
Deutsche Genossenschafts-Hypothekenbank AG

# ANNUAL REPORT 2006

Member of the
Cooperative Financial Services Network

Deutsche
Genossenschafts-
Hypothekenbank

# OVERVIEW

| Business Development € mn | 2006 | 2005 | 2004 | 2003 |
|---|---|---|---|---|
| New business | 18,226 | 16,157 | 15,363 | 11,704 |
| – Real estate lending<br>including: loan extensions | 4,128 | 4,177 | 3,334 | 3,817 |
| – Portfolio investments | 2,753 | 1,767 | 965 | 932 |
| – Public-sector lending*<br>including: loan extensions | 11,345 | 10,213 | 11,064 | 6,955 |
| *Pfandbrief* sales and other refinancing sources | 11,714 | 13,228 | 13,085 | 9,881 |
| **Balance Sheet** | | | | |
| Total assets | 85,671 | 79,140 | 73,813 | 69,097 |
| Real estate lending | 23,531 | 24,790 | 24,809 | 24,779 |
| MBS | 4,923 | 3,396 | 2,216 | 1,865 |
| Public-sector lending | 44,588 | 41,833 | 39,379 | 37,584 |
| Covered bonds (*Pfandbriefe*) and other debt securities | 70,706 | 66,789 | 60,477 | 55,071 |
| Liable capital | 2,214 | 2,197 | 1,977 | 1,953 |
| **Profit and Loss Account** | | | | |
| Gross profit | 297 | 290 | 334 | 295 |
| Administrative expenses | 191 | 178 | 180 | 186 |
| Other operating expenses | 13 | 5 | 3 | 2 |
| Revaluation results | 24 | 42 | 41 | 40 |
| Provisions for loan losses | – 84 | – 98 | – 113 | – 131 |
| Operating profit | 33 | 51 | 79 | 16 |
| Profit transfer | – | – | 18 | 18 |
| **Number of Employees** | | | | |
| Annual average (full-time equivalent) | 594 | 582 | 581 | 593 |
| Vocational trainees | 21 | 22 | 21 | 18 |

* Comprises originated loans to local authorities, plus securities and promissory note loans eligible as cover assets for public-sector covered bonds

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Ladies and Gentlemen, dear business associates,

At DG HYP, 2006 was characterised by consistent further development and implementation of our business strategies for residential and commercial real estate lending as well as active portfolio management. The increasingly intense competition in all segments of real estate lending in Germany is posing notable challenges to the real estate banks' business – and DG HYP is facing these challenges with new product ideas, sales initiatives and workflow optimisation. The main keys to positioning ourselves successfully on the market are innovative strength and a readiness to change. The German real estate market continues to offer attractive potential for business thanks to its size and central location in Europe. That is why we believe that competition offers an opportunity to further develop DG HYP, and to remain competitive in the future.

DG HYP is the largest real estate bank within the German cooperative banking sector. We have comprehensive expertise in retail and commercial real estate lending business, as well as in public sector lending, not to mention the active management of real estate financing portfolios. This means that we are the most important product supplier in the real estate sector for around 1,250 cooperative banks. Our cooperation with the cooperative banks continues to be the central pillar of our business model.

Given this background, we were able to achieve key milestones in the 2006 financial year. We have geared our sales activities in the German cooperative banking sector to all-embracing advice in the real estate finance. At the same time, by launching "immo express", we have provided the cooperative banks and Bausparkasse Schwäbisch Hall with an innovative 'lighthouse' product. Our aim is to win new customers for residential real estate financing in the tough competition with direct banks and with institutions offering an internet-based service. This also lays the foundations to be able to further expand the German cooperative banking sector's share of the market for this key anchor business. In addition, DG HYP increasingly uses its expertise for real estate and the capital market to provide consulting services for third parties for everything to do with real estate and portfolio management. Particularly for our customers in the cooperative banking sector, this offers a major opportunity to generate competitive advantages for real estate financing and public sector lending – whether via optimising own real estate financing portfolios or by structuring attractive financing solutions for real estate investors and local authorities.

In the past few years, DG HYP has successfully established direct business with commercial real estate investors. In addition to its business with the German cooperative banking sector, this is a key sphere of activity for the bank to ensure a broad presence on the real estate financing market, thus bolstering strength of earnings. In this regard, in 2006 we were able to further build on the success that DG HYP has been able to achieve in this division since 2001. We are particularly pleased with the perceptible growth in new international business that we have been able to generate, both via our representative offices in New York and London as well as in European cross-border business.

At DG HYP, active portfolio management is an elementary component of the value chain for state-of-the-art real estate banking. The structure of both the markets and of the competition has undergone sustained change over the past few years. The credit and capital markets are converging; as a result, the lending business is increasingly being driven by demand for credit investments on the capital market. That is why DG HYP issues covered bonds (mortgage bonds – *Pfandbriefe*) and also uses, above all, MBS transactions and portfolio transfers to further grow its real estate lending business with new products and services – flexibly, innovatively, and geared towards growth.

