance coverage should result in a 0.25% decrease in the Bank's Tier I capital ratio.

Concentration – The materiality of credit concentration risk for the Bank requires various entities at the Bank to monitor and take action so as to allow the Bank to control such risk concentrations.

To this end, the Bank specifies in its credit policies the risk appetite for various areas related to credit, including credit concentration.

Risks diversification – The Bank’s credit policies are based on diversification and controlled management of risks.

Risks diversification is characterized by several aspects:

- Diversification of the loan portfolio among the different economic sectors, including limiting exposure in certain sectors.
- Diversification of size groups of clients.
- Diversification of linkage segments.
- Restrictions on exposure to specific operating segments.
- Restrictions on exposure to individual borrowers and borrower groups.
- Geographic diversification where relevant (construction industry, mortgages).

Economic sectors – The Bank’s Executive Management and Board of Directors hold discussions on the issue of credit to certain industrial sectors, as is necessary, mainly as it relates to industries that are sensitive to fluctuations in business cycles. Credit policies for the sensitive industries are set on the basis of an economic analysis of the developments forecast for these industries. The Bank maintains distribution of indebtedness among different sectors, so as not to create exceptional indebtedness according to provisions of Proper Banking Conduct Directive 315. Loans to certain sectors, such as diamonds, construction (including sub-sectors thereof) – are handled by professional units or by personnel specializing in these industries. Specific rules and procedures have been prescribed for these specific sectors, beyond those relating to the issue of credit, in order to deal with their special credit risks. In the diamond sector, the Bank prefers to require collateral external to the sector, in order to mitigate and hedge the credit risk.

Major clients – The Bank provides credit to large clients through the Corporate sector, which operates teams with sector expertise. Occasionally the Bank limits its share of credit to a major client relative to total extent of credit to that client in the banking system, and in some cases, in order to participate in financing of certain transactions, the Bank requires a financing package to be put in place with participation of other banks (under consortium agreements). The Bank strictly complies with limits on indebtedness of a borrower and a group of borrowers, as well as on total indebtedness of major borrowers and groups of borrowers whose net indebtedness to the Bank exceeds 10%, pursuant to Proper Banking Conduct Directive 313.

Linkage sectors – This distribution is also reflected in providing credit in various linkage segments, so that part of the credit is more susceptible to fluctuations in the Consumer Price Index (CPI-linked credit), some is more susceptible to changes in the prime lending rate (non-linked NIS-denominated credit), and some – to foreign currency exchange rate fluctuations (foreign-currency denominated credit or linked to foreign-currency exchange rate).

Geographic diversification – The Bank maintains geographic diversification with regard to credit for construction and mortgages, in order to reduce over-concentration in extending credit.

Credit risk mitigation – housing

Collateral

In accordance with Bank procedures for mortgages, loans are only provided if secured by property collateral. In some cases, the Bank demands guarantors for the debt, in addition to property collateral.

For verification of information about the property offered to the Bank as collateral and to determine its value, an assessor visit to the property is normally required, providing a report which describes the property, its location, physical condition and market value. Assessors are party to an agreement with the Bank and act in accordance with Bank guidance, including a structured procedure for conducting assessments, identifying exceptions etc.

The common practice for assessment in the mortgage sector is to use an abbreviated assessment. However, the Bank requires an extended assessment for some of the loans for purchase of existing apartments, self-construction or general-purpose loans with high-risk property types, which includes additional tests subject to criteria set for this matter.

Insurance

According to Bank procedures, all properties serving as collateral must be insured under property insurance. In addition, the borrowers are insured by life insurance assigned to the Bank in case of death prior to complete repayment of the loan.

For some loans (usually loans with LTV ratio higher than 75%), the Bank contracted with EMI Corp., which provides credit insurance in case the proceeds from realization of the property collateral for the loan should fail to cover the outstanding loan amount. This credit insurance process is a key risk mitigator.

As from November 1, 2012, the Bank of Israel restricted origination of housing loans with LTV over 75%, so that as of this date the Bank no longer approves new loans with credit insurance and LTV over 75% (except for loans exempted from this directive, such as refinancing loans).

Loan to Value (LTV) ratio

The maximum LTV ratio approved by the Bank is determined by the credit policies and is periodically reviewed. Generally, the Bank requires borrowers to contribute part of the financing for the acquisition. This equity payment forms a safety cushion in case the property is realized during a down-turn in the real estate market. Furthermore, borrower equity is a further indication of the borrower's financial robustness. As from November 1, 2012, the Bank restricted the LTV ratio for approval of applications for housing loans, pursuant to the Bank of Israel directive on this matter. The LTV ratio for loans to acquire rights to real estate constituting a "single apartment" (as defined in the directive) shall not exceed 75%, for an "alternative apartment" (as defined in the directive), the LTV ratio shall not exceed 70%, and for acquisition of an investment property, general-purpose loan or loan extended to foreign residents – the LTV ratio shall not exceed 50%. For more information see Note 25H to the financial statements.

Below is the composition of net credit exposure by risk mitigation type (NIS in millions):

					December 31, 2016
		Exposure covered by guarantees[2]		Exposure covered	
	Gross credit exposure[1]	Amounts deducted	Amounts added	by qualified financial collateral	Net credit exposure
Sovereign debts	49,253	(326)	612	(20)	49,519
Public sector entity debts	1,706	–	351	(1)	2,056
Banking corporation debts	2,879	(1)	281	(1)	3,158
Corporate debts	69,549	(14,123)	13,464	(9,093)	59,797
Debts secured by commercial real estate	2,857	(10)	–	(156)	2,691
Retail exposure to individuals	28,170	(4)	–	(2,153)	26,013
Loans to small businesses	12,510	(244)	–	(1,917)	10,349
Residential mortgages	118,849	–	–	(692)	118,157
Other assets	4,586	–	–	–	4,586
Total	290,359	(14,708)	14,708	(14,033)	276,326

					December 31, 2015
		Exposure covered by guarantees[2]		Exposure covered	
	Gross credit exposure[1]	Amounts deducted	Amounts added	by qualified financial collateral	Net credit exposure
Sovereign debts	39,136	(309)	811	(13)	39,625
Public sector entity debts	926	–	332	(43)	1,215
Banking corporation debts	2,156	(4)	262	–	2,414
Corporate debts	69,977	(690)	–	(9,603)	59,684
Debts secured by commercial real estate	2,842	(10)	–	(276)	2,556
Retail exposure to individuals	27,220	(4)	–	(2,254)	24,962
Loans to small businesses	11,025	(388)	–	(1,876)	8,761
Residential mortgages	113,008	–	–	(519)	112,489
Other assets	4,637	–	–	–	4,637
Total	270,927	(1,405)	1,405	(14,584)	256,343

(1) Balances of on– and off-balance sheet balances, after on– and off-balance-sheet offsets, after provision for credit losses, excluding impact of credit risk mitigation, credit conversion factors and risk weighting factors, as defined under Basel rules.

(2) Mitigating credit risk by using guarantees results in exposures moving from their original exposure group to exposure groups with a lower risk weighting factor. Consequently, sometimes the extent of exposure in a given exposure group, after credit risk mitigation, is higher than the extent of exposure in this group before risk mitigation.

Credit risk using the standard approach

Calculation of credit risk using the standard approach is based on external credit ratings assigned by External Credit Assessment Institutions (ECAI). The Bank uses rating data from two rating agencies – Moody's and S&P.

Ratings from these rating agencies are used to determine the risk weighting of the following exposure groups:

- Sovereigns
- Public sector
- Banking corporations
- Corporations

The appropriate risk weighting is assigned based on counter-party data.

The risk weighting for banks is assigned based on the risk weighting of the country where the bank is incorporated and is one notch lower than the risk weighting for the rating of said country.

For investment in issuances with a specific issue rating, the risk weighting for the debt shall be based on this rating, unless the issuer is a banking corporation or a public sector entity. In such cases, the risk weighting would be based on the issuer rating, rather than on the specific issue rating.

The following table maps the ratings by international rating agencies used by the Bank:

Moody's	S&P
Aaa to Aa3	AAA to AA-
A1 to A3	A+ to A-
Baa1 to Baa3	BBB+ to BBB-
Ba1 to Ba3	BB+ to BB-
B1 to B3	B+ to B-
Caa1 or lower	CCC+ or lower

Note that the majority of credit risk at the Bank is not rated by an external rating.

Analysis and preparation of frameworks

As part of the Bank's business operations, in order to prepare operating frameworks for credit exposure and other risks with regard to foreign banks and financial institutions, the Bank uses ratings from leading international rating agencies: Fitch, Moody's and S&P, which are used by the Bank for analysis as well as for setting exposure limits.

When preparing the operating framework for Israeli banks, the Bank is also assisted by ratings from rating agencies S&P Ma'alot and Midroog.

Credit risk analysis using the standard approach

Below is composition of credit exposure amounts[1] by exposure group and weighting, before and after credit risk mitigation[2] (NIS in millions):

Before credit risk mitigation

	As of December 31, 2016											
	0%	20%	35%	50%	75%	100%	150%	250%	1250%	Gross credit exposure	Deducted from equity	Total
Rated exposures:												
Sovereign debts	46,492	2,331	–	–	–	323	107	–	–	49,253	–	49,253
Public sector entity debts	–	–	–	1,706	–	–	–	–	–	1,706	–	1,706
Banking corporation debts	–	2,611	–	155	–	93	–	–	–	2,859	–	2,859
Corporate debts	–	8	–	53	–	1	–	–	–	62	–	62
Total	46,492	4,950	–	1,914	–	417	107	–	–	53,880	–	53,880
Non-rated exposures:												
Banking corporation debts	–	9	–	11	–	–	–	–	–	20	–	20
Corporate debts	–	–	–	–	–	69,348	139	–	–	69,487	–	69,487
Debts secured by commercial real estate	–	–	–	–	–	2,836	21	–	–	2,857	–	2,857
Retail exposure to individuals	–	–	–	–	28,059	20	91	–	–	28,170	–	28,170
Loans to small businesses	–	–	–	–	12,390	30	90	–	–	12,510	–	12,510
Residential mortgages	–	–	55,725	24,368	37,061	1,422	273	–	–	118,849	–	118,849
Other assets	1,504	–	–	–	–	2,082	87	909	4	4,586	87	4,673
Total	1,504	9	55,725	24,379	77,510	75,738	701	909	4	236,479	87	236,566
Total	47,996	4,959	55,725	26,293	77,510	76,155	808	909	4	290,359	87	290,446

After credit risk mitigation

	As of December 31, 2016											
	0%	20%	35%	50%	75%	100%	150%	250%	1250%	Gross credit exposure	Deducted from capital	Total
Rated exposures:												
Sovereign debts	47,106	2,331	–	–	–	82	–	–	–	49,519	–	49,519
Public sector entity debts	326	–	–	1,705	–	–	–	–	–	2,031	–	2,031
Banking corporation debts	–	2,609	–	155	–	92	–	–	–	2,856	–	2,856
Corporate debts	–	2,589	–	10,936	–	1	–	–	–	13,526	–	13,526
Total	47,432	7,529	–	12,796	–	175	–	–	–	67,932	–	67,932
Non-rated exposures:												
Public sector entity debts	–	–	–	25	–	–	–	–	–	25	–	25
Banking corporation debts	–	182	–	120	–	–	–	–	–	302	–	302
Corporate debts	–	–	–	–	–	46,159	112	–	–	46,271	–	46,271
Debts secured by commercial real estate	–	–	–	–	–	2,670	21	–	–	2,691	–	2,691
Retail exposure to individuals	–	–	–	–	25,914	9	90	–	–	26,013	–	26,013
Loans to small businesses	–	–	–	–	10,278	22	49	–	–	10,349	–	10,349
Residential mortgages	–	–	55,304	24,348	36,814	1,418	273	–	–	118,157	–	118,157
Other assets	1,504	–	–	–	–	2,082	87	909	4	4,586	87	4,673
Total	1,504	182	55,304	24,493	73,006	52,360	632	909	4	208,394	87	208,481
Total exposure	48,936	7,711	55,304	37,289	73,006	52,535	632	909	4	276,326	87	276,413

(1) Balance of on– and off-balance sheet balances, after on– and off-balance-sheet offsets, after provision for credit losses, excluding impact of credit conversion factors and risk weighting factors, as defined under Basel rules.

(2) Mitigation using guarantees, credit derivatives and other qualified collateral.

Before credit risk mitigation

	December 31, 2015											
	0%	20%	35%	50%	75%	100%	150%	250%	1250%	Gross credit exposure	Deducted from capital	Total
Rated exposures:												
Sovereign debts	36,224	2,573	–	16	–	323	–	–	–	39,136	–	39,136
Public sector entity debts	–	–	–	912	–	–	–	–	–	912	–	912
Banking corporation debts	–	1,613	–	392	–	123	–	–	–	2,128	–	2,128
Corporate debts	–	–	–	127	–	1	–	–	–	128	–	128
Total	36,224	4,186	–	1,447	–	447	–	–	–	42,304	–	42,304
Non-rated exposures:												
Public sector entity debts	–	–	–	–	–	14	–	–	–	14	–	14
Banking corporation debts	–	16	–	12	–	–	–	–	–	28	–	28
Corporate debts	–	–	–	–	–	69,653	196	–	–	69,849	–	69,849
Debts secured by commercial real estate	–	–	–	–	–	2,839	3	–	–	2,842	–	2,842
Retail exposure to individuals	–	–	–	–	27,114	25	81	–	–	27,220	–	27,220
Loans to small businesses	–	–	–	–	10,937	19	69	–	–	11,025	–	11,025
Residential mortgages	–	–	54,422	19,927	37,033	1,351	275	–	–	113,008	–	113,008
Other assets	1,630	–	–	–	–	2,014	51	932	10	4,637	87	4,724
Total	1,630	16	54,422	19,939	75,084	75,915	675	932	10	228,623	87	228,710
Total	37,854	4,202	54,422	21,386	75,084	76,362	675	932	10	270,927	87	271,014

After credit risk mitigation

	December 31, 2015											
	0%	20%	35%	50%	75%	100%	150%	250%	1250%	Gross credit exposure	Deducted from capital	Total
Rated exposures:												
Sovereign debts	37,029	2,580	–	16	–	–	–	–	–	39,625	–	39,625
Public sector entity debts	309	–	–	869	–	–	–	–	–	1,178	–	1,178
Banking corporation debts	–	1,610	–	392	–	123	–	–	–	2,125	–	2,125
Corporate debts	–	–	–	127	–	1	–	–	–	128	–	128
Total	37,338	4,190	–	1,404	–	124	–	–	–	43,056	–	43,056
Non-rated exposures:												
Public sector entity debts	–	–	–	23	–	14	–	–	–	37	–	37
Banking corporation debts	–	171	–	118	–	–	–	–	–	289	–	289
Corporate debts	–	–	–	–	–	59,370	186	–	–	59,556	–	59,556
Debts secured by commercial real estate	–	–	–	–	–	2,553	3	–	–	2,556	–	2,556
Retail exposure to individuals	–	–	–	–	24,874	8	80	–	–	24,962	–	24,962
Loans to small businesses	–	–	–	–	8,695	15	51	–	–	8,761	–	8,761
Residential mortgages	–	–	54,091	19,886	36,886	1,351	275	–	–	112,489	–	112,489
Other assets	1,630	–	–	–	–	2,014	51	932	10	4,637	87	4,724
Total	1,630	171	54,091	20,027	70,455	65,325	646	932	10	213,287	87	213,374
Total exposure	38,968	4,361	54,091	21,431	70,455	65,449	646	932	10	256,343	87	256,430

(1) Balance of on– and off-balance sheet balances, after on– and off-balance-sheet offsets, after provision for credit losses, excluding impact of credit conversion factors and risk weighting factors, as defined under Basel rules.

(2) Mitigation using guarantees, credit derivatives and other qualified collateral.

Counter-party credit risk

Counter-party credit risk (CCR) is the risk that the counter-party to a transaction will be in default before final clearance of the transaction cash flows. Economic loss would be incurred only when the transaction with the counter-party would have a positive economic value upon such default. The market value of the transaction, which may be positive or negative for either party, actually depends on volatility of market factors. Should the counter-party be in default, and the transaction have a positive fair value, this may cause the Bank to incur a loss, liquidity issues and difficulties in carrying out further transactions. Counter-party risk may be affected by other risks, including: credit risk, market risk, liquidity risk, operating risk and reputation risk of the counter-party to the transaction. Counter-party risk has been defined as a material risk at the Bank. The Risk Manager is the Manager, Finance Division.

The Bank has set specific policies on addressing counter-party risk for banks and sovereigns and another document, which is part of the Bank's credit policies, concerns client activities in financial derivatives. The risk appetite associated with activities in derivatives is reflected in restrictions imposed on instruments and currencies. The trading in derivative instruments is part of the Bank's management of assets and liabilities, and is subject to restrictions prescribed by the Board of Directors. The Bank trades in these derivative instruments, both for its clients and for its own account, as part of the management of basis and interest exposure in the various linkage segments. The risk appetite refers to operations of the Bank's Financial Management Sector. These investments are individually reviewed by the Risks Management Committee, headed by the Manager, Finance Division, and are submitted for approval by the Asset and Liability Management Committee headed by the President. Various procedures ensure that the Bank may offer to clients a wide range of financial instruments – while maintaining an appropriate framework for addressing such risk.

Exposure to banks and foreign countries involves multiple risk factors, including country risk with regard to economic standing, geo-political standing and transfer risk, arising from administrative restrictions on transfer of foreign currency. In these operations, the Bank's risk appetite, as included in the policy document, involves routing most of the proactive operations to developed nations and to major banks in these countries, rated A+ or higher. Operations maintain proper diversification of exposures to banks and sovereigns. The Bank has very little business with less developed nations rated lower, only in response to client needs.

Risk measurement is based on stress tests which are conducted regularly in view of specific restrictions imposed on activity with the counter-party as well as on aggregate, with restrictions on total portfolio exposure. In cases such as OTC derivatives, where a market price may not be quoted, pricing and exposure estimation are based on commonly used pricing models. These models are regularly validated by the Bank's Validation Department. For business with banks and sovereigns, the Bank has developed an internal model for calculating facilities with each counter-party, based on the quality, rating and capital of such banks and sovereigns.