In its business with loans to local authorities, DG HYP has been able to further expand its leading position in the German cooperative banking sector by continuous new business growth. At the same time, the bank has once again proven its benchmark position for mortgage bond business with the high demand and excellent conditions for its jumbo *Pfandbrief* issue in October 2006.

Finally, in the 2006 financial year, DG HYP was able to make significant progress in further developing risk management and credit workflows, which is also documented by the successful Basel II implementation for entry into FIRB status from 1 January 2007.

All told, we believe that DG HYP enjoys an excellent position to continue to offer attractive services in the future for our customers in the German cooperative banking sector, the real estate sector, and amongst the local authorities. We will thus continue to play an active, creative role on the market as a state-of-the-art real estate bank.

The Management Board of DG HYP
Hamburg, April 2007

# RESIDENTIAL REAL ESTATE FINANCE IN GERMANY:
## New opportunities in a changing market

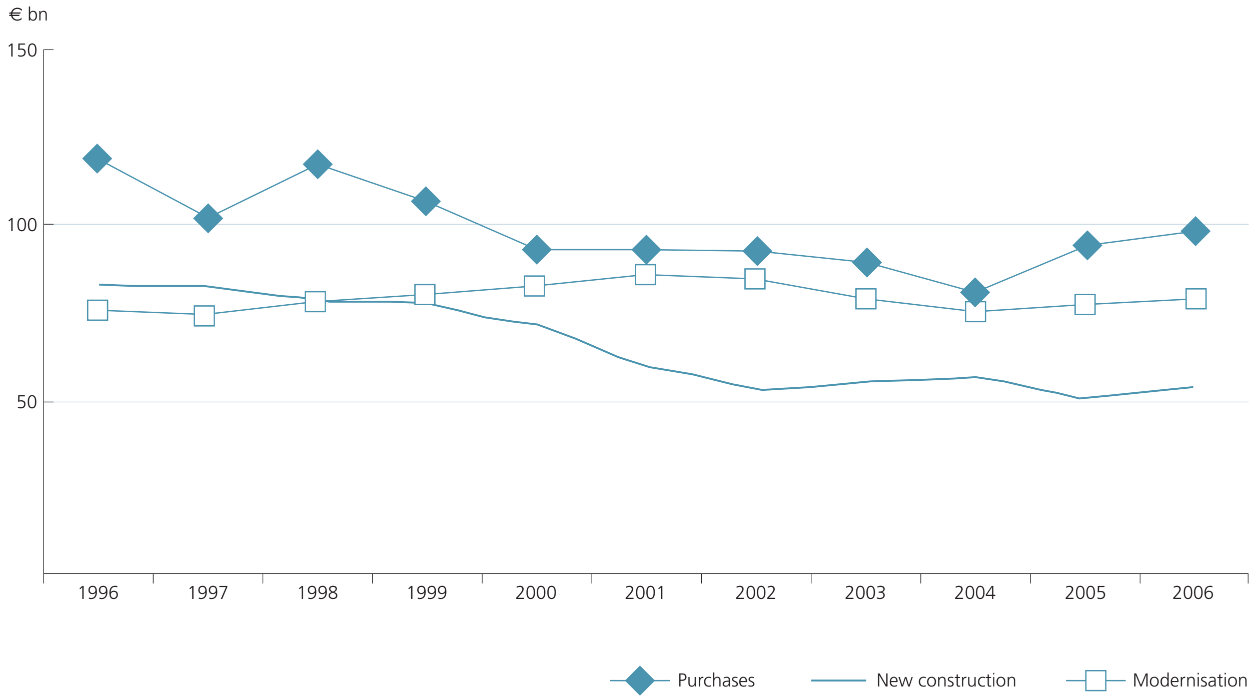
The German residential real estate market has undergone fundamental change in recent years. Whilst a variety of factors have been driving the trend towards a classic buyer's market, with increasingly predatory competition, the residential real estate finance business continues to offer outstanding opportunities for building and maintaining long-term customer relationships – with associated cross-selling potential. In this environment, all market participants are facing new, extraordinary challenges – yet at the same time, they are finding new opportunities by developing attractive products responding to the needs of the market, and of target groups.