In order to estimate exposure, the Bank uses diverse systems, as in its business operations, with control based on information available in these systems and on a special control system developed by the Bank to estimate client exposure and to alert any deviations. The control mechanism for operations with foreign banks relies on special reports created in the Bank's infrastructure system and exception reports generated to monitor business in Israel and overseas, including a Banks Report, which lists all exposures to banks as well as deviation reports, which reflect deviations from agreed facilities, if any. In addition, another control system is in place in the trading room, which includes a feature to present an overview of trading facilities with banks and sovereigns.

The Bank regularly adjusts its exposure to banks and countries and regularly reviews publications about ratings of financial institutions to which the Bank is exposed, through the Financial Institution Relations Department of the Finance Division. Other indicators based on market benchmarks are regularly reviewed to alert any events which may indicate change in the financial standing of major financial institutions to which the Bank is exposed.

The Bank's current risk profile indicates that most of the Bank's exposure to counter-party risk is to foreign corporations and banks, with a non-material exposure level. The Bank also has low exposure to sovereigns.

The Bank regularly reviews and monitors the action required to mitigate this risk. Note that in this year, the Bank emphasized monitoring of the effects of political and economic events, mostly in Europe, on Bank operations with counter-parties exposed to such effects. The Bank's risk level with regard to these events is low.

Restrictions and controls – The Bank has operations involving financial derivatives, mostly vis-à-vis clients, which are required to maintain capital adequacy or to maintain collateral based on scenarios. These operations are regularly monitored by the Bank on intra-day basis by a dedicated control system developed by the Bank. The Bank has relatively little activity vis-à-vis clients who are mostly engaged in trading financial derivatives and short-selling or with clients who are not subject to capital requirements or collateral. These clients are closely monitored at a higher frequency than other clients.

At the Bank, a limit restriction applies for banks and sovereigns, including reference to derivatives. Furthermore, a restriction applies to customer facilities based on certain parameters. The Risk Control Division includes a dedicated department, specialized in control of exposure arising from capital market operations, which daily reviews clients active in this field. As part of Risk Control Division operations, the trading room operations are controlled, including testing of compliance with various restrictions prescribed by the Board of Directors and Executive Management.

Risk mitigation – in order to participate in capital market activity, clients are required to provide collateral in accordance with Bank procedures. In its activities vis-à-vis banks and sovereigns, the Bank signs ISDA agreements and CSA annexes. This allows for setting off transactions, so that the amount exchanged between parties to the transaction is limited to the net exposure amount, thereby reducing exposure of either party. CSA addendums regulate funds transfer between parties to a transaction whenever exposure reaches a certain pre-defined level, thereby reducing counter-party exposure.

Below is the composition of exposures related to counter-party credit risk (NIS in millions):

	December 31, 2016					
	Interest contracts	Foreign currency contracts	Contracts for shares	Commodity contracts	Credit derivatives[2]	Total
Par value of derivative instruments after impact of add-on factor	143	1,202	504	2	–	1,851
Positive fair value, gross, of derivatives[1]	1,406	1,618	641	2	4	3,672
Effect of offset agreements	(1,052)	(1,080)	(85)	–	–	(2,217)
Total exposure with respect to derivative instruments	498	1,740	1,061	4	4	3,306
Collateral with respect to derivative instruments (before safety factors)	(6)	(552)	(706)	(2)	–	(1,266)
Impact of safety factors on collateral	1	209	293	–	–	503
Total current credit exposure after credit risk mitigation	493	1,397	648	2	4	2,543

	December 31, 2015					
	Interest contracts	Foreign currency contracts	Contracts for shares	Commodity contracts	Credit derivatives[2]	Total
Par value of derivative instruments after impact of add-on factor	138	1,122	434	1	–	1,695
Positive fair value, gross, of derivatives[1]	1,633	1,354	371	1	–	3,359
Effect of offset agreements	(1,271)	(494)	(53)	(1)	–	(1,819)
Total exposure with respect to derivative instruments	500	1,982	752	1	–	3,235
Collateral with respect to derivative instruments (before safety factors)	(78)	(672)	(734)	(1)	–	(1,485)
Impact of safety factors on collateral	26	275	245	–	–	546
Total current credit exposure after credit risk mitigation	448	1,585	263	–	–	2,296

(1) Includes exposure arising from counter-party credit risk with respect to client activity on the stock exchange, calculated based on stock exchange rules.

(2) The Bank's credit derivatives operations are not classified as brokerage operations. For information about transactions to buy and sell credit protection, see Note 28.B. to the financial statements.

Securitization

The Bank does not operate in the field of asset securitization. It is Bank policy to avoid, in principle, investment in complex securitization instruments.

Market risk and interest risk

Market and interest risk management in the bank portfolio

Market risk – This is the risk of loss from on– and off-balance sheet positions, arising from change in fair value of financial instruments, due to change in market risk factors (interest rates, exchange rates, inflation, prices of equities and commodities). The Bank has no exposure to commodities and its exposure to equities is not material, so that Bank exposure to such risk is primarily due to basis risk – the risk exists when the Bank's assets and liabilities are denominated in different currencies or are in different linkage segments – and from interest rate risk, which the risk to Bank profit (change in revenues) or to Bank capital, primarily due to fluctuations in interest rates, fluctuations of various curves used by the Bank in its business operations or from the fact that a change in interest rates may result in a change in composition of the Bank's assets and liabilities due to exercise of options for early repayment due to change in market interest rates. Changes in interest rates impact Bank profits (change in revenues) and the value of Bank assets (change in fair value). The Bank manages its market risk and interest risk in integrated fashion, under the same organizational structure and using similar tools, data structures, methodology and systems.

Market risk and interest risk form an integral part of banking business and of management of Bank assets and liabilities. However, excessive market risk and/or interest risk may expose the Bank to loss and may pose a threat to Bank capital. Therefore, the Bank’s Board of Directors and management have specified, in the Bank's structured process for risks mapping and identification, that market risk and interest risk are material risks and that management of these risks is critical for stability of the Bank, especially in view of the low interest rate environment and the potential for change in market interest trend. Therefore, the Bank’s Board of Directors issued a special document on handling of market risk and interest risk, which stipulate the principles whereby the Bank should act in order to identify, measure, monitor, review and control the market risk and interest risk on a regular basis, both in the normal course of business and in times of stress. Management of these risks is designed to maintain a reasonable risk level, in conformity with the exposure caps, i.e. the risk appetite specified for these risks, while taking advantage of opportunities and constant monitoring of the risk profile, so that the Bank would not be exposed to significant loss.

Management of market risk and interest risk at the Bank consists of two main risk concentrations: the bank portfolio and the negotiable portfolio. The negotiable portfolio includes portfolios managed by the Trading Room (portfolio of debentures held for trade by the Interest Trade Unit (market maker), derivative transactions classified under Trading Room portfolios and interest options classified under Trading Room portfolios), as ell as portfolios of debentures held for trade and strategy in Israeli and foreign currency, managed by the Asset Management Department, as well as derivatives used for executing strategies. The portfolio also includes hedging transactions for instruments included in the negotiable portfolio. This portfolio is small relative to activity in the bank portfolio and is associated with low risk.

The bank portfolio, which is the Bank's primary activity, consists of all transactions not included in the negotiable portfolio, including financial derivatives used to hedge the bank portfolio. This portfolio is exposed primarily to interest risk. The exposure which the Bank wishes to retain is due to the Bank's business operations and is reflected in the Bank's financial statements. This exposure is limited by the risk appetite, specified individually for market risk and interest risk in the bank portfolio, which is reviewed by the Bank at least once a day, using various tools and models. Any deviation from or even getting close to the specified exposure limits are regularly reported and immediately addressed, in conformity with principles specified in the policy document created by the Bank.

Market risk and interest risk are managed at Group level, including the Bank's overseas affiliates and subsidiaries. Operations vis-à-vis Bank Yahav are regularly coordinated, in particular for setting the Group risk appetite, which requires monitoring of the Group-level risk profile. Policy principles were specified in line with Bank strategy and with regulatory requirements, i.e. Proper Banking Conduct Directives of the Bank of Israel, relevant Basel Committee directives and in line with globally accepted best practice. The Bank of Israel directives relevant for market risk management are: Proper Banking Conduct Directive 339 "Market Risk Management"; Proper Banking Conduct Directive 333 "Interest Risk Management", which expands the regulations with regard to interest risk, mostly with regard to Bank activity in the bank portfolio; and Proper Banking Conduct Directive 208 "Capital Measurement and Adequacy", with regard to definition of revaluation management and capital allocation under Pillar 1 with respect to the negotiable portfolio.

The directive includes the Basel II directives with regard to definition of the negotiable portfolio, management and revaluation thereof and stipulates that inclusion of an instrument and/or position in the negotiable portfolio is subject to compliance with objective criteria (free of any treaty which restricts their negotiability or which may be fully hedged) and subjective criteria (trading intent or hedging of other components in the negotiable portfolio, active portfolio management and frequent, accurate valuation of the portfolio).

The Bank is required to allocate capital with respect to interest risk and equities in the negotiable portfolio, for exchange rate risk for all banking activities and for option risk. The Bank uses the effective duration method in measuring interest risk, and the Delta Plus method in measuring option risk. This method quantifies the risk associated with operations of the options portfolio based on the discounting values. These reflect the sensitivity of the options portfolio to movements in the underlying asset and in standard deviation.

Capital allocation for currency exposure (basis risk) is at 8% of the net open position in each currency. No capital allocation is made for inflation exposure (NIS / CPI position). As part of the provisions of this directive, the Bank also calculates specific risk in the negotiable portfolio. Capital requirements with respect to specific risk are intended to provide protection against negative change in the price of a single security due to factors related to the individual issuer. The capital requirement with respect to specific risk is in lieu of the capital requirement with respect to credit risks in the bank portfolio.

Bank operations in the negotiable portfolio are subject to restrictions which reflect low risk appetite and therefore, the Bank's capital allocation with respect to market risk is very low.

The bank portfolio includes the positions not classified as negotiable positions in the negotiable portfolio. The Bank handles interest risk in the bank portfolio and overall additional capital allocation with respect there to, in conformity with Basel Pillar 2. Capital allocation in conformity with Basel Pillar 2 is reviewed both under scenarios which reflect the normal life state and under stress scenarios, including systemic scenarios and threat scenarios. This is done as part of the ICAAP process, as described in chapter "Capital adequacy".

The Bank structure, which is weighted towards the mortgage portfolio, produces long-term uses for which the Bank requires sources. Due to incomplete alignment of the average duration of uses and the average duration of sources, the Bank's economic value is exposed to increase in interest rate curves.

Developments in market and interest risk

This risk is monitored on a regular basis, both in managing interest risk for the overall portfolio in VaR terms, and in EVE (Economic Value of Equity) terms, as well as another range of scenarios which mostly reflect stress conditions.

For more information about these models, their use and limitations – see below.

The overall market risk has increased during the year and was classified as low-medium, primarily due to continued high volume of housing loan origination. During the year, the Bank acted to raise sources for medium and long terms, both through negotiable issues and by raising deposits from the public, special deposits which provide a solution for client needs in the current interest rate environment. The Bank uses these sources to manage its interest exposure within the specified risk appetite, so that risk benchmarks are within a reasonable distance from the specified restrictions.

Linkage segment management

Currency exposures – It is Bank policy to maintain minimal (operating) currency positions, except for specific strategic positions approved by the different committees and/or Trading Room positions, in conformity with approved risk restrictions. Foreign currency strategic positions are capped by a Stop Loss mechanism to restrict and reduce risk.

Inflation exposure – The risk appetite varies with expected profit from holding a position and the Bank's capacity to reduce the exposure within a reasonable time frame. This exposure is included among the risk appetite benchmarks and models applied by the Bank to all market risks. The risk assessment was changed in the fourth quarter of this year, reduced to low-medium, given the exposure and inflation estimates. For more information about the Bank's financial capital and linkage status, see chapter "Risks overview" in the Report by the Board of Directors and Management.

Means of supervision over and implementation of the policy

The Bank has put in place an organizational structure for management of market risk and interest risk in the bank portfolio, which includes the Board of Directors, management and the three lines of defense. This structure is supported by special committees and forums, created for such risks management and in order to create an internal controls system, designed to prevent deviation from Bank policy in its activity in the negotiable portfolio and in the bank portfolio.

Upon any unusual occurrence in the capital market, such as an unexpected change in interest rates, shake-ups in the foreign currency markets, changes in fiscal and/or monetary policies, the special committees and forums created by the Bank for such situations, convene for a special discussion in order to reach the decisions required by these occurrences.

Below is the organizational structure created at the Bank for management and control of market risk and interest risk:

Bank's Board of Directors – The Bank's Board of Directors approves, at least once a year, the policy document which incorporates how exposure to market risk and interest risk in the bank portfolio should be managed, after it has been approved by Bank management and by the Board's Risks Committee. This document outlines, *inter alia*, the authority ranking for market risks management, the risk appetite (exposure restrictions) and the frequency of discussions and reporting of exposure status at different levels. The risk appetite framework specified by the Board of Directors was enhanced by management guidelines (restrictions), set lower than the Board of Directors restrictions, in order to allow exposure to be reduced even before it deviates from the risk appetite specified by the Board of Directors. The risk appetite is specified under normal and stress conditions, by a range of benchmarks which restrict market risk; in addition, specific risk appetite benchmarks were specified with respect to interest risk in the bank portfolio and with respect to Bank activity in the negotiable portfolio. The Board of Directors restrictions and management guidelines reflect the risk appetite, which is consistent with the business strategy, liquidity planning, financing sources and capital planning at the Bank.

The Board's Risks Management Committee is an advisory entity for the Board plenum with regard to market risk and interest risk in the bank portfolio. In 2016, there was no material change in principles of the policy document on management of market and interest risk and there were no deviations from the risk appetite which had been set. There were also no significant deviations in the actual policy applied from the specified policy. The Bank is reviewing and preparing to apply the principles made public in 2016 in the Basel Committee position paper on interest risk management.

The market and interest risk profile is monitored on a daily level by the Finance Division and the Risks Control Division; on a weekly level by the Risks Management Committee, headed by the Manager, Finance Division; and on a monthly level by the Management Committee for the Management of Assets and Liabilities, headed by the Bank President & CEO. The market and interest risk profile in the bank portfolio is presented to the Bank's Board of Directors using the Bank's quarterly Risk Document. The discussion by the Board of Directors covers development of the risk profile, major action taken by the Bank in the different portfolios during the reviewed period and of market developments, in particular risks in markets in Israel and overseas which may potentially impact the business profile of Bank operations and its market and interest risk profile in the bank portfolio. Any deviation, should it occur, is to be reported to the Board of Directors, along with action taken to eliminate it.

As noted, the Bank maintains interfaces vis-à-vis subsidiaries with regard to setting risk appetite for the Group. Reports by Group entities about the risk profile in view of the risk appetite are presented in the Bank's quarterly Risks Document.

The Bank President & CEO – heads the Asset and Liability Management Committee (ALMC), which is the advisory entity to the President & CEO with regard to market risks. This committee generally meets once a month, or more frequently, when special developments in the various markets occur or are forecast. The President & CEO, in conformity with the Exposures Procedure and subject to restrictions imposed by the Board of Directors, has the decision-making authority with regard to management of market exposures. The Bank's risks management policies are discussed, formulated, and monitored by the Management Committee for the Management of Assets and Liabilities.

First line of defense – Lines of business management

The Manager, Finance Division (CFO) is the manager of market, interest and liquidity risks at the Bank. The Risks Management Committee serves as the advisory body for the Division Manager. the Committee convenes weekly to discuss current aspects of the management of assets and liabilities.

The Manager, Finance Division specifies guidelines for current operations of market and interest risks management, subject to restrictions specified by the Board of Directors and by management.

When a financial event is identified and declared, which requires special preparation, the Manager, Finance Division convenes – with approval of the President & CEO, a special forum to discuss and make decisions on how to handle the event. The operation of this forum is incorporated in a specific procedure.

The Financial Management Sector of the Finance Division is the entity which manages exposure to market, interest and liquidity risks on a regular basis and acts to implement the policies and the decisions made, for management of these risks and control required based on operations of the first line of defense, in conformity with Bank of Israel directives.

Second line of defense – Risks Management Function

The Manager, Risks Control Division (the Chief Risks Officer – CRO) is responsible for the overall Risk Owner framework. The Risks Monitoring Forum for market, interest and liquidity risks and validation, serves as the advisory body to the Chief Risks Officer with regard to management of Bank exposure to market and interest risks in the bank portfolio, which is convened at least monthly. This Forum, which includes representatives from the Finance Division and from the Risks Control Division, discusses and specifies methodology for risks management and control, including measurement methods which can support portfolio monitoring activity and addresses various aspects arising from management and control of market, interest and liquidity risks, including conclusions from model validation processes, conducted by the Bank's Validation Unit which operates in t he second line of defense, methodologies and usefulness of various stress tests. The Bank has in place a unit for control of market, liquidity and interest risks, under the Risks Control Division. This unit is independent of other entities responsible for management and trading of various instruments and is responsible, *inter alia*, for assessing the adequacy of models used by the banking corporation for reviewing the alignment of actual operations and exposures with approved principles and exposure caps, for periodic review of actual results vs. model forecasting, for development of methodologies and conducting stress testing, for preparing risk quantification reports and for regular reporting of testing outcome. Thus, this unit provides another control circuit for control operations of the first line of defense.

Third line of defense – Internal Audit

Internal Audit serves as the third line of defense within corporate governance for risks management at the Bank, conducting regular control to review and assess the effectiveness of internal controls at the Bank, in accordance with the multi-annual work plan of the Internal Audit Division.

Hedging and risks mitigation policy

A major tool for management and mitigation of interest risk is setting shadow prices at the Bank (transfer pricing). Shadow prices are determined daily at the Bank by the Asset and Liability Management Department of the Financial Management Sector and reflect the needs for management of various exposures under the policy on risk / reward management.

Another tool is buying / selling government debentures. The Asset and Liability Management Department o the Financial Management Sector also manages the interest and/or basis position through forward contracts, swap transactions and options. The advantages of using these tools stem from rapid execution at large amounts, which allows the Bank to "move positions" within a reasonable time frame for asset and liability management. In addition, these transactions are unfunded, are highly liquid and are conducted through the Bank's trading room.

Derivatives transactions, which are identified as hedging balance sheet positions in accordance with accounting rules, are to be specified as hedge accounting transactions, in accordance with the Bank's hedging procedure. Hedge effectiveness is the degree of correlation between changes in fair value or between cash flows of the hedged item and of the hedging derivative. The hedge is considered highly effective if the changes in fair value or cash flows of the hedged item, are nearly fully set off by changes in fair value or cash flows of the hedging instrument. Hedge effectiveness is tested quarterly.

Derivatives in the bank portfolio used for economic hedging of balance sheet activity, or which cannot be defined as an accounting hedge, impact accounting profit and loss. The gap derives from difference in

accounting treatment between balance sheet items and derivatives other than accounting hedges. This effect is regularly monitored and managed subject to guidelines specified by management, by the Financial Management Sector and is reported and discussed by various risks management committees.

At least once a year, the Bank reviews the underlying assumptions of models used to manage market and interest risk, including behavioral assumptions made in order to determine forecasting of certain instruments.

The Bank reviews the concentration of interest risk by linkage segment and by major instrument type. The concentration map is discussed annually by risks management committees.

The Bank constantly acts to increase awareness of market and interest risks in the bank portfolio at Group level, both at headquarter units, at branches and at overseas units of the Bank, through operating procedures, training and seminars on this topic. Furthermore, constant contact is maintained with all relevant units for management of market and interest risk. Coordination between units is designed to achieve a uniform methodology for management of market and interest risks in the bank portfolio.

Tools for risk measurement management

Measurement of market and interest risks is supported by a wide range of information systems, models, processes, risk benchmarks and stress tests. The information systems involved in the calculation are regularly reviewed, through internal controls processes at the Bank, including specific surveys for monitoring activities and information and continuous validation processes, in order to ensure completeness and accuracy of data and calculations.

Market risk in both portfolios (bank and negotiable) are managed overall by using the VaR model and stress tests. For application of these models, the Bank's available capital is defined as a non-linked NIS-denominated source. The Bank operates within the Board of Directors' specified risk appetite for and interest market risk in terms of VaR and stress tests. The risk appetite stipulates that the VaR for all of the Bank's activities in one-month investments, will not exceed 6% of shareholders' equity, and that the maximum loss in stress tests, in the highest of all calculation methods, will not exceed 15% of equity. Management has also specified guidelines for these two restrictions. The Bank constantly maintains a risk profile which is lower than these restrictions.

The VAR model is a statistical model that estimates the loss expected for the Bank in a certain investment period and at a predetermined statistical level of assurance. This model measures risk level in terms of money, where the Bank aligns the investment horizon for the portfolios reviewed using this benchmark. The Bank uses a method previously developed with assistance from overseas experts, which integrates multiple VaR calculation methods commonly used world-wide. The VaR calculation is in addition to a back testing calculation, designed to review the quality of its calculation estimates, i.e. review the model forecast, compared to actual results. The Bank has specified a risk appetite in VaR terms, for the entire Bank portfolio and for its activities in various options portfolios (for various underlying assets). VaR calculations for the Bank's overall portfolio are made daily, while calculations for the option portfolios are made hourly. The outcome of VaR calculation and other risk benchmarks at the Bank are made using a special system acquired by the Bank for management of its market and interest risk and are reported on a special portal. All data required for estimation of these risks is stored in a central database. This database is subject to automated controls applied regularly.

Stress testing – These are various methods designed to estimate the Bank's expected loss as a result of sharp fluctuations in prices of market risks factors. This model estimates, using different methods, the potential loss at the left tail of the distribution, i.e. beyond the significance level determined in calculating the VaR. The Bank's stress test methods are two-fold: Subjective methods, reliant on an economic outline specified by Bank experts, and objective methods, which rely, *inter alia*, on past stress events and scenarios as well as on scenarios stipulated by the Bank of Israel in Directive 333 for interest risk management, where the curve moves in parallel throughout its length at rates of between 1% and 4%.

As part of testing the left-hand tail of distribution of the Bank portfolio, the Bank reviews other benchmarks, such as Stressed VaR, which estimates the expected VaR in case of a return of market conditions during the 2008-2009 financial crisis, as well as the Expected Shortfall VaR, a benchmark which estimates the average loss, beyond the specified significance level (average for the left-hand tail), so as to assign a weight to extreme events which are beyond the significance level and are not reflected in the VaR calculation.

Interest risk is managed using two approaches: the earnings approach and the economic value approach. The Bank has specified the economic value approach to be the key method for risk management – but has developed another model, based on the earnings approach.

Under the earnings approach – The financing margin is the difference between (cumulative) interest revenues received across all uses and (cumulative) interest expenses paid across all sources. The financing margin model allows the Bank to review expected earnings under different operating assumptions (turnover under different balances, for both assets and liabilities, changes in interest rate curves, assuming operations in conformity with work plans), including sensitivity analysis to changes in various interest rate curves.

The calculation is made by advanced computer systems developed by the Bank, at the individual transaction level. This model serves as a decision support system for Risk Managers at the Bank. The calculation is made from the individual transaction level, which allows for segmentation and analysis by different criteria, such as: instrument type, linkage basis, term to maturity etc.

The earnings approach is applied at two levels: static and dynamic. At the static level – calculation of net financing revenues for the Bank at a certain point in time. At the dynamic level – calculation of financing revenues under different interest operating scenarios for the coming year.

Economic value approach – EVE (Economic Value of Equity) is a model which reflects the economic value approach. This is the Bank's main model for estimating interest risk in the bank portfolio. The EVE model reviews the effect of changes to interest rate curves on the economic value of the bank portfolio, the negotiable portfolio and the overall portfolio (negotiable + bank), under various assumptions with regard to changes in interest rate curves (by segment, such as: derivatives, deposits and mortgages, by linkage basis). Assumptions about changes to the interest rate curve under normal and stress situations, including corresponding upwards/downwards shifts of the interest rate curve at high rates and historical scenarios for increase / decrease in the interest rate curve which may not reflect concurrent changes in the interest rate curve.

The economic value of the different portfolios is calculated as the present value of cash flows from Bank assets (exposed to changes in interest rates), net of the present value of cash flows from Bank liabilities (exposed to changes in interest rates). The change in economic value due to changes in interest rate curves (the EVE benchmark) is calculated as the difference between future cash flows of asset and liabilities discounted at current interest rates, and the difference discounted at expected interest rates under interest rate scenarios. Future forecasting of financial instruments is made in conformity with generally accepted practice around the world for calculating fair value. Financial instruments bearing fixed interest are forecast to final maturity, in conformity with the maturity schedule; financial instruments bearing adjustable interest are forecast to the nearest interest rate adjustment date. The fixed spread over the adjustable interest anchor is calculated and reviewed as part of overall management of interest risk. Cash flow discounting is applied using Zero Coupon (risk-free curves) for the various linkage bases.

One of these scenarios is a scenario involving a parallel move of the curves by 2%. This scenario, which reflects a stress event, was specified by the Bank of Israel as a scenario which requires the Bank to report to the Supervisor of Banks in case its result reaches 20% of the Bank's core capital. As noted, the Bank’s Board of Directors specified a 15% restriction for this scenario, i.e. lower than the value subject to reporting to the Supervisor of Banks.

In order to measure risk in the overall portfolio, the Bank adds to interest risk in the bank portfolio the restrictions for the negotiable portfolio under stress / normal conditions.

Nature and scope of reporting systems for market and interest risk

The Bank uses a system which enables management and control of market and interest risk, using a single system, as well as calculating the required capital adequacy with respect to market risk. All calculations of market risk values are automatically generated by the system, on a daily basis, with calculations of risk values for option portfolios generated on intra-day (hourly) basis – Intra-day VaR. The Bank has a comprehensive database or market data and positions, used for these calculations. This database allows all those who take part in risk management and control, i.e. the three lines of defense, to retrieve information and to calculate revaluations using the system. As part of the Bank's control operations, it has put in place a process of comparing derivative pricing by trading systems used by the Bank, against alternative pricing, calculated by the system.

Restrictions of models used by the Bank to manage market and interest risk

The main models used by the Bank to estimate market and interest risk, as with all models, have restrictions which may be due to model assumptions, input values used or mismatch between the models and market conditions, in particular with regard to stress conditions. The Bank is aware of these restrictions and therefore backs these models with other tools and processes. The VaR model is not appropriate for use under stress conditions, since it relies on historical data, which may not incorporate an estimate of the potential for an extreme market event. Furthermore, the VaR calculation methods generally accepted world-wide assume a normal distribution, which is not maintained under stress conditions. Therefore, as noted above, a few years ago the Bank made a change to its VaR methodology, abandoning the calculation which assumes a normal distribution – in order to align the calculations with variable market conditions and to alert when markets become volatile. In addition, the main way to overcome assumptions of this model is by using stress tests which are "forward-looking", i.e. do not rely on historical data and therefore complement the VaR model. The Bank has developed diverse methods for conducting stress tests to support the VaR calculations; in some of these methods, the Bank does not rely on any models or statistical assumptions, but rather on subjective assessment by Bank experts. The Bank also uses methods based on earnings analysis to provide another view of its risk profile, other than through a model based on economic value. A key component of the Bank's capacity to identify and handle model restrictions is the strict, constant validation process applied by the Bank to models being used, which reviews all model components: input, model calculations and use of the output. This validation process also reviews the models used by the Bank for pricing of derivative transactions.

Handling of inherent behavioral options in on-balance sheet instruments

Some instruments have inherent options which are sensitive to change in interest rates. Forecasting such instruments requires use of behavioral assumptions which are based on models and/or empirical calculations made by the Bank. These models are subject to constant validation, including back testing, designed to review the forecast vs. actual conditions.

Below is a mapping of major inherent behavioral options:

Early repayment of mortgages – behavioral model

Mortgages are spread over the contractual maturity, in addition to behavioral assumptions based on an empirical review of borrower behavior in the various linkage segments. Parameters of the behavioral model are reviewed monthly and brought for discussion by the relevant management committees.

Deposits – behavioral model

The Bank offers a wide range of deposits with inherent behavioral options: withdrawal at periodic exit points, regular exercise of liquid options and future deposits by standing order. The expected future cash flows with respect to these deposits is based on historical behavioral analysis of options exercise, withdrawal and deposit by depositors. These data are regularly reviewed, as part of testing the model assumptions.

Market risk analysis

Below is the capital requirement due to market risk by risk element (NIS in millions):

	December 31, 2016			December 31, 2015		
	Capital requirements(1)			Capital requirements(2)		
Risk element(4)	Specific risk	General risk	Total	Specific risk	General risk	Total
Interest risk(5)	–	119	119	–	93	93
Equity risk	–	–	–	–	–	–
Foreign currency exchange rate risk	–	38	38	–	29	29
Total market risk	–	157	157	–	122	122

(1) The capital requirement was calculated at 13.26%.

(2) The capital requirement was calculated at 12.80%.

(3) Risk associated with options activity is included under the different components, and was calculated using the Delta Plus approach, as defined in the Supervisor of Banks' directive.

(4) Calculated using the Effective Duration approach, as defined in the Supervisor of Banks' directive.

Below is the VaR for the Bank Group (NIS in millions):

	All of 2016	All of 2015
At end of period	386	195
Maximum value during period	386 (Dec.)	379 (May)
Minimum value during period	235 (JAN)	193 (OCT)

Back-testing of the historical-analytic VaR model shows one case in which the daily loss exceeded the forecast VaR value. This deviation, of a small amount, was primarily due to an increase in the NIS-denominated curve (for longer terms). This number of cases is within the criteria specified by the Basel Committee for review of the VaR model quality.

Analysis of interest risk in bank portfolio

Below is the effect of a parallel shift of the curve by 2% on the economic value of the Bank's portfolio in EVE terms (NIS in millions):

						December 31, 2016
						Change in fair value
		Israeli currency				Foreign currency
	Non-linked	Linked to CPI	Dollar	Euro	Other	Total
2% increase	(1,221)	421	(55)	(25)	5	(875)
Decrease of 2%	1,710	(574)	75	29	(5)	1,235

						December 31, 2015
						Change in fair value
		Israeli currency				Foreign currency
	Non-linked	Linked to CPI	Dollar	Euro	Other	Total
2% increase	(631)	83	(72)	(37)	(11)	(668)
Decrease of 2%	875	(198)	91	39	12	819

In preparing the mortgage repayment cash flows forecast for the Bank, assumptions with regard to the pre-payment rate and manner are taken into account. Market risk in the Bank's negotiable portfolio, primarily composed of portfolios managed in the trading room, is managed by means of quantitative limitations specified for each portfolio based on its activity.

Share price risk

Bank policy with regard to investment in non-banking corporations is to realize the current portfolio and individually review any new investments. Shares of non-banking corporations in which the Bank invested were acquired for the purpose of earning capital gains, and are listed at fair value in the available-for-sale security portfolio and under investment in associates, where the Bank has a material investment in such entity. Investments in non-banking corporations are managed by the Business Banking Division. The steering committee for investments in non-banking corporations convenes quarterly and advises Bank management on investments in non-banking corporations. The steering committee is responsible for management and maintenance of the existing portfolio, trying to improve it so as to allow for rational realization of this portfolio within a reasonable time frame but with no specified schedule, in order to allow for maximum returns. Quarterly reports are provided to the Risk Control Division and to other divisions.

About 2% of these investments in non-banking corporations are negotiable and presented at their market value. The remainder of these investments are presented at cost or at their carrying amount. In case of impairment of a non-temporary nature, in accordance with management assessment, a provision for impairment of the investment is made by the Bank.

For more information about equity investments in the bank portfolio, see chapter "Major investees" on the Report by the Board of Directors and Management. and Notes 12 and 15.A to the financial statements.

Below is information about the composition of equity investments in the bank portfolio:

		December 31, 2016
	Fair value	Capital requirement(1)
Shares	58	8
Venture capital / private equity funds	77	10
Total investment in shares in bank portfolio	135	18

		December 31, 2015
	Fair value	Capital requirement(2)
Shares	57	7
Venture capital / private equity funds	77	10
Total investment in shares in bank portfolio	134	17

(1) The capital requirement was calculated at 13.26%.
(2) The capital requirement was calculated at 12.80%.

Operating risk

Operating risk management

Operating risk is defined by the Bank of Israel as the risk of loss due to inappropriateness or failure of internal procedures, people, systems or due to external events.

The Bank applies a wider definition of operating risk, in accordance with the change in this definition by European and other banks. The revised definition would turn the framework for addressing operating risk into an active one, designed to support operations of the business units, to improve major business processes associated with their operations and thus, to increase business value, rather than only reducing the expected loss due to operating risk. The newly revised definition does not supersede the existing ones, which is supported by Basel and by the Bank of Israel, but rather expands it in order to create a framework for operating risk management, which analyzes processes, systems and other risks which may impact the business viability of the Bank.

With the developments in global markets and the higher complexity of financial activity and supporting technological infrastructure, an understanding has emerged, that Bank exposure to potential loss due to failures in regular operating activity may impact the business activity. Operating failure events which occurred at financial institutions in recent years have increased legislator awareness and financial institutions' awareness of operating failure events, to the large potential for damage which may be caused by such operating risk event and to their main attributes, as follows:

- Operating events may occur throughout the organization and are inherent to financial institution operations.
- Operating risk may potentially impact earnings, revenues, value and reputation of the Bank.
- Operating risk has inter-relationships with other risks, such as market risk, credit risk, liquidity risk, reputation risk and other risks. Thus, for example, an operating risk event may cause reputation risk to materialize, after which the Bank may face a liquidity event.
- A significant share of operating failures has very low probability but relatively large damage potential – which may even threaten Bank stability.
- Operating risk has diverse instances, from human error, malfunction in technological systems, fraud, embezzlement, war, fire, robbery etc.
- Operating events sometimes occur which are not under control of the financial institution, and may develop as a result of external events, some of which are unforeseen, with chances of occurring which cannot be estimated in advance, such as: natural disaster (earthquake, flooding), security event.

Bank management and the Board of Directors attach great importance to managing operating risk, due to its materiality, as part of the Bank's overall framework for risk management and control. The Board of Directors and management have determined that management of operating risk requires creation of an appropriate culture within the organization, by means of training, dissemination of related content and application of elevated standards of internal control at all levels.

The Bank has a special policies document for addressing operating risk. The operating Risk Owner at the Bank is the Manager, Risks Control Division – who is also the Bank's Chief Risks Officer. The framework stipulated for handling this risk includes the framework required for handling fraud and embezzlement, which are part of the operating risk categories according to Bank of Israel directives.

The framework for handling operating risk is based on three lines of defense:

- **First line of defense** The Bank's approach is that risk management is based, first and foremost, on the business units, which review the major business processes and put in a continuous effort of self-assessment of the risk associated there with.
- **Second line of defense** The Risks Control Division, and in particular the Operating Risks Department of the Risks Control Division, is tasked with a comprehensive view and monitoring of the operating risk handling framework and with responsibility for handling risk in view of activities in the first line, through a range of processes, tools and methods: Locating major risk hubs in business operations of the first line, through collection of actual operating failure data and conducting specific surveys for identification of potential future failures, as well as adapting the operating risk handling framework to Bank needs, in line with business development at the Bank and with regulatory requirements. The Division also strives for integration between various entities at the Bank, which have monitoring roles for risks adjacent to operating risk (compliance, business continuity, technology, information security and cyber security, SOX) as part of the deployment of the Bank's internal control system.
- **Third line of defense:** Internal Audit conducts audits of operating risk management in order to ascertain the effectiveness of handling such risk, in accordance with the work plan.

Bank policy specifies the Bank's operating risk appetite at 1% of the Bank's capital under normal conditions. This risk is constantly monitored by follow up on any default events which caused a loss, managed by category of operating risk and also includes loss due to legal risk, information security and cyber risk, fraud and embezzlement as well as IT. The policies also stipulate the risk appetite for potential loss upon occurrence of a stress event. The Bank acts to specify a high-quality risk appetite, primarily by creating forward-looking risk indicators which can indicate a potential for development of operating risk, in addition to collection of actual losses, i.e. losses which have already occurred.

The policy specifies the channels for management and reporting of operating risk, designed to ensure proper risk management for all products, activities, processes and material systems of the Bank. To this end, the Bank operates forums at all levels, tasked with handling operating risk:

- **Management Committee for Operating Risks and Control:** Receive periodic reports about operating risks and review progress made by the Bank with regard to handling operating risk and other internal controls aspects.
- **Steering Committee for Management of Operating Risk, Information Security and Cyber Security:** A wider forum, consisting of managers of business line, operations and risk control. The forum discusses, *inter alia*, current reports, monitoring of material events and risks, constant monitoring of the handling framework and approval of changes to work processes in order to minimize the inherent operating risk inherent .
- **Risks Monitoring Forum in operating and business divisions:** Forum consisting of unit managers and discusses unique aspects of risk for these divisions, conducts focused monitoring of the risk profile in the divisions, by discussion of failure events, if any, at the division and the outcome of the risk survey conducted at the division or at units operating within the division.
- **Fraud and Embezzlement Forum:** Forum for monitoring and management of fraud and embezzlement risks and for monitoring implementation of the framework for handling such risks at the Bank.
- Because operating risk is closely linked to the required internal control framework, the Bank operates an internal controls forum, which is the key component for integration of the different control entities – in particular for operating risk, including: information security and cyber, business continuity, accounting and financial reporting, security, compliance, legal risk and in presence of Internal Audit. This forum operates in conformity with specific procedures, to provide an overview of all the aforementioned internal controls risks.

For risk management at Bank units, the Bank appointed internal controls trustees. The internal controls trustees, most of whom operate in the first line of defense, are responsible for handling operating risk and IT risk at their unit. Trustees report any event related to operating risk into a special system created at the Bank – the Operating Risks Portal (PASTEL). This system is used by the Bank for analysis and reporting of operating risk by different criteria. Trustee reports disseminated to a pre-specified list of managers at the Bank and each event is assigned a severity level, in addition to the event description. Currently there are over 150 internal controls trustees working at the Bank, most of them at Bank branches. They are in regular contact with the Operating Risk Department at the Bank HQ.

The Bank conducts surveys to identify and map operating risks at various divisions, as a continuous process focused on mapping and assessment of material risk at each unit. The Bank acts to define, where possible, key performance indicators (KPI) in order to form a tighter link between business targets and the level of inherent operating risk, in conformity with the Bank's revised definition as described above. The survey results and action items are discussed, as part of self-assessment processes, by specific forums, attended by managers of the surveyed units and representatives from the Risks Control Division.

In addition to these surveys, the Bank also analyzes external events in Israel and overseas, which may provide information about potential circumstances and damage which may result in materialization of operating risk. Such analysis serves the Bank in implementation of appropriate steps for parallel processes within the Bank.

One of the key events made public late in the third quarter of 2016 involved opening of accounts and issuing of credit cards to clients of Wells Fargo bank, without their knowledge. This dramatic event, which involved severe fines amounting to USD 190 million, termination of over 5,000 bank employees and resignation of the CEO, was studied in-depth by the Bank – including identification of the material failures in conduct of this bank, discussed by various Bank committees in the fourth quarter of this year.

The Bank allocates capital with respect to operating risk using the standard approach. According to this approach, the Bank was segmented into eight lines of business, as stipulated by the Bank of Israel, with a standard risk weighting assigned to each line of business, reflecting its sensitivity to loss with respect to operating risk. This segmentation and addressing the required capital allocation are incorporated in a specific policy document which governs the aspects required for capital allocation using the standard approach and, in particular, specified the lines of business in Bank operations.

The Bank framework for handling operating risk is reviewed quarterly, as part of the Bank's Risks Document. The risk profile is presented in this context, i.e. the actual loss level, in view of the risk appetite and the most material events which occurred during the quarter are also presented and analyzed.

The Bank has prepared to put in place comprehensive infrastructure for addressing fraud and embezzlement risk. As part of this effort, the Bank operates a range of laws designed to identify anomalies. Handling of fraud and embezzlement is in conformity with a specific policies document, using a framework which integrates several entities at the Bank: Risks Controls, information security and cyber, human resources and the Technology Division.

The third line of operation in the area of operating risks is that of internal audit, which acts independently. The operating risk policies specifies the role of Internal Audit as the entity in charge of carrying out periodic audits of risk management processes, debriefing of fraud and embezzlement events, participation as observer on committees and involvement with the Internal Controls Forum.

Operating risk mitigation

Due to the significance of operating risk, the Bank takes different steps to mitigate this risk. The most important step is to instill a corporate culture which promotes strong awareness of operating risk, and of deployment of risk-mitigating processes. The internal controls trustees, across the entire organization, are the long arm of the operating Risk Manager in this process. As noted above, the Bank initiates delivery of in-person and technology-based training about operating risk to new employees and to units and populations within such units which were identified as being associated with high operating risk.

Changes to revised processes and new processes with potential for materialization of operating risk undergo a structured process of approval by business entities and by control entities, prior to launch, using a checklist – and are sent for approval by the Steering Committee. This mechanism is used to review all aspects of the change, ensuring a professional review of the root risk and how to mitigate it.

One of the tools used by the Bank is debriefing and lesson learning flowing internal and/or external events. Conclusions formulated by this process are incorporated into work processes, systems, training content and procedures – and are also disseminated using the operating risk system to internal controls trustees for deployment at their units.

The Bank has established policies and operating plans for case of emergency, for backup, recovery and business continuity in case of physical damage to Bank infrastructure. This plan, supported by emergency procedures and pre-appointed officers, is exercised annually and the conclusions from such exercises is incorporated into the action plan.

Mitigating operating risk via insurance – the Bank is insured under a banking insurance policies, against damage which may be incurred in the course of normal operations, as a result of human error, fraud, embezzlement etc. The Bank obtains an officers' insurance policies, which applies to all officers at the Bank and at the different Bank Group companies, which provides insurance coverage for personal claims which may be filed against officers with respect to their actions in the course of their position with Group companies. Obtaining such an officer liability insurance policy is subject to approval by the General Meeting of Bank shareholders.

The Bank has obtained specific insurance policies for property damage and liability, which provide insurance coverage of Bank property and liability. The Bank has a specific policy document which governs insurance aspects related to Bank operations.

Business continuity

The Bank applies Proper Banking Conduct Directive 355. In implementing the directive, the Bank maintains a management and reporting framework, including a steering committee which supervises implementation of the plan and a manager responsible for actual implementation. Once every six months, a status report is provided to management and to the Board of Directors' Risks Committee. The Bank implements a multi-annual exercise program, which includes drills and technology trials, in order to review and improve readiness and awareness of Bank management and employees to handling disaster scenarios; this included exercise of the secondary computer site (DRP).

In the second half of 2016, progress was made on implementation and management of the business continuity plan, including better technology survivability and improved readiness of DRP sites. Highlights of activities:

Training and drilling:

- In-person training at Bank branches, including core branches.
- Regular training on business continuity in banking courses at the Training Center.
- Comprehensive annual exercise using national reference scenarios and internal scenarios, including exercise of in-depth scenarios of the business continuity plan, with participation of the business divisions and the Situation Room.
- Exercise of alternate Trading Room, involving employees of the Trading Room and the Finance Division, including system operation and conducting transactions.
- Exercise of select branches in operating the business continuity plan and how the branch is to be operated under various emergency scenarios.
- Conducting technology exercises, operating systems at DRP site, including review of the recovery time of computer systems, in conformity with the Bank's recovery plan.
- Taking part in exercises conducted by the Bank of Israel.

Refreshers on basic procedures and BIA:

- In conformity with the maintenance procedure for the business continuity plan, the Bank conducts a refresher of emergency services, once every two years.
- In late 2016, the Bank completed a refresher of emergency services, including the business divisions, and accordingly updated the emergency files of the divisions and the business continuity plan.
- In conformity with the maintenance plan, the Bank recently refreshed the basic procedures of the business continuity plan, including: the policy document, the reference scenario document, the recovery document, the Bank's master procedure etc.

Information security and cyber security

Directive 361 with regard to Cyber Defense Management provides guidelines for proper management of cyber risk, which require expansion and adjustment of the IT risk management framework with regard to the threat space perception and the required defensive capabilities. Accordingly, the Bank has an approved strategy and comprehensive cyber defense policy and has specified the defense lines for implementation thereof, has appointed an Information Security and Cyber Defense Manager, reporting to the Manager, Risks Control Division – responsible, *inter alia*, for setting policy on information security and cyber defense at the Bank, development of a cyber defense work plan, monitoring the implementation of this work plan and review of the effectiveness of systems and processes for information security and cyber defense.

The relationships and information flow between these units have been specified in procedures, including reference to: information security, physical security, IT governance, IT operations, risk management, fraud, human resource management, business continuity, client relationship management, spokesperson operations and legal counsel.

Information security and cyber defense policies at the Bank is implemented, inter alia, by the Mizrahi Tefahot Technology Division Ltd. As part of this effort, the management concept applied includes guidelines for management of cyber security. Application of these guidelines and ensuring that they are current while incorporating them into strategic decisions and business and operational activity at the Bank – would ensure the consistency and integrity of the cyber security management concept over time.

The information security and cyber security policy is based on the following principles:

- Mapping and identifying cyber risks.
- Establishing an effective set of controls with cross-organizational integration of technology, human resources, processes and procedures.
- Specifying mechanisms to protect client and business activities in the online domain, in conformity with Proper Banking Conduct Directive 367.
- Proactive cyber security implemented through mapping and knowledge of the environment, forecasting and study of threats, weighting of the current situation report, development of responsiveness processes, use of techniques for deception, diversion and delay, cyber resilience and recovery capacity, conducting processes of inquiry, debriefing and execution of judgment.
- Implementation of multi-layer security in several circles and disciplines (both logical and physical), from the external system accessible to clients and through to internal systems, information and intelligence sharing.
- Using a system for monitoring, control and response for management of cyber events with integrated, corporate-wide view of components such as human resources, means of communications and procedures.
- Periodic and current reporting of risks management as a whole.
- Current analysis and assessment of cyber threats and exercising all those involved in handling cyber events.
- Development of stress scenarios related to information security and cyber.

In addition, the Bank's On line Banking sector is certified under the information security management standard ISO 27001.

In 2016, the Bank prepared for implementation of Proper Banking Conduct Directive no. 367 with regard to online banking systems and to risk management in this area as from January 1, 2017.

In 2016, the Bank conducted multiple attempts to introduce viruses and ransomware. The existing defense systems blocked these attempts. The appropriate reports have been duly delivered to the various entities involved.

In 2016 there were no significant cyber events which caused damage to the Bank.

Information technology risk

In recent years, the risk associated with IT management has increased, due to development and deployment of new technologies and evolution of new risk and threats. Other than under routine conditions, the IT management framework addresses system failures, such as: system faults and preparation for emergency. This is also intended to ensure that the Bank maintain business continuity during an alert or emergency. This may mitigate reputation risk and business risk which may arise under such conditions.

The Technology Division Manager is responsible for management of IT assets and the management framework is specified in a special policy document, in line with principles specified in policy documents on risk management and control at the Bank. The IT asset management policy is in line with requirements of the Supervisor of Banks and, in particular, with the principles stipulated in Proper Conduct of Banking Business Directive 357 "IT management"; Proper Conduct of Banking Business Directive 350 "Operating risk management"; Proper Conduct of Banking Business Directive 355 "Business continuity management" and Proper Conduct of Banking Business Directive 361 "Cyber security management". The Bank has minimal risk appetite for this risk, which is included, as noted above, under management of risk appetite under routine conditions and under stress conditions, for operating risk.

In the work plan for 2016, the Bank strongly emphasized improvement of the methodology to introduce changes to various work environments, improve survivability of core systems, addressing potential failure scenarios and setting benchmarks for sampling of system availability. In addition, the Bank expanded the scope of systems installed in the DRP site, due to revised business requirements of the Bank in order to ensure business continuity. The Bank continued to deploy advanced control and monitoring tools, expand current rules based on structured work patterns to identify anomalies in the Bank's network.

For more information about the project to replace the core banking system at Bank Yahav, see chapter "Significant developments in IT" of the Report of the Board of Directors and Management.

Note that Bank Yahav has classified the operating risk profile, including information security, and its reputation risk profile as medium, due to the level of technology risk during system stabilization and deployment, which reflects the potential for operating damage, disruption to business activities and impact to bank reputation.

Legal risk

Proper Banking Conduct Directive no. 350 concerning "Operating risks" defines legal risk to include, inter alia, exposure to fines or penalties arising from supervisory action, as well as from individual arrangements.

The Bank regards legal risk in its wider definition, with regard to Bank conduct in its relationships with various stake holders (clients, suppliers, other third parties etc.) Legal risk includes risks arising from legislative and regulatory provisions, rulings by judiciary or quasi-judiciary authorities as well as legal risks arising from regular Bank operations. The Chief Legal Counsel for the Bank has been appointed Chief Legal Risks Manager. The Bank constantly strives to minimize as much as possible the legal risks associated with its current operations, and acts to disseminate a practical culture leading to identification and mitigation of legal risk in all its different aspects.

The Bank's Legal Division regularly analyzes the legal risk components, the risk boundaries (arising, for example, from the counter-party identity, from creation of collateral etc.) as well as specific risk attributes while reviewing its risk level and exposure with attention to the different lines of business at the Bank.

The Bank's Legal Division applies internal processes to ensure regular monitoring of developments in legislation, rulings and other regulatory provisions which could have implications for the day-to-day activities of the Bank Group. In this context, the Legal Division provides guidance to relevant Bank entities with regard to implementation of the implications arising from these developments. The Legal Division provides regular counsel to different Bank units, including to some subsidiaries. This is done, *inter alia*, by providing opinions, editing and updating legal documents, support for updates to procedures etc.

The Bank has specified procedures to help in minimizing legal risk, including regulating the interface between the Legal Division and different Bank departments. The Legal Division is also involved in training delivered to branches, at the Bank's Training Center and in compiling professional eLearning kits for imparting the legal knowledge required for regular Bank operations.

Similar reference is made for Bank affiliates overseas (branches and subsidiaries), with these affiliates receiving assistance from local external attorneys approved by the Bank's Legal Division. The Bank's overseas subsidiaries and affiliates have adopted similar procedures with regard to management of legal risk, and provide immediate and quarterly reports to the Legal Risk Manager of the Bank with regard to any legal risks identified in these entities.

For more information about an investigation by the US Department of Justice concerning Bank Group business with its US clients, see Note 26.C.12 to the financial statements.

Liquidity and financing risk

Management of liquidity and financing risk

Liquidity risk results from uncertainty as to the availability of sources and the ability to realize assets within a specified period of time and at a reasonable price. Liquidity risk is managed in conjunction with Proper Conduct of Banking Business Directive 310 "Risk management", Directive 342 "Liquidity risk management" and Directive 221 "Liquidity coverage ratio". The risk is managed subject to the limitations of the Board of Directors and Executive Management in an effort to minimize the losses deriving from an investment of surplus liquidity in assets that are highly liquid, but have a low yield.

Liquidity risk management is governed by a policies document submitted annually or more frequently for approval by the Board of Directors. The policies document covers how risk is managed, including roles and responsibilities of the various organs, the regular management of liquidity risk, all parameters used for risk measurement in the normal course of business and under various stress scenarios, restrictions specified by the Board of Directors and by management, including restrictions on source concentration and composition, as well as a detailed emergency plan for handling a liquidity crisis, including various states of alert for liquidity risk management and potential means under each scenario type and the estimated time for execution.

The Bank's Board of Directors sets strategy for liquidity risk management and the risk appetite in conformity with regulatory requirements, using a range of restrictions on three risk dimensions: Normal course of business, scenarios (liquidity coverage ratio and minimum liquidity ratio – internal model) and concentration. Bank management has specified a further set of restrictions to serve as management guidelines – beyond those specified by the Board of Directors.

Current and periodic management of liquidity risk is conducted on Group basis, with due attention to legal, regulatory and operating restrictions on the capacity to transfer liquidity. Management is conducted in conjunction with the general risk management framework at the Bank. This framework consists of the first line of defense – Risk Managers at the Finance Division; the second line of defense – risk controllers at the Risks Control Division; and the third line of defense – Internal Audit. Regular management includes monitoring of restrictions set by the Board of Directors and management as well as risk indicators, including with regard to financing source concentration, liquidity exposures at Bank and Group level as well as liquidity gaps resulting from on– and off-balance sheet operations.

The Bank's liquidity management is proactive and strict, including diverse tools for mitigating liquidity risk, both in using detailed models int different world situations, in strict maintenance of liquid means with minimal credit risk which may be immediately realized, and in active management of sources for diversification and extension of the term to maturity and diversification of sources. The Bank has a Liquidity Forum, which convenes daily, under the responsibility of the Finance Division, which discusses the liquidity situation and strives to align the liquidity "needs" of different Bank units with the liquidity "providers" and liquidity managers. In addition, a forum headed by the Finance Division Manager operates at the Bank, for regular monitoring of the implementation of the minimum liquidity ratio directive(Directive 221) and compliance with targets for all business units at the Bank for raising and management of resources. the Risk Control Division also conducts regular, independent controls over risk benchmarks, risk development and event debriefs, as needed.

The Bank has developed an internal model to estimate the liquidity needs and liquid resources, as required by Directive 342 and in accordance with Basel provisions, which specified internal, system and integrated stress scenarios for Israeli currency and foreign currency, from a one-month perspective, for calculating the minimum liquidity ratio – the ratio of liquidity cushion to net forecasted outflows under these scenarios. This is based on behavioral attributes of depositors and on risk focal points, in line with the various scenarios. In early 2017, the internal model was revised. As part of this revision, depositor loyalty was re-characterized using a scorecard model based on client type and nature of activity.

The Bank also applies models for longer and shorter terms, such as Net Stable Funding Ratio (NSFR) – the ratio of stable financing sources (Available Amount of Stable Funding) – existing sources which are highly likely to be available to the banking corporation within 1 year or longer to total long-term uses (Required Amount of Stable Funding) – existing uses which the banking corporation is likely to be required to fund within 1 year or longer). The estimation is based on the latest directives issued by the Basel Committee on this matter. As noted above, restrictions have been specified by the Board of Directors and by management for liquidity ratios under various scenarios, including for terms other than one month and in the normal course of business.

In September 2016, the Bank of Israel issued a Q&A File with regard to Directive 221 "Liquidity coverage ratio". The update stipulated that banking corporations would not be required, as of January 1, 2017, to maintain a minimum liquidity ratio (as specified in Proper Banking Conduct Directive 342) equal to or higher than 1. Therefore, as from the start of 2017, the Board of Directors restrictions with regard to minimum liquidity ratio (internal model) were replaced by management restrictions.

The Bank also applies tools for monitoring liquidity risk using endogenous and exogenous indicators, which may point to an increase in risk up to crisis status. The Bank developed an integrated benchmark for monitoring financial markets in Israel, in order to identify any instability in the financial system in Israel – this benchmark is a decision-support tool for declaring a state of alert due to systemic failure. In 2016, there were several observed events which resulted in shocks to financial markets, such as: sharp declines in equity indexes in Europe in the first quarter of 2016 due to severe concern about stability of European banks and the Brexit event (the UK leaving the EU) in the second quarter of 2016. In actual fact, in all cases there was no impact to the Bank's liquidity situation.

The Bank’s Board of Directors and management receive various reports at daily, weekly, monthly and quarterly frequency – including reports of unusual events in liquidity management and unusual developments in the Bank's liquid sources. In 2016 there were no recorded deviations from the Board of Directors’ restrictions.

The Bank's emergency financing plans refer to management of each emergency and specify the management team responsible for handling it (by level). These plans include detailed specification of additional liquid means for use in emergency as well as a list of operative steps (and the entity authorized to lunch them), also referring to management of communications, both internal and external.

Financing risk

Financing risk arises from shortage of financing sources or too high costs for such sources. This risk is managed, as part of the liquidity risk, using Board and management restrictions on concentration of financing sources and through reduced dependence on material counter-parties.

Concentration of financing sources is monitored through a wide range of restrictions set by the Board of Directors, management as well as by key risk indicators, classified into several sub-categories: Size, client type, individual depositor, number of clients, product and average deposit term. A "super-benchmark" was defined, which averages all indicators related to concentration of financing sources. Current management of source composition includes setting policy on source diversification and financing terms as well as setting specific targets for risk benchmarks. Concentration is monitored daily and is regularly managed and reported.

The Bank's main financing sources are stable and diverse sources for different time horizons – retail and business deposits, long-term deposits from financial institutions and issues of debentures and notes. The Bank sees the great importance of diversification of its financing sources and acts pro-actively to identify sources for longer terms, including through a wide range of deposits offered by the Bank to its clients, deposits with unique attributes, which allow clients to benefit from relatively high interest over the long term with optional liquidity during the deposit term. In the fourth quarter of 2016, concentration risk for financing sources remained low.

Furthermore, exposure to derivatives is regularly managed, in line with the exposure to each counter-party, counter-party collateral is immediately increased or collateral is immediately demanded from the counter-party.

For more information about financing sources, see chapter "Developments in financing sources" in the Report by the Board of Directors and Management.

Liquidity coverage ratio

As from April 1, 2015, the Bank applies Directive 221 "Liquidity coverage ratio" which became effective on that date. This Directive stipulates minimum liquidity ratios for a one-month term (regulatory LCR), calculated based on uniform multipliers for the banking system, specified by the Bank of Israel based on Basel III directives. In conformity with transitional provisions, the minimum requirement increased in 2016 to 80% and as from January 1, 2017, the minimum requirement is 100%. The Bank's Board of Directors specified a further safety cushion beyond the minimum ratio. This ratio is managed and reported for all currencies in aggregate and for NIS separately, both at Bank level and on Group basis. The ratio for the bank solo and the consolidated ratio are calculated daily and reported as the average of daily observations over 90 days prior to the report date. This regulation is in addition to liquidity risk management using internal models, as stipulated by Directive 342, as described above.

In 2016, the Bank continued to maintain appropriate liquidity by investing excess liquidity in liquid assets of very high quality – Level 1 assets. The average (consolidated) liquidity coverage ratio for the fourth quarter of 2016 was 117% (the minimum ratio required by the Supervisor of Banks was 80%), compared to 105% in the third quarter. The increase in the average ratio compared to the previous quarter is due to continued increase in retail and other deposits and continued improvement in the structure of Bank resources, which resulted in increase in liquid assets. In 2016 there were no recorded deviations from the restrictions on this ratio.

The major factors affecting the liquidity coverage ratio results are composition of Bank sources and uses. High-Quality Liquid Assets ("HQLA") are Level 1 assets, which are typically highly negotiable and associated with low risk. These include cash, current accounts and deposits with central banks, debentures of sovereigns with a 0% risk weighting and debentures of the State of Israel. In the fourth quarter of 2016, the average balance of high-quality liquid assets amounted to NIS 38.9 billion, an increase from the previous quarter, when the average balance amounted to NIS 35 billion. Cash outflows primarily consist of un-secured wholesale financing – deposits which corporations and financial institutions deposited with the Bank, as well as outflows with respect to exposure to derivatives. Cash inflows primarily consist of credit receipts and inflows with respect to exposure to derivatives. The average balance of net cash outflows in the fourth quarter of 2016 amounted to NIS 33.2 billion, compared to NIS 33.3 billion in the previous quarter. The ratio in the fourth quarter of 2016 was higher compared to the previous quarter, due to continued improvement of the Bank's source structure, by establishing stable financing sources and diverting short-term financing sources to longer term ones.

Below are details of liquid assets by level, as required by Directive 221 (NIS in millions):

	December 31, 2016	Average for fourth quarter of 2016
Level 1 assets	41,440	38,910
Level 2a assets	13	13
Level 2b assets	–	–
Total HQLA	41,453	38,923

The ratio is primarily cyclical and may be forecast based on internal estimates by the Bank. The key factor which affects evolution of this ratio over time is growth in Bank business, both in raising and management of source composition and increase in uses. In 2016, the Bank acted to increase this ratio, in conformity with the outline described in Proper Banking Conduct Directive 221, to achieve a minimum ratio of 80% in 2016 and a minimum ratio of 100% at the start of 2017, through dynamic management of source composition. The Bank's Board of Directors and management have specified an additional safety margin over and above the required minimum ratio, so that the effective restrictions used for current management are higher than stipulated by the aforementioned directive.

Below is information about liquidity coverage ratio (NIS in millions):

	For the three months ended December 31, 2016	
	Total unweighted value(2) (Average)	Total weighted value(3) (Average)
Total high-quality liquid assets		
Total high-quality liquid assets		38,923
Outgoing cash flows		
Retail deposits from individuals and from small businesses, of which:	90,466	5,695
Stable deposits	27,669	1,383
Less stable deposits	31,334	3,368
Deposits for terms longer than 30 days	31,463	944
Unsecured wholesale financing, of which:	46,960	29,425
Deposits other than for operational needs (all counter-parties)	46,762	29,227
Unsecured debts	198	198
Secured wholesale financing	–	163
Additional liquidity requirements, of which:	72,979	20,196
Outflows with respect to derivatives exposure and other collateral requirements	16,325	16,325
Credit lines and liquidity	29,264	2,070
Other contingent financing obligations	27,390	1,801
Total outgoing cash flows		55,479
Incoming cash flows		
Secured loans	352	163
Inflows from regularly repaid exposures	7,830	5,632
Other incoming cash flows	21,227	16,433
Total incoming cash flows	29,409	22,228
		Total adjusted value(4)
Total high-quality liquid assets		38,923
Total outgoing cash flows, net		33,251
Liquidity coverage ratio (%)		117

(1) Information is presented in terms of simple average of daily observations during the reported quarter.
(2) Unweighted values are to be accounted for as outstanding balances payable or which may be payable by the holder, within 30 days (for both inflows and outflows).
(3) Weighted values are to be accounted for after applying appropriate security factors or inflow / outflow rates (for inflows and outflows).
(4) Adjusted values are to be calculated after applying: Safety factors and inflow / outflow rates; and all applicable restrictions (i.e. restriction on High-Quality Liquid Assets and restriction on inflows, as specified in Proper Banking Conduct Directive 221).

Below is information about liquidity coverage ratio (NIS in millions):

	For the three months ended December 31, 2015	
	Total unweighted value[2] (Average)	Total weighted value[3] (Average)
Total high-quality liquid assets		
Total high-quality liquid assets		27,011
Outgoing cash flows		
Retail deposits from individuals and from small businesses, of which:	82,766	5,005
Stable deposits	25,131	1,257
Less stable deposits	25,729	2,791
Deposits for terms longer than 30 days	31,906	957
Unsecured wholesale financing, of which:	39,967	25,231
Deposits other than for operational needs (all counter-parties)	39,759	25,023
Unsecured debts	208	208
Additional liquidity requirements, of which:	66,377	16,444
Outflows with respect to derivatives exposure and other collateral requirements	13,779	13,779
Credit lines and liquidity	31,441	2,306
Other contingent financing obligations	21,157	359
Total outgoing cash flows		46,680
Incoming cash flows		
Inflows from regularly repaid exposures	5,472	3,211
Other incoming cash flows	17,811	13,668
Total incoming cash flows	23,283	16,879
		Total adjusted value[4]
Total high-quality liquid assets		27,011
Total outgoing cash flows, net		29,801
Liquidity coverage ratio (%)		91

(1) Information is presented in terms of simple average of daily observations during the reported quarter.

(2) Unweighted values are to be accounted for as outstanding balances payable or which may be payable by the holder, within 30 days (for both inflows and outflows).

(3) Weighted values are to be accounted for after applying appropriate security factors or inflow / outflow rates (for inflows and outflows).

(4) Adjusted values are to be calculated after applying: Safety factors and inflow / outflow rates; and all applicable restrictions (i.e. restriction on High-Quality Liquid Assets and restriction on inflows, as specified in Proper Banking Conduct Directive 221).

Other risks

Compliance and regulatory risk

Bank business operations are subject to regulation. Compliance risk is the risk of imposition of legal or regulatory sanctions, material financial loss or impact to reputation, which the Bank may incur due to its failure to comply with compliance provisions.

As from January 1, 2016, when the new Proper Conduct of Banking Business Directive 308 became effective, the scope of responsibility within compliance risk management was expanded; therefore, the compliance provisions include laws, rules and regulations (including positions stated by the Supervisor of Banks in conjunction with handling public inquiries), internal procedures and the Code of Ethics which apply to banking operations at the Bank.

Compliance provisions also include the following laws: ISA Enforcement Proceeding Streamlining Act (Legislative Amendments), 2011; Securities Law 1968; Mutual Investment Act, 1994; Arrangement of Engagement in Investment Consultancy, Investment Marketing and Management of Portfolios Act, 1995 (hereinafter: "the Advisory Act"); hereinafter jointly – "securities laws" as well as the Restrictive Trade Practices Act, 1988. Compliance with these laws is also addressed in conjunction with the "Internal Enforcement Program" for Securities Act and for the Restrictive Trade Practices Act, respectively.

Compliance risk includes cross-border risk, which is presented separately below.

The Bank has minimal risk appetite for compliance and regulatory risk, with regard to compliance with statutory provisions applicable to the Bank. Therefore, the Bank has specified that any faults discovered in compliance with statutory provisions would be addressed by Bank units as a top priority. The Bank has specified a multi-annual work plan for the Compliance Function, which includes qualitative targets for reducing compliance risk across the Bank.

The compliance and regulatory Risk Manager for the Bank is the Manager, Risks Control Division. The Compliance Officer is responsible for continuous management of this risk.

Compliance and regulation risk is managed by three lines of defense:

The first line of defense includes business units and other risk-taking units at the Bank, which are responsible for reducing and controlling compliance risk.

The second line of defense includes the Risks Control Division and the Compliance Division, as well as other "second line" units (Human Resources and Administration Division, Accounting and Financial Reporting Division, Legal Division, Bank Secretary), which are responsible for some compliance areas.

The third line of defense includes Internal Audit, which conducts independent audit of the Compliance Function, including review of the appropriateness and effectiveness of the Compliance Function, including review of controls in line with estimated risk level.

The Manager, Risks Control Division and CRO of the Bank serves as the person in charge of enforcement of securities law and anti-trust law. As required by Proper Banking Conduct Directive 308 ("Compliance Officer"), the Bank appointed a Chief Compliance Officer and a Compliance Function reporting there to (reporting to the Manager, Risks Control Division) whose role is to assist Bank management and the Board of Directors in effective management of compliance risk.

The Bank operates in conformity with policies on compliance and regulation risk management, approved by the Bank Board of Directors. The Compliance Officer acts in conformity with a letter of appointment approved by the Board of Directors, to deploy a compliance culture at the Bank, its subsidiaries and overseas affiliates by implementing a Group policy and supervising the implementation of appropriate compliance processes at subsidiaries and affiliates. Compliance risk is managed by identification, documentation and assessment of compliance risk associated with business operations of the Bank, including developments related to new products, business conduct, lines of business or new clients, or to material changes to any of the above, through various measurement methods.

The Bank also maintains effective enforcement programs for securities law and for anti-trust law, adapted for the Bank and its unique circumstances, as part of overall risks management at the Bank. This is designed to ensure compliance with securities law and to avoid violation thereof. The Chief Enforcement Officer, through the Compliance Officer, handles issues of Bank compliance with obligations arising from securities law in general and in accordance with the enforcement program in particular. The Chief Enforcement Officer is the person responsible, on behalf of Bank management, for on-going implementation of the enforcement program and its deployment across the Bank.

The Compliance Division maps compliance risks in various areas, conducts compliance surveys on different topics from time to time and delivers training to deploy the compliance policy across the Bank. The Compliance Officer is a member of different forums at the Bank, in order to ensure an enterprise-wide view of various compliance aspects. In order to ensure compliance with all statutory provisions, as noted above, the Compliance Officer maintains a control system in line with control plans. These controls are designed to verify compliance of Bank branches and departments with various statutory provisions, as well as the effectiveness of controls applied by the various business and headquarters departments.

In 2016, the risk level for compliance and regulation decreased, in our opinion. The decrease is due to continued addressing of risk classified as High and continued reinforcement of control in both First Line and Second Line units. This is against the backdrop of increased regulation and frequently issued new directives.

For more information see the Detailed Risks Management Report on the Bank website.

Cross-border risk

Cross-border risk is the risk of financial loss (including due to legal proceedings, fines or sanctions imposed by statutory authorities or others in Israel and in other countries) and of impact to reputation, arising from the Bank's failure to comply with statutory provisions originating in other countries – whether provisions binding on the Bank or provisions which are not binding, but failure to comply with them may cause the Bank to incur damage, or from overseas activities of Bank clients in contravention of any statutory provisions.

Cross-border risk includes, *inter alia*, risk of damage, including impact to reputation, due to lawsuits or other enforcement proceedings brought by authorities in other countries, with regard to foreign tax laws applicable to certain Bank clients, AML and terror financing laws, sanctions imposed by international bodies and foreign authorities or other laws. Cross-border risk applies primarily at the Bank's overseas affiliates; in transactions with clients who are foreign residents; in business operations conducted by Bank representatives in foreign countries; and with regard to funds of individual Israeli clients invested overseas.

Cross-border risk includes the risk arising from obligations arising from US tax laws applicable to Bank Group operations outside of the USA (the Foreign Account Tax Compliance Act – "FATCA"). For more information about FATCA, see chapter "Legislation and Supervision of Bank Group Operations" under the chapter "Corporate Governance" on the financial statements.

The Bank has minimal risk appetite for compliance and regulatory risk, with regard to compliance with statutory provisions applicable to the Bank. Therefore, the Bank has specified that any faults discovered in compliance with statutory provisions would be addressed by Bank units as a top priority. The Bank has specified a multi-annual work plan for the Compliance Function, which includes qualitative targets for reducing compliance risk across the Bank.

The cross-border Risk Owner for the Bank is the Manager, Risks Control Division. The Compliance Officer is responsible for continuous management of this risk.

The Bank has zero appetite for cross-border risk. Therefore, the Bank has specified that any faults discovered with regard to cross-border risk would be addressed by Bank units as a top priority. The Bank has specified a multi-annual work plan for the Compliance Function, which includes qualitative targets for reducing compliance risk across the Bank.

Cross-border risk is managed by three lines of defense:

The first line of defense includes business units and other risk-taking units at the Bank, is responsible for reducing and controlling cross-border risk. The first line of defense includes International Operations, which is responsible for operations of tourist and private banking branches in Israel and for overseas affiliates of the Bank, through the local compliance unit of each affiliate. The first line of defense also includes the Retail Division and the Business Division in their operations involving foreign resident clients.

The second line of defense is based on the Compliance Division under the Risks Control Division, which is responsible for deploying an organization-wide compliance culture with procedures and laws, for identification and assessment of cross-border risk, for delivering appropriate training and for specifying procedures. To this end, the Compliance Division is assisted by the Legal Division, the Planning and Operations Division which supports the implementation of processes and IT systems and the Technology Division, which develops computer-based tools for risk identification, monitoring and mitigation.

The third line of defense is Internal Audit, which conducts periodic audit of the management of cross-border risk.

As part of management of cross-border risk, the Bank especially monitors and reviews any monetary transactions where any party to such transaction is located in a country subject to international sanctions.

The Bank has trained 15 branches specialized in management of foreign-resident client accounts and only allows foreign residents to open accounts in these branches. Current foreign-resident clients with a significant balance were relocated from other Bank branches to these specialized branches.

After an increase in risk intensity last year, cross-border risk continued to moderately decrease in 2016, due to continued preparation for risk management.

Prohibition of money laundering

The Bank has zero risk appetite with regard to AML risk.

The AML Risk Owner for the Bank is the Manager, Risks Control Division.

The Chief Compliance Officer for the Bank Group, appointed in the Risks Control Division, is also in charge of implementation of the Prohibition of Money Laundering Act, and of the Prohibition of Financing Terrorism Act for the Bank Group, including Bank affiliates overseas.

The Compliance Division acts to deploy statutory provisions on this matter. The Division handles subjective reports of unusual activity reported to the AML Authority, and conducts various controls over activity in different accounts based on their risk profile, providing regular advice to branches on this matter and delivers training customized for Bank staff in different roles. Moreover, in line with Bank policy, a knowledge test is administered once every two years to all Bank employees.

The Bank operates different computer systems for identifying unusual activity and for monitoring the handling of subjective reports.

The Bank applies on a Group basis, with required changes, its policies in this area as well as statutory provisions, at its subsidiaries and branches in Israel and overseas.

Following the amendment of the Prohibition of Money Laundering Act, which adds serious tax offenses to the list of original violations, making them subject to all requirements with regard to AML, the Bank is preparing to adjust work processes and infrastructure for compliance with this requirement.

AML risk increased in 2016, primarily due to addition of serious tax offenses, as noted, to the Prohibition of Money Laundering Act.

Reputation risk

The Bank has mapped reputation risk as a material risk, because past events indicate that impact to the reputation of a financial institution may result in significant loss of value. Reputation risk is a stand-alone risk, but may also arise from materialization of other risks at the Bank, such as materialization of an operating risk event. Furthermore, impact to Bank reputation may bring about the materialization of other risks, in particular liquidity risk – with growing demand by clients to withdraw deposits.

The Bank has defined its risk appetite for reputation risk as minimal. In recent years, the Bank took action to put in place a framework for handling reputation risk. The Bank considers that this risk should be addressed based on similar principles to those used to address other risks, such as credit risk or market risk – even though this risk is considered harder to quantify. Therefore, similarly to other risks, the Bank's Board of Directors has created a dedicated policy document for addressing reputation risk, which specifies guidelines for risk management, risk appetite, risk measurement and ways to mitigate risk. Accordingly, the Bank incorporated reputation risk into its regular risks management processes, including the process for approval of new products or activities and in self-assessment processes conducted by the Bank and has put in place a framework for regular measurement of this risk. The Bank emphasizes creation of a reporting chain and the required activity under stress conditions, in order to mitigate the impact of such risk, should it materialize. This activity requires identification of risk materialization at its early stages, in order to allow for qualitative and quantitative tools to be applied as early as possible, in order to address this risk. The policy refers to all Bank subsidiaries and stipulates mandatory reporting and the required actions in case of an event classified as a reputation event. The Bank regularly coordinates with Bank Yahav on this matter.

The Reputation Risk Manager is the Manager, Marketing, Promotion and Business Development Division at the Bank.

Reputation risk is managed in conformity with the policy on three levels: In advance (under normal conditions), in real time (alert condition) and in retrospect.

Bank policy also defines the roles of the Risk manager and stipulates how the risk should be addressed under normal conditions and in case of a stress event. The Risk Manager heads the Reputation Risk Committee, which regularly convenes quarterly and as needed, in case of concern about materialization of a stress event. The Committee routinely discusses the outcome of continuous monitoring of this risk which is conducted, *inter alia*, based on internal and external information sources, through surveys and studies, on line discourse, media review and reports by other Risk Managers at the Bank. The work process under stress conditions, i.e. in case of an event which may impact reputation, is incorporated in a specific reporting and action procedure. The objective of this procedure is to define how information is located, the reporting chain, including declaration of a reputation event, how to act during the event and how to declare the event ended, including debriefing and other assessment to review the impact of the event on Bank image, once the event has ended. The Bank has also specified, as part of its business continuity plan, the creation of a media command post, headed by the Risk Manager, which would allow the Bank to handle reputation risk in case of emergency.

The Bank routinely measures its reputation risk in the capital market, in the public and among clients and the business community. This measurement is based on specific quarterly studies which review public opinion (Bank clients and those of other banks), on monthly monitoring of on line discourse, on satisfaction surveys among Bank clients etc. Reports with regard to reputation risk are sent to Bank management and to the Board of Directors in the quarterly Risks Document – as is the case for all risks mapped by the Bank.

In 2016, there were no events which negatively impacted the Bank's reputation.

Strategic risk

Strategic risk is the risk, in real time or potentially in future, of impact to Bank profits, capital or reputation, due to erroneous business decisions, improper deployment of decisions or insufficient preparation for changes in the business environment. This means the risk that the Bank chose the wrong strategy or that the Bank would not be able to implement the business and strategic plan as planned. The materiality of strategic risk requires the Bank to take measures which would allow it to manage this risk and take steps for assessment and early identification of events which may preclude implementation of the strategy.

The Bank operates in conformity with the outline of a five-year strategic plan, most recently approved by the Bank Board of Directors on November 21, 2016, whose principles have been made public. Deviation from Bank strategy is subject to approval by the Bank’s Board of Directors. This risk is monitored by the Planning, Operations and Client Asset Division (hereinafter: "the Planning and Operations Division") and is challenged by the Risks Control Division.

The Strategic Risk Manager is the President & CEO; based on his guidance, management periodically reviews the implementation of the strategy: monitoring of regulatory, economic or technology developments which affect the strategy and initiating annual work plans derived from and in conformity with the strategic plan. In addition, the Planning and Operations Division and the Risks Control Division regularly and independently monitor strategic risk from different control aspects, primarily the following: achievement of targets, risk mapping and identification, stress testing, threat tests and continuous monitoring of the risk profile in view of the Bank's risk appetite. In addition to continuous monitoring of the implementation of work plans and aligning them with the strategic outline, the Bank also monitors developments of external factors which may impact the Bank's strategic risk. The work plans of Bank divisions are adapted, when needed, to the changing business environment in order to achieve business targets and the strategic outline. The Bank is prepared for emergencies so as to reduce the impact to the Bank's business and strategic plan, should extreme economic or geo-political conditions evolve.

Developments in the business environment which may impact strategic risk

- In recent years, the global economy has been unstable and economic growth has been more moderate, along with a near-zero interest rate environment and moderate growth in global demand, as well as increased geo-political tension around the world, due to the emergence of Islamic fundamentalism. The economic growth rate in Israel has slowed down in recent years, due to stagnating exports. The Bank regularly monitors the potential implications of a global and local economic slow-down, which may lead to deterioration in the financial standing of households or may impact business activity in various economic sectors. In particular, the Bank is preparing for a potential change in the interest rate trends in the Israeli economy.
- Growing competition in the financial system, in view of expanded operations of non-banking entities, especially in the credit market and given the entry of technology companies into the financial brokerage area, in particular for the household and small business segments.
- The impact of regulatory provisions in core areas of banking operations, including the potential impact of recommendations made by the Committee for Increased Competition in Common Financial Banking Services in Israel ("the Shtrum Committee").

Remuneration

For more information about the Remuneration of officers in financial corporations act (Special permission and non-allowance of expenses for tax purposes with respect to excessive remuneration), 2016 – see chapter "Legislation and Supervision of Bank Group Operations" in the financial statements.

On June 10, 2014, the General Meeting of Bank shareholders approved, as recommended by the Remuneration Committee on April 29, 2014 and as approved by the Board of Directors on May 4, 2014, the officer remuneration policy at the Bank ("Officer remuneration policy"). This remuneration policy was approved following discussions by the Remuneration Committee of the Board of Directors, in order to align the officer remuneration policy, as approved by the General Meeting of Bank shareholders on August 27, 2013, as required by the Companies Law, 1999 ("the original remuneration policy") with Proper Banking Conduct Directive no. 301A "Remuneration Policies at Banking Corporations". Both for approval of the original remuneration policy and for approval of the current officer remuneration policy – the Remuneration Committee, which consists entirely of external Board members (in conformity with the Companies Law and with Proper Banking Conduct Directive 301 "Board of Directors"), was assisted by various advisors: The law firm of "Meitar, Liqvornik, Geva, Leshem, Tal Attorneys at Law" as legal counsel, as well as Ernst & Young and Professor Sharon Henes as economic advisors. The officer remuneration policy applies to all Bank officers, including the Chairman of the Board of Directors, the Bank President & CEO, gatekeepers (Chief Accountant, Chief Internal Auditor, Chief Legal Counsel and Chief Risks Officer), vice presidents, CIO, Bank Secretary and Board members. For more information about the Chairman of the board of Directors, see Note 22 to the financial statements.

In conformity with the officer remuneration policy, the Remuneration Committee and the Board of Directors approved the officer remuneration plan (with regard to the Bank President & CEO, his terms of employment and office, including the remuneration plan, which includes a monetary bonus and equity-based remuneration by allotment of option warrants by way of private placement, the General Assembly of Bank shareholders approved those terms on June 10, 2014). As noted above, the remuneration plan distinguishes between business officers and gatekeepers, for whom a "monetary preservation bonus" was specified – which is not contingent on performance – and individual performance benchmarks were specified – which are independent of the business which they supervise.

Based on the remuneration principles specified by the Remuneration Committee and adopted by the Board of Directors, as reflected in the officer remuneration policy – the Remuneration Committee recommended and the Board of Directors approved in June 2014 a remuneration policy for all Bank employees other than officers ("the remuneration policy").

The remuneration policy specifies remuneration terms of all key employees at the Bank, those of other managers at the Bank and of other Bank employees for 2014-2016. Key employees are defined, in the remuneration policy, as any employee reporting directly to Bank officers and all division and sector managers at the Bank – even if they do not report directly to Bank officers.

The group of key employees at the Bank, other than officers, consists in 2016 of 52 managers, including 10 managers in subsidiaries.

The remuneration policy applies Group-wide; it also applies, *mutatis mutandis*, to Bank subsidiaries other than Bank Yahav – whose remuneration policy has been communicated to the Bank.

The objective of the remuneration policy is to ensure that remuneration of Bank employees, including key employees, would be consistent with the Bank's risk management framework, with its long-term objectives, with the Bank's strategic plan and its control environment, as well as with actual employee performance over the short, medium and long terms. Accordingly, the goals underlying the remuneration policy were: create an incentive structure for Bank employees which maintains a proper balance between fixed and variable remuneration components and which promotes effective, well established risk management which does not encourage risk taking beyond the Bank's risk appetite and allows the Bank to maintain a solid capital base; align remuneration incentives payable to Bank employees with the Bank's strategic plan, with long-term objectives of the Bank, with the Bank's results over time and with actual contribution of Bank employees to achieving such Bank objectives; alignment of Bank contracting with Bank employees other than officers, in order to create balanced conditions which do not jeopardize the robustness and stability of the Bank, as well as preserving senior Bank employees and ensuring, in as much as possible, the Bank's capacity to recruit high-quality managers in future, allowing for organization-wide considerations such as cost of remuneration and desired remuneration gaps between various ranks of Bank employees, as well as the competitiveness in the banking sector, the Bank's size, scope of operations and nature of its business.

Remuneration components of Bank employees include fixed and variable remuneration, as customary at the Bank, as well as any other benefit, payment or commitment to make a payment, provided with respect to their employment at the Bank.

The great majority of key employees are employed by individual employment contract. As for officers, their terms of office and employment include waiver and indemnification, as customary at the Bank.

Variable remuneration for key employees and other managers includes a monetary bonus and long-term equity-based remuneration. Variable remuneration is designed to align the interests of managers and key employees with those of the Bank and to reinforce the link between the Bank's overall performance and the key employee's contribution to achievement of such performance, and the key employee's remuneration – with consideration to the Bank's risk profile.

Variable remuneration is objective-dependent and performance-dependent and as such, encourages key employees to generate economic value and to promote the Bank's medium-term and long-term objectives, while maintaining the Bank's risks management framework and risk appetite. Therefore, performance-based remuneration payable to key employees is contingent on Bank performance in the medium and long terms, considering the Bank's strategic plan – but would not encourage taking risks beyond the Bank's risk appetite and would maintain a proper balance between fixed and variable remuneration components.

Equity-based remuneration is typically awarded by way of options, granted in advance, in three annual lots – for each period of the remuneration policy, as described in the outline of offering to employees, as approved by the Board of Directors on June 19, 2014, after approval by the Remuneration Committee. As well as a capped monetary bonus, such that the total value of variable remuneration would not exceed 100% of the key employee's total fixed remuneration. With regard to the 2014 outline of offering to employees and another outline dated 2015, see Immediate Reports no. 2014-01-091176 and 2015-01-088305, respectively (reference to this report constitutes inclusion by way of reference of the content thereof).

Key employees' eligibility for variable remuneration is contingent on fulfillment of all threshold conditions specified in the officer remuneration policy, in line with the officer remuneration policy, i.e.: Return on equity for the bonus year shall be at least 9%; Overall capital adequacy ratio and core capital adequacy ratio for the Bank, for the bonus year, shall be no less than the minimum ratios specified in Bank of Israel regulations and, under special circumstances, should the return on equity be lower than 9% but the second condition is fulfilled – a special bonus of up to two monthly salaries may be awarded.

Eligibility of key employees to a monetary bonus is based on quantitative, company-wide criteria identical to those applicable for officers: return on equity, return on Bank shares relative to benchmark, operating efficiency ratio and average ratio of deposits to loans. In addition, eligibility of key employees for a monetary bonus is based on qualitative criteria, consisting of individual performance benchmarks (specified annually, based on performance targets according to the work plan for each year) and which include objectives related to risks management and compliance as well as evaluation by their supervisors. The individual performance benchmarks for each key employee are based on the risks handled by each employee in their role. In addition, a threshold was specified for the evaluation criteria, below which the key employee would not be eligible for any annual monetary bonus. The individual performance benchmarks specified for managers, related to risk control and compliance, are related to development and implementation of risks monitoring mechanisms and to development and implementation of effective alerts to deviation from the definitions specified by Bank management and Board of Directors, as well as supervision and control of implementation of required statutory provisions, as the case may be. Individual performance benchmarks specified for managers involved in audits are related to the scope and quality of audits performed under their supervision with reference to coverage of major risk factors in their field, implementation of a clear professional policy in support of Bank objectives and deployment of high professional standards. These performance benchmarks are not contingent on performance of Bank business lines and units which they supervise or audit, as the case may be.

Eligibility of key employees for options, for each of the annual lots, would be determined based on the four Bank-wide benchmarks, as described above (for officers other than President & CEO or Chairman of the Board of Directors, the cumulative weighting of Bank-wide benchmarks is 80%, individual performance objectives are weighted at 10% and supervisor evaluation is weighted at 10%).

The Bank has specified steps ("minimum achievement", "target achievement", "maximum achievement"), the achievement of which would confer eligibility to receive variable remuneration at different rates.

In conformity with the employee offering outline, options have been allotted to officers, to other key employees and to other managers at the Bank and at Bank subsidiaries, with respect to the policy period ("the outline"). As for officers and key employees, the outline stipulates that the number of options for which they would be eligible with respect to each annual lot, would vest in three equal parts over three

18-month periods starting on three consecutive years as from the date of eligibility (one year after the financial statements for the year for which the lot has been allotted have been made public). Threshold conditions and steps have been specified with regard to eligibility for exercise in deferred periods, too.

In conformity with the remuneration policy, a key employee must reimburse, including by way of offset, any variable remuneration paid them – if paid based on data which turned out to be erroneous and were restated on the Bank's (consolidated) financial statements within three years following the end of the year for which the variable remuneration was paid, but no later than three years after termination of their employment by the Bank.

Furthermore, the remuneration policy stipulates – and option offerees have committed accordingly – that no private hedging arrangements may be entered into which would eliminate the effect of risk-sensitivity inherent in their remuneration.

As for managers other than key employees, the three lots awarded them would vest on the 1st, 2nd and 3rd anniversary (respectively) of the option award date and they may be exercised over a period of 4.5 years. Eligibility for options would be based on the Bank-wide criteria, which are identical for officers and for other key employees.

For officers not employed by individual employment contract and for all other Bank employees – the monetary bonus consists of a general bonus and individual bonus, based on their department and with due consideration to objectives for revenues, risk management, compliance, compliance with regulatory requirements and internal audit findings, public complaints and service quality to clients. In addition, the individual contribution of each employee and their supervisor's evaluation would be taken into consideration.

Following the enactment of the Remuneration of Officers in Financial Corporations Act (Special Permission and Non-allowance of Expenses for Tax Purposes with Respect to Excessive Remuneration), 2016 ("the Executive Remuneration Act") and following revisions to Proper Banking Conduct Directive 301A on remuneration, on February 14, 2017 the Bank approved a revised officer remuneration policy, as recommended by the Remuneration Committee and approved by the Board of Directors ("the current remuneration policy"). The policy applies from 2017 through 2019.

In formulating the current remuneration policy, the Remuneration Committee, which consists entirely of external Board members (in conformity with the Companies Law and with Proper Banking Conduct Directive 301 "Board of Directors"), was assisted by various advisors: The law firm of "Meitar, Liqvornik, Geva, Leshem, Tal Attorneys at Law" as legal counsel, as well as Professor Sharon Henes as economic advisors. The officer remuneration policy applies to all Bank officers, including the Chairman of the Board of Directors, the Bank President & CEO, gatekeepers (Chief Accountant, Chief Internal Auditor, Chief Legal Counsel, Chief Risks Officer and Bank Secretary), vice presidents, CIO, Bank Secretary and Board members. For more information about the Chairman of the Board of Directors and the Bank President & CEO, including with regard to adapting their remuneration to provisions of the Executive Remuneration Act, see Note 22 to the financial statements.

The Remuneration Committee of the Bank’s Board of Directors, which is the main entity supervising remuneration at the Bank, held 14 meetings in 2016. Total remuneration paid to Committee members in 2016 for attending Committee meetings amounted to NIS 528 thousand.

Below is a summary of quantitative data for variable remuneration (NIS in millions):

	All of 2016			
	Officers		Key employees	
	Number of employees	Total remuneration	Number of employees	Total remuneration
Employees who received variable remuneration during the reported year	13		51	
Guaranteed bonuses awarded during the reported year	4	1	–	–
Signing bonuses awarded during the reported year	–	–	–	–
Severance pay paid during the reported year	–	–	1	4
Total deferred compensation balance as yet unpaid				
Cash-based	–	–	52	3
Share-based instruments(1)	13	18	52	13

	All of 2015			
	Officers		Key employees	
	Number of employees	Total remuneration	Number of employees	Total remuneration
Employees who received variable remuneration during the reported year	14		52	
Guaranteed bonuses awarded during the reported year	4	1	–	–
Signing bonuses awarded during the reported year	–	–	–	–
Severance pay paid during the reported year	–	–	–	–
Total deferred compensation balance as yet unpaid				
Cash-based	–	–	52	3
Share-based instruments(1)	13	14	52	8

Below is additional information about remuneration for the reported year (NIS in millions):

Officers		All of 2016		All of 2015
Total value of remuneration with respect to the reported year	Non deferred	Deferred	Non deferred	Deferred
Fixed remuneration				
Cash-based	26	–	27	–
Variable remuneration				
Cash-based	6	–	8	–
Share-based instruments[(1)]	–	6	–	6

Key employees		All of 2016		All of 2015
Total value of remuneration with respect to the reported year	Non deferred	Deferred	Non deferred	Deferred
Fixed remuneration				
Cash-based	49	–	48	–
Variable remuneration				
Cash-based	6	2	5	1
Share-based instruments[(1)]	–	4	–	4

(1) Based on fair value on the award date.

Appendix – Composition of supervisory capital

Below is the detailed composition of supervisory capital, in conformity with disclosure requirements of Basel Pillar 3 as of December 31.

In order to present the connection between the Bank's consolidated balance sheet and supervisory capital components, the following table includes references to another table, later in this chapter (hereinafter: "Stage 2"). This other table lists the balance sheet items which include the supervisory capital components.

According to the directives, each line of this table should be completed, even if the supervisory capital component or the supervisory adjustment are zero or negligible.

		2016		2015		
		Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	References from step 2
		NIS in millions				
Tier I capital: Instruments and retained earnings						
1	Ordinary share capital issued by the banking corporation and ordinary share premium for shares included in Tier I capital	2,221	–	2,214	–	1+2
2	Retained earnings, including dividends proposed or declared after the balance sheet date	10,821	–	9,747	17	3
3	Accumulated other comprehensive income and retained earnings for which disclosure has been given	(85)	44	(38)	59	4
4	Tier I equity instruments issued by the banking corporation, eligible for inclusion in regulatory capital during transitional period	–	–	–	–	
5	Ordinary shares issued by consolidated subsidiaries of the banking corporation, which are held by a third party (non-controlling interests)	463	98	474	140	5
6	Tier I equity before regulatory adjustments and deductions	13,420	142	12,397	216	
Tier I capital: Regulatory adjustments and deductions						
7	Prudential valuation adjustments	–	–	–	–	
8	Goodwill, net of related deferred tax liability, if applicable	87	–	87	–	6

		2016		2015		
		Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	References from step 2
		NIS in millions				
9	Other intangible assets, other than mortgage-servicing rights, net of related deferred tax liability	–	–	–	–	7+8
10	Deferred tax assets that rely on future profitability of the banking corporation, excluding those arising from temporary differences	–	–	–	–	9
11	Accumulated other comprehensive income with respect to cash flows hedging of items not listed at fair value on the balance sheet	5	4	6	8	10
12	Shortfall of provisions to expected losses	–	–	–	–	
13	Increase in shareholders' equity due to securitization transactions	–	–	–	–	
14	Unrealized gains / losses from changes to fair value of liabilities arising from change to own credit risk of the banking corporation. In addition, with regard to liabilities with respect to derivatives, all debt value adjustments (DVA) arising from own credit risk of the banking corporation is to be deducted	10	7	5	8	11
15	Excess deposits over provision, net of deferred tax liabilities to be settled should the asset become impaired or be disposed in conformity with Public Reporting Directives	–	–	–	–	12+13
16	Investment in own ordinary shares, held directly or indirectly (including commitment to purchase shares subject to contractual obligations)	–	–	–	–	
17	Reciprocal cross-holdings in ordinary shares of financial corporations	–	–	–	–	
18	Investments in the capital of financial corporations not consolidated in the public financial statements of the banking corporation, where the banking corporation does not hold more than 10% of the issued ordinary share capital of the financial corporation	–	–	–	–	14

		2016		2015		
		Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	References from step 2
		NIS in millions				
19	Investments in the capital of financial corporations not consolidated in the public financial statements of the banking corporation, where the banking corporation holds more than 10% of the issued ordinary share capital of the financial corporation	–	–	–	–	
20	Mortgage servicing rights whose amount exceeds 10% of Tier I equity	–	–	–	–	
21	Deferred tax assets arising from temporary differences, whose amount exceeds 10% of Tier I equity	–	–	–	–	
22	Amount of mortgage servicing rights, deferred tax assets arising from temporary differences and investments that exceed 10% of the ordinary share capital issued by financial corporations, which exceeds 15% of Tier I equity of the banking corporation	–	–	–	–	
23	Of which: With respect to investments that exceed 10% of the ordinary share capital issued by financial corporations	–	–	–	–	
24	Of which: With respect to mortgage servicing rights	–	–	–	–	
25	Of which: Deferred tax assets arising from temporary differences	–	–	–	–	
26	Regulatory adjustments and other deductions stipulated by the Supervisor of Banks	–	–	–	–	
26.A	Of which: With respect to investments in capital of financial corporations	–	–	–	–	
26.B	Of which: With respect to mortgage servicing rights	–	–	–	–	
26.C	Of which: Additional regulatory adjustments to Tier I equity, not included in sections 25.A and 25.B.	–	–	–	–	
	Regulatory adjustments to Tier I equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	–	–	–	–	

		2016		2015		
		Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	References from step 2
		NIS in millions				
27	Deductions applicable to Tier I equity, due to insufficient additional Tier I and Tier II capital to cover deductions	–	–	–	–	
28	Total regulatory adjustments to and deductions from Tier I equity	103	10	98	16	
29	Tier I capital	13,318	153	12,299	232	
Additional Tier I capital: Instruments						
30	Additional Tier I equity instruments issued by the banking corporation and premium for such instruments	–	–	–	–	
31	Of which: Classified as equity in conformity with Public Reporting Regulations	–	–	–	–	15a+16a
32	Of which: Classified as liabilities in conformity with Public Reporting Directives	–	–	–	–	
33	Additional Tier I equity instruments issued by the banking corporation, eligible for inclusion in regulatory capital during transitional period	–	–	–	–	15a+16a
34	Additional Tier I equity instruments issued by subsidiaries of the banking corporation, held by third party investors	–	–	–	–	17
35	Of which: Additional Tier I equity instruments issued by subsidiaries of the banking corporation, held by third party investors, subject to phase-out from additional Tier I capital	–	–	–	–	
36	Tier I capital, before deductions	–	–	–	–	
Additional Tier I capital: Deductions						
37	Investment in own additional Tier I equity instruments, held directly or indirectly (including commitment to purchase such instruments subject to contractual obligations)	–	–	–	–	
38	Reciprocal cross-holdings in additional Tier I equity instruments	–	–	–	–	

		2016		2015		
		Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	References from step 2
		NIS in millions				
39	Investments in the capital of financial corporations not consolidated in the public financial statements of the banking corporation, where the banking corporation does not hold more than 10% of the issued ordinary share capital of the financial corporation	–	–	–	–	
40	Investments in the capital of financial corporations not consolidated in the public financial statements of the banking corporation, where the banking corporation does not hold more than 10% of the issued ordinary share capital of the financial corporation	–	–	–	–	
41	Other deductions stipulated by the Supervisor of Banks	–	–	–	–	
41.A	Of which: With respect to investments in capital of financial corporations	–	–	–	–	
41.B	Of which: Other deductions from Tier I capital, not included in section 1.A	–	–	–	–	
	Other deductions from Tier I capital, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	–	–	–	–	
	Of which: Additional regulatory adjustments to Tier I capital, not included in section 38.A	–	–	–	–	
42	Deductions applicable to additional Tier I capital, due to insufficient Tier II capital to cover deductions	–	–	–	–	
43	Total deductions from additional Tier I capital	–	–	–	–	
44	Additional Tier I capital	–	–	–	–	
45	Tier I capital	13,318	153	12,299	232	

		2016		2015		
		Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	References from step 2
		NIS in millions				
Tier II capital: Instruments and provisions						
46	Instruments issued by the banking corporation (not included in Tier I capital) and premium on such instruments	599	–	417	–	18a
47	Tier II capital instruments issued by the banking corporation, eligible for inclusion in regulatory capital during transitional period	2,680	2,680	3,127	3,127	18b
48	Tier II capital instruments issued by subsidiaries of the banking corporation to third party investors	213	–	–	–	19
49	Of which: Tier II capital instruments issued by subsidiaries of the banking corporation, held by third party investors, subject to phase-out from Tier II capital	–	–	–	–	
50	Group provisions for credit losses by effect of related tax	1,397	–	1,372	–	20
51	Tier II capital, before deductions	4,888	2,680	4,916	3,127	
Tier II capital: Deductions						
52	Investment in own Tier II capital instruments, held directly or indirectly (including commitment to purchase such instruments subject to contractual obligations)	–	–	–	–	
53	Reciprocal cross-holdings in Tier II capital instruments of financial corporations	–	–	–	–	
54	Investments in the capital of financial corporations not consolidated in the public financial statements of the banking corporation, where the banking corporation does not hold more than 10% of the issued ordinary share capital of the financial corporation	–	–	–	–	
55	Investments in the capital of financial corporations not consolidated in the public financial statements of the banking corporation, where the banking corporation holds more than 10% of the issued ordinary share capital of the financial corporation	–	–	–	–	

		2016		2015		
		Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	References from step 2
		NIS in millions				
56	Other deductions stipulated by the Supervisor of Banks	–	–	–	–	
56.A	Of which: With respect to investments in capital of financial corporations	–	–	–	–	
56.B	Of which: Other deductions from Tier II capital, not included in section 51.A	–	–	–	–	
	Regulatory adjustments to Tier II capital, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	–	–	–	–	
57	Total deductions from Tier II capital	–	–	–	–	
58	Tier II capital	4,888	2,680	4,916	3,127	
59	Total equity	18,206	2,832	17,215	3,359	
	Total risk weighted assets in conformity with treatment required prior to adoption of Directive 202, in conformity with Basel III	–	–	–	–	
60	Total risk weighted assets	131,902	–	129,486	–	
Capital ratios and capital conservation buffer						
61	Tier I capital	10.10%		9.50%		
62	Tier I capital	10.10%		9.50%		
63	Total capital	13.80%		13.29%		
64	Not applicable	–		–		
65	Not applicable	–		–		
66	Not applicable	–		–		
67	Not applicable	–		–		
68	Not applicable	–		–		
Minimum requirements stipulated by the Supervisor of Banks						
69	Minimum Tier I capital adequacy ratio required by Supervisor of Banks	9.76%		9.30%		
70	Minimum Tier I capital adequacy ratio required by Supervisor of Banks	9.76%		9.30%		
71	Minimum overall capital adequacy ratio required by Supervisor of Banks	13.26%		12.80%		

		2016		2015		
		Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	References from step 2
		NIS in millions				
Amounts below deduction threshold (before risk weighting)						
72	Investments in capital of financial corporations (other than banking corporations and their subsidiaries), that do not exceed 10% of ordinary share capital issued by the financial corporation and that are below the deduction threshold	–	–	–	–	
73	Investments in Tier I capital of financial corporations (other than banking corporations and their subsidiaries , that do exceed 10% of ordinary share capital issued by the financial corporation and that are below the deduction threshold	2	–	2	–	
74	Mortgage servicing rights	–	–	–	–	
75	Deferred tax assets arising from temporary differences, that are below the deduction threshold	907	–	930	–	
Cap for inclusion of provisions in Tier II						
76	Provision eligible for inclusion in Tier II in respect of exposures subject to standardized approach, prior to application of cap	1,397	–	1,372	–	
77	Cap on inclusion of provisions in Tier II under standardized approach	1,527	–	1,502	–	
78	Provision eligible for inclusion in Tier II in respect of exposures subject to internal ratings-based approach, prior to application of cap	–	–	–	–	
79	Cap on inclusion of provisions in Tier II under internal ratings-based approach	–	–	–	–	

		2016		2015		
		Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	Balance	Amounts not deducted from equity, subject to required treatment prior to adoption of Directive 202, in conformity with Basel III	References from step 2
		NIS in millions				
Equity instruments not eligible as regulatory capital subject to transitional provisions						
80	Current cap for instruments included in Tier I equity that are subject to transitional provisions	–	–	–	–	
81	Amount deducted from Tier I equity due to cap	–	–	–	–	
82	Current cap for instruments included in additional Tier I equity that are subject to transitional provisions	–	–	–	–	
83	Amount deducted from additional Tier I capital due to cap	–	–	–	–	
84	Current cap for instruments included in Tier II equity that are subject to transitional provisions	2,680	–	3,127	–	
85	Amount deducted from Tier II capital due to cap	48	–	65	–	

Below are supervisory capital components, as included on the Bank's consolidated balance sheet[1].

According to disclosure requirements of Pillar 3, the relationship between the balance sheet, as it appears on the Bank's financial statements, and supervisory capital components must be presented in the above table. The following table shows the Bank's consolidated balance sheet in detail, listing the balance sheet items which include the supervisory capital components:

	Consolidated supervisory balance sheet		References supervisory regulatory capital components
	As of December 31		
	2016	2015	
	NIS in millions		
Assets			
Cash and deposits with banks	41,725	30,489	
Securities	10,262	11,845	
Of which: Investments in equity of financial corporations, not exceeding 10% of share capital of each financial corporation	–	–	14
Of which: Investments in equity of financial corporations, exceeding 10% of share capital of each financial corporation, not exceeding the deduction threshold	–	–	
Of which: Other securities	10,262	11,845	
Securities loaned or purchased in resale agreements	9	71	
Loans to the public	172,779	160,604	
Provision for credit losses	(1,438)	(1,400)	
Of which: Group provision for credit losses included in Tier II	(1,293)	(1,271)	20
Of which: Provision for credit losses not included in regulatory capital	(145)	(129)	
Loans to the public, net	171,341	159,204	
Loans to Governments	330	316	
Investments in associates	34	36	
Of which: Investments in equity of financial corporations, exceeding 10% of share capital of each financial corporation, not exceeding the deduction threshold	2	2	
Of which: Investments in other associates	32	34	
Buildings and equipment	1,585	1,583	
Intangible assets and goodwill	87	87	
Of which: Goodwill	87	87	6
Of which: Other intangible assets	(0)	–	7
Assets with respect to derivative instruments	3,584	3,527	
Other assets	1,498	2,000	
Of which: Deferred tax assets	907	930	
Of which: Deferred tax assets, other than those arising from temporary differences	–	–	9
Of which: Deferred tax liability with respect to intangible assets	–	–	8
Of which: Other deferred tax assets	907	930	
Of which: Excess deposit over provision	–	–	12
Of which: Other additional assets	591	1,070	
Total assets	230,455	209,158	

(1) There is no difference between the consolidated balance sheet and the consolidated supervisory balance sheet.

	Consolidated supervisory balance sheet		References supervisory regulatory capital components
	As of December 31		
	2016	2015	
	NIS in millions		
Liabilities and Equity			
Deposits from the public	178,252	162,380	
Deposits from banks	1,537	1,166	
Deposits from the Government	50	58	
Securities loaned or sold in conjunction with repurchase agreements	–	–	
Debentures and subordinated notes*	27,034	23,719	
Of which: Subordinated notes not recognized as regulatory capital	2,463	2,083	
Of which: Subordinated notes recognized as regulatory capital	3,278	3,544	
Of which: Qualifying as supervisory capital components	599	417	16a,18a
Of which: Not qualifying as regulatory capital components and subject to transitional provisions	2,680	3,127	16b,18b
Liabilities with respect to derivative instruments	3,566	3,634	
Of which: With respect to internal credit risk	17	13	11
Other liabilities	6,692	5,786	
Of which: Deferred tax liability arising from retirement	–	–	13
Total liabilities	217,131	196,743	
Equity attributable to equity holders of the banking corporation	12,714	11,847	
Of which: Ordinary share capital	12,957	11,923	
Of which: Ordinary share capital	2,164	2,147	1
Of which: Retained earnings	10,821	9,747	3
Of which: Cumulative other comprehensive loss	(85)	(38)	4
Of which: Losses with respect to adjustments with respect to employee benefits	(67)	(40)	
Of which: Unrealized gains from adjustment to fair value of available-for-sale securities	(27)	(12)	
Of which: Net losses from cash flow hedges	9	14	10
Of which: Net change from translation of financial statements	–	–	
Of which: Capital reserves	58	67	2
Of which: Preferred share capital	–	–	
Of which: Qualifying as supervisory capital components	–	–	15a
Of which: Not qualifying as regulatory capital components and subject to transitional provisions	–	–	15b
Of which: Other equity instruments	–	–	
Of which: Qualifying as supervisory capital components	–	–	
Of which: Not qualifying as regulatory capital components and subject to transitional provisions	–	–	
Non-controlling interests	610	568	
Of which: Non-controlling interests attributable to Tier I equity	463	474	5
Of which: Non-controlling interest attributable to additional Tier I equity	–	–	17
Of which: Non-controlling interests attributable to Tier II capital	–	–	19
Of which: Non-controlling interests not attributable to regulatory capital	147	94	
Total shareholders' equity	13,324	12,415	
Total liabilities and equity	230,455	209,158	

Glossary and index of terms included in the Risk Management Report

Below is a summary of terms included in the Risks Management Report and and index for these terms

1. Terms with regard to risks management at the Bank and to capital adequacy

Term	Explanation	Index in the Risks Report
Back testing	A process for assessment of appropriateness of model results, which includes a comparison of model forecasts and actual results.	Chapter "Market risk and interest risk"
Basel Committee	The Basel Committee is a forum for cooperation on matters of bank supervision. The Committee's objectives are to increase understanding in key supervision issues and to improve the quality of supervision over banking corporations around the world. The Committee is mostly known for the international standards on capital adequacy, core principles for effective supervision over banks and for coordination between different countries in order to create cross-border supervision over banks world-wide.	This term appears multiple times.
Basel II	A framework for assessment of capital adequacy and risks management, published in its final version by the Basel Committee on Bank Supervision in 2006.	This term appears multiple times.
Basel III	A framework for assessment of capital adequacy and risks management, initially published by the Basel Committee on Bank Supervision in 2010.	This term appears multiple times.
Basis (linkage) risk	The risk of capital erosion due to changes in exchange rates and inflation rate. The exposure to basis risk exists when the Bank's assets and liabilities are denominated in different currency or linkage segments.	Chapter "Regulatory capital", chapter "Market and interest risk"
Business continuity	A situation where the Bank operates continuously and with no disruption.	Chapter "Summary risk profile for the Bank", chapter "Risk culture", chapter "Operating risk"
Compliance and regulatory risk	The risk of imposition of legal or regulatory sanctions, material financial loss or impact to Bank image, which the Bank may incur due to its failure to comply with compliance provisions (such as: statutory provisions, regulation, standards and conduct commonly expected from the corporation).	Chapter "Summary risk profile for the Bank", chapter "Other risks"
Counter-party credit risk	The risk that the other party to a transaction would be in default before final settlement of cash flows in the transaction.	Chapter "Summary risk profile for the Bank", chapter "Regulatory capital", chapter "Credit risk"
Credit rating (score)	A credit rating is a score assigned to a borrower, as part of assessment of its capacity to fulfill its obligations when due and in full.	Chapter "Credit risk"

Term	Explanation	Index in the Risks Report
Credit risk	Credit risk is the risk that a borrower or counter-party of the Bank would not fulfill its obligations towards the Bank.	This term appears multiple times.
CRM – Credit Risk Mitigation	Methods for reducing credit risks, such as: Insuring credit exposure through a guarantee or a deposit.	Chapter "Credit risk"
Cross-border risk	The risk of financial loss (including due to legal proceedings, fines or sanctions imposed by statutory authorities or others in Israel and in other countries) and of impact to reputation, arising from the Bank's failure to comply with statutory provisions originating in other countries – whether provisions binding on the Bank or provisions which are not binding, but failure to comply with them may cause the Bank to incur damage, or from overseas activities of Bank clients in contravention of any statutory provisions.	Chapter "Summary risk profile for the Bank", chapter "Other risks"
CSA – Credit Support Annex	An appendix to an ISDA agreement, designed to reduce exposure to counter-party risk, by establishing a way to transfer funds between counter-parties whenever the exposure reaches a certain pre-defined level.	Chapter "Credit risk"
Economic value approach – EVE – Economic Value of Equity	The economic value approach to analysis and estimation of the effect of changes in interest rates on the fair value of assets, liabilities and off-balance sheet positions of the Bank.	Chapter "Market risk and interest risk"
Expected Shortfall VaR	A model which estimates the average loss for the VaR model, beyond the confidence level specified in the VaR model.	Chapter "Market risk and interest risk"
External credit rating agencies	Rating agencies which provide external credit ratings and recognized by the Supervisor of Banks, in conformity with specified qualification requirements. Qualified external credit rating agencies are: S&P, Moody's and Fitch.	Chapter "Credit risk"
Financing risk	Financing risk, or funding liquidity risk, is the risk that the corporation would not be able to efficiently service its cash flows and collateral needs, both expected and unexpected, both present and future, without this affecting its day-to-day operations or its financial standing.	Chapter "Liquidity and financing risk"
HQLA – High Quality Liquid Assets	High-Quality Liquid Assets which may be easily and quickly converted into cash at a small loss (or no loss) under a stress scenario.	Chapter "Liquidity and financing risk"
ICAAP – Internal Capital Adequacy Assessment Process	Internal process for assessment of overall capital adequacy at the Bank. This process includes, *inter alia*, setting capital targets, capital planning processes and review of capital status under various stress scenarios. This process is part of Pillar 2 of the Basel II directive.	This term appears multiple times.

Term	Explanation	Index in the Risks Report
Inflationary exposure	Exposure to loss due to the effect of changes in the Consumer Price Index on profit or capital of the corporation, including through effect on off-balance sheet items.	Chapter "Market risk and interest risk"
Interest risk	The risk to Bank profit (change in revenues) or to Bank capital, primarily due to fluctuations in interest rates, fluctuations of various curves used by the Bank in its business operations or from the fact that a change in interest rates may result in a change in composition of the Bank's assets and liabilities due to exercise of options for early repayment due to change in market interest rates. Changes in interest rates impact Bank profits (change in revenues) and the value of Bank assets (change in fair value).	Chapter "Summary risk profile for the Bank", chapter "Regulatory capital", chapter "Market and interest risk"
KPIs – Key performance indicators	Key performance indicators, used as a tool to formulate insights about the status of process execution across the Bank.	Chapter "Operating risk"
KRI – Key risk indicators	Key risk indicators are risk benchmarks and/or statistical benchmarks used to monitor key factors associated with key risks factors at the banking corporation, in order to try and diagnose risk materialization, as early as possible.	Chapter "Liquidity and financing risk"
Legal risk	Legal risk is part of operating risk and includes the risk of loss due to exposure to fines, lawsuits and/or punitive action due to breach of contract or disagreements. Legal risk includes risks arising from legal exposure due to Bank conduct with its various interested parties (such as: clients, suppliers and other third parties).	Chapter "Summary risk profile for the Bank", chapter "Operating risk"
Liquidity risk	The risk to profit and stability of the banking corporation, due to its inability to satisfy its liquidity requirements.	Chapter "Summary risk profile for the Bank", chapter "Credit risk", chapter "Operating risk", chapter "Liquidity and financing risk"
Loan to Value (LTV) ratio	The ratio between the approved facility when extended and the asset value.	Chapter "Credit risk"
Market risk	This is the risk of loss in on– and off-balance sheet positions, arising from change in fair value of financial instruments, due to change in market risk factors (interest rates, exchange rates, inflation, prices of equities and commodities).	This term appears multiple times.
Minimum total capital ratio	This ratio reflects the minimum supervisory capital requirement which the Bank is required to maintain in conformity with Proper Banking Conduct Directive 201.	Chapter "Regulatory capital"

Term	Explanation	Index in the Risks Report
Model validation	Model validation is a process designed to test and assess the model performance and the risk associated with using it. The model validation process includes review of various model components, principles and assumptions, input / output and processing.	Chapter "Corporate governance for risks management at the Bank Group", chapter "Credit risk"
Operating risk	The risk of loss due to inappropriateness or failure of internal processes, people and systems or due to external events. This risk is inherent in all products, activities, processes and systems.	This term appears multiple times.
Pillar 1	The first pillar of the Basel II project, includes calculation of minimum capital requirements with respect to credit risk (including counter-party risk), market risk (negotiable portfolio only) and operating risk.	This term appears multiple times.
Pillar 2	The second pillar of the Basel II project, refers to the Supervisory Review Process. This part consists of the following basic principles: - The Bank shall conduct the ICAAP process, as defined above. - The Supervisor shall conduct a process to assess the ICAAP process conducted by the Bank, to review the Bank's capacity to monitor and achieve supervisory capital ratios. - The Bank is expected to operate above the specified minimum capital ratios.	This term appears multiple times.
Pillar 3	The third pillar of the Basel II project, designed to promote market discipline by developing a set of disclosure requirements, which would allow market participants to assess the capital, risk exposure and risk assessment processes – and use these to assess the Bank's capital adequacy.	Chapter "Scope"
Reputation risk	Reputation is a set of concepts, ideas and beliefs by interested parties about the corporation, based on their experience and expectations. Reputation risk is the risk to corporate profit, stability or capacity to achieve its objectives, due to impact to reputation which may arise from practices applied by the corporation, its financial standing or negative publicity (whether true or false).	Chapter "Summary risk profile for the Bank", chapter "Operating risk", chapter "Other risk"
Risk	Risk is the potential (likelihood) of impact to capital, profit, stability of the corporation or its capacity to achieve its business objectives.	This term appears multiple times.
Risk appetite	A decision made by the Bank with regard to the risk level which the banking corporation is willing to assume, given the risk / reward attributes.	This term appears multiple times.
Risk assets	These consist of credit risk, operating risk and market risk, calculated using the standard approach as stated in Proper Banking Conduct Directives 201-211.	Chapter "Summary risk profile for the Bank", chapter "Regulatory capital"

Term	Explanation	Index in the Risks Report
Risk profile	Assessment of the aggregate risk inherent in exposures and business operations of the Bank at a certain point in time.	This term appears multiple times.
Risks Document	A document which concisely presents the Bank's risk profile, in order to allow the Board of Directors to monitor action taken by management and to ensure that such action is in line with the risk appetite and with the risks management framework approved by the Board of Directors. The Risks Document is compiled and sent to the Board of Directors quarterly.	This term appears multiple times.
Risks management framework	A framework for risks management, which includes policy, procedures, measurement, risk appetite and controls for risk management.	Chapters "Remuneration" and "Corporate governance for risks management at the Bank Group"
Risks survey	A risk survey is conducted at least once every three years or over a period of up to three years. The survey may include identification of risks associated with various processes at the Bank, assessment of identified risk, recommendations for mitigation of such risks and prioritization of handling it.	Chapter "Operating risk"
Standard approach	An approach used to calculate the required capital with respect to credit risk, market risk or operating risk. Calculation of capital allocation is based on a formula, which is based on supervisory assessment components which have been specified by the Supervisor of Banks.	Chapter "Regulatory capital", chapter "Credit risk"
Strategic risk	Strategic risk is the risk, in real time or potentially in future, of impact to Bank profits, capital or reputation, due to erroneous business decisions, improper deployment of decisions or insufficient preparation for changes in the business environment. This means the risk that the Bank chose the wrong strategy or that the Bank would not be able to implement the business and strategic plan as planned.	Chapter "Other risks", chapter "Summary risk profile for the Bank"
Stress tests	A title for various methods used to assess the financial standing of a banking corporation under a scenario.	This term appears multiple times.
Stressed VaR	Estimate of the Value at Risk (VaR) based on historical data which describe a relevant crisis period.	Chapter "Market risk and interest risk"
Supervisory capital (total capital)	Supervisory capital consists of two tiers: – Tier I equity , which includes Tier I shareholder equity and additional Tier I equity. – Tier II equity. As defined in Proper Banking Conduct Directive 202 "Measurement and capital adequacy – supervisory capital".	Chapter "Scope", chapter "Regulatory capital"

Term	Explanation	Index in the Risks Report
Three lines of defense	The risks management concept is divided into three lines of defense: First line – risks takers: Business line management is responsible for identification, assessment, measurement, monitoring, mitigation and reporting of the inherent risks. It is also responsible for management of an appropriate control environment for risk management. Second line – risk controllers: The risks management function is tasked with complementing the risks management activities by the line of business. Responsible, *inter alia*, for planning and development of a risks management framework and for challenging risks management by the lines of business. Third line – Internal Audit conducts an independent review and challenges the controls, processes and systems used for risks management.	This term appears multiple times.

2. Terms with regard to banking and finance

Term	Meaning	Index in the Risks Report
Asset and Liability Management (ALM)	A technique applied by organizations to align the composition of assets and liabilities in order to ensure an adequate return on equity. This means management of risks arising from gaps between the composition of assets and liabilities, at the business level. This includes processes for management of market and liquidity risks, setting shadow pricing etc.	Chapter "Corporate governance for risks management at the Bank Group", chapter "Credit risk", chapter "Market and interest risk"
Average effective duration	The average term to maturity of debentures. Measured in years, by weighting principal and interest payments for the debenture over its term to final maturity. The average effective duration of a debenture reflects the financial instrument's sensitivity to changes in interest rates. Average effective duration is calculated as the ratio between the weighted average debenture payouts to its price.	Chapter "Regulatory capital", chapter "Market and interest risk"
Banking portfolio / non-negotiable portfolio	The banking portfolio, which is the Bank's primary activity, consists of all transactions not included in the negotiable portfolio, including financial derivatives used to hedge the banking portfolio.	Chapter "Market risk and interest risk"
Credit control	A review process designed to assess performance of the team involved in extending credit and the overall status of the credit portfolio. This process is retroactively conducted by the Bank's Credit Control Department; the review includes a review of rating reliability and appropriateness of classification and provision.	Chapter "Credit risk"
Credit underwriting	A process which includes analysis and assessment of credit risk inherent in a transaction and approval of such transaction in conformity with policy and procedures, in order to extend credit.	Chapter "Scope", chapter "Credit risk"
Debt under restructuring	Problematic debt under restructuring is defined as debt for which, for economic or legal reasons related to financial difficulties of the debtor, the Bank has made a concession by way of modification to terms and conditions of the debt, designed to make it easier for the debtor to make cash payments in the near term (reduction or postponement of cash payments due from the debtor), or by way of receiving other assets as debt repayment (in whole or in part).	Chapter "Credit risk"
Debt under special supervision	Debt under special supervision is debt with potential weaknesses, which require special attention by Bank management. Should these weaknesses not be addressed, the likelihood of debt repayment may deteriorate.	Chapter "Credit risk"

Term	Meaning	Index in the Risks Report
Derivatives	A financial instrument or contract whose value changes in response to changes in the price of the underlying asset (a financial instrument, physical asset, index, credit rating or other underlying asset), requires a small or minimal initial investment, compared to other contract types, and is expected to be settled on a future date.	This term appears multiple times.
Financial covenants	Covenants agreed between lender and borrower in the loan contract, which specify suspensive conditions for extending credit, such as achieving certain financial ratios. Occasionally, a breach of such condition may give cause to demand immediate repayment of the credit.	Chapter "Credit risk"
Financial project assistance	A method for financial project assistance (closed assistance) is a financing method where the borrower expects to be repaid primarily from expected project receipts, which are both the repayment source and the collateral for exposure. As part of this method, the financed projects are closely monitored.	Chapter "Credit risk"
Impaired debt	Debt is classified as impaired when its principal or interest is in arrears over 90 days, unless the debt is well secured and is in collection proceedings. Further, any debt whose terms and conditions have been changed in conjunction with restructuring of problematic debt would be classified as impaired debt, unless prior to and following such restructuring, a provision for credit losses by extent of arrears was made with respect to the debt pursuant to the appendix to Proper Banking Conduct Directive 314 on problematic debt in housing loans.	Chapter "Credit risk"
Inferior debt	Inferior debt is debt insufficiently secured by collateral or by debtor repayment capacity, and for which the Bank may incur a loss if faults are not corrected, including debt over NIS 700 thousand which is 60-89 days in arrears.	Chapter "Credit risk"
ISDA agreement	An agreement which covers transactions in derivatives between banks and allows for aggregation and offset into a single amount of net obligations of either party to all transactions together, upon occurrence of a bankruptcy event or another event which qualifies for transaction closing, according to the agreement.	Chapter "Credit risk"
Liquidity cushion	The balance of liquid assets at the Bank, after applying appropriate predefined safety factors.	Chapter "Operating risk"
Minimum liquidity coverage ratio	The ratio of liquidity cushion to net forecasted cash outflows for the next month, under various scenarios.	Chapter "Operating risk"

Term	Meaning	Index in the Risks Report
Negotiable portfolio	The Bank's negotiable portfolio includes the portfolios managed as market maker in the trading room, as well as portfolios of securities held for trade and transactions in derivatives conducted as part of a specific market strategy, managed by Financial Management under specific limitations on exposure and profitability.	Chapter "Market risk and interest risk"
OTC – Over the Counter	Transaction involving financial instruments which is conducted over the counter and not on a stock exchange.	Chapter "Regulatory capital", chapter "Credit risk"
Problematic debts	Debt classified under one of the following negative classifications: special supervision, inferior or impaired.	Chapter "Summary risk profile for the Bank", chapter "Credit risk"
Provision for credit losses	A provision designed to cover expected credit losses in the Bank's credit portfolio. These losses reflects the net write-off amount which is likely to materialize for a loan or loan group, given the facts and circumstances as of the evaluation date.	Chapter "Summary risk profile for the Bank", chapter "Credit risk"
Securitization	Traditional securitization is a structure where cash flow from a collection of base exposures is used to serve at least two different layers of positions or risk layers, which reflect different credit risk levels. Payments to investors are contingent on the performance of the specific base exposures, as opposed to payments arising from the obligation of the entity which generated such exposure.	Chapter "Credit risk"

3. Terms with regard to regulatory directives

Term	Meaning	Index in the Risks Report
FATCA – Foreign Accounts Tax Compliance Act	The US Foreign Accounts Tax Compliance Act stipulates mandatory reporting to the US tax authority (IRS) of accounts held by US persons with foreign financial institutions (outside the USA).	Chapter "Other risks"
LCR – Liquidity Coverage Ratio	Liquidity Coverage Ratio is defines as the ratio of High Quality Liquid Assets and net cash outflow for the next 30 days, under a stress scenario. This ratio is a benchmark for the Bank's capacity to fulfill its liquidity needs for the coming month.	Chapter "Summary risk profile for the Bank", chapter "Liquidity and financing risk"

4. Other terms

Term	Meaning	Index in the Risks Report
Corporate governance	The ensemble of relations between management, the Board of Directors, shareholders and interested parties which form the structure used to determine Bank objectives and the means to achieve and to monitor these objectives. Corporate governance also supports definition of roles and responsibilities as well as the decision-making process.	Chapter "Corporate governance for risks management at the Bank Group", chapter "Credit risk", chapter "Other risks", chapter "Scope", chapter "Regulatory capital", chapter "Market and interest risk"
SOX	US legislation, partially adopted by the Bank of Israel, designed to regulate responsibilities and internal controls over financial reporting and disclosure at the organization.	Chapter "Operating risk"