**Germany: one of Europe's most attractive real estate markets**

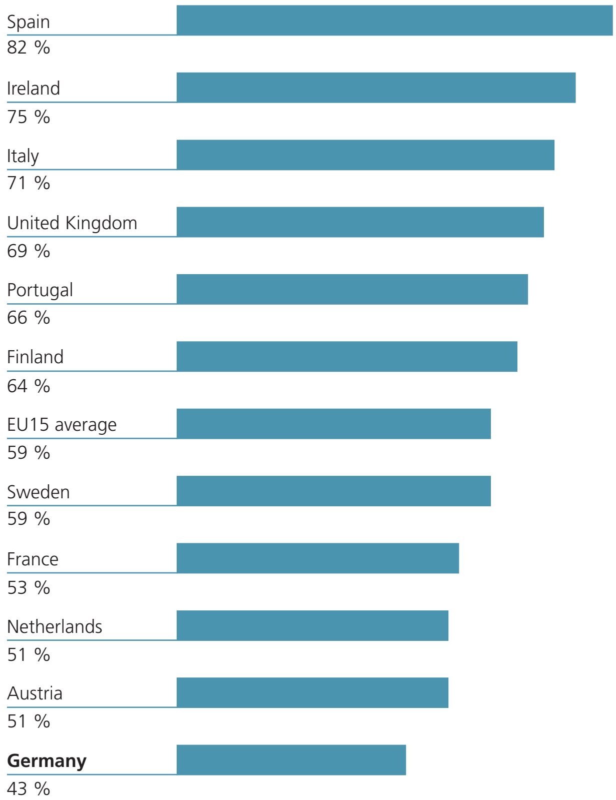
Germany ranks amongst the most attractive European real estate markets, not just due to the sheer size of its 82-million population and its position at the very heart of Europe, but also given the very low proportion of citizens owning the properties they live in. At just 43 per cent, this indicates significant potential to catch up with other international markets. However, the overall volume of new residential construction has been stagnating for years. Whilst new construction activity has declined significantly since the beginning of this decade – currently unchanged at around € 53 billion – construction work performed on existing buildings increased slightly, to € 78 billion. Total transaction volume in real estate purchases is around € 99 billion.

Various trends have driven this development: besides the economic cycle, it particularly reflects a fundamental market change. The shift in demands and requirements of real estate buyers can be related to different factors. Demographic changes, which are bringing about profound changes in the age pyramid, have led to a decline in the number of young families who were traditionally first-time buyers of real estate. To the extent that older people make use of real estate lending at all, they predominantly invest in modernisation projects designed to enhance quality of life – or they sell their family home in order to buy more suitable residential properties in inner-city locations. Rising energy prices provide a strong incentive to invest in modernisation measures to save energy, such as heat insulation, more efficient heating systems or solar panels.

RESIDENTIAL REAL ESTATE MARKET –
NEW CONSTRUCTION/MODERNISATION/PURCHASES (1996–2006)



## PROPORTION OF RESIDENTIAL REAL ESTATE OWNED IN THE EU

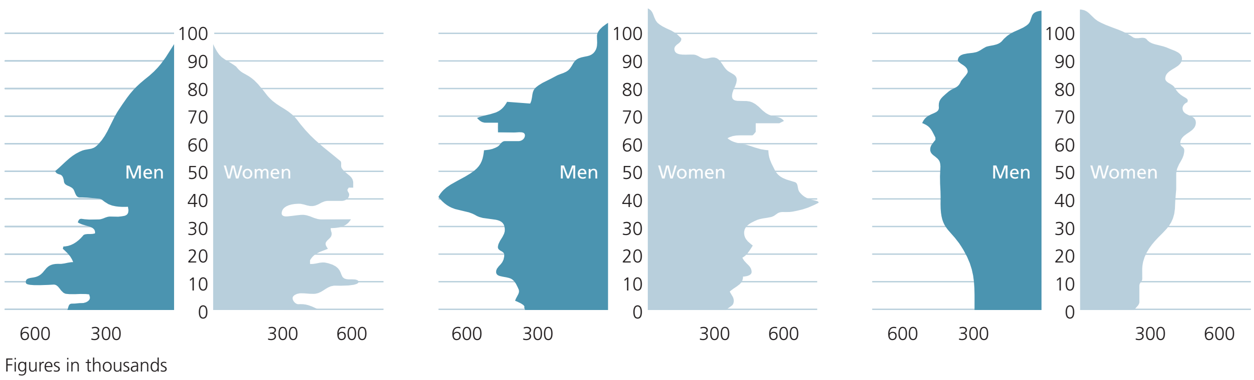



Source: Eurostat

More than ever, real estate markets need to be differentiated by region, as the emergence of prospering regions (as well as those suffering from structural weakness) put higher demands on the mobility of the work force. This has a direct effect on real estate markets. 'Location' as a criterion for purchases has thus gained in importance in several respects. At a macro level, preferred locations tend to be close to economic centres, whilst at a micro level, infrastructure and the immediate vicinity, together with shopping facilities and the social network remain important. As structurally weak, rural regions are becoming increasingly desolate – particularly in East Germany, but also in certain regions of the 'old' Federal Republic – there is continued demand for attractive housing in high-growth urban regions, such as Hamburg or Munich. Regional differences in real estate price developments reflect these trends.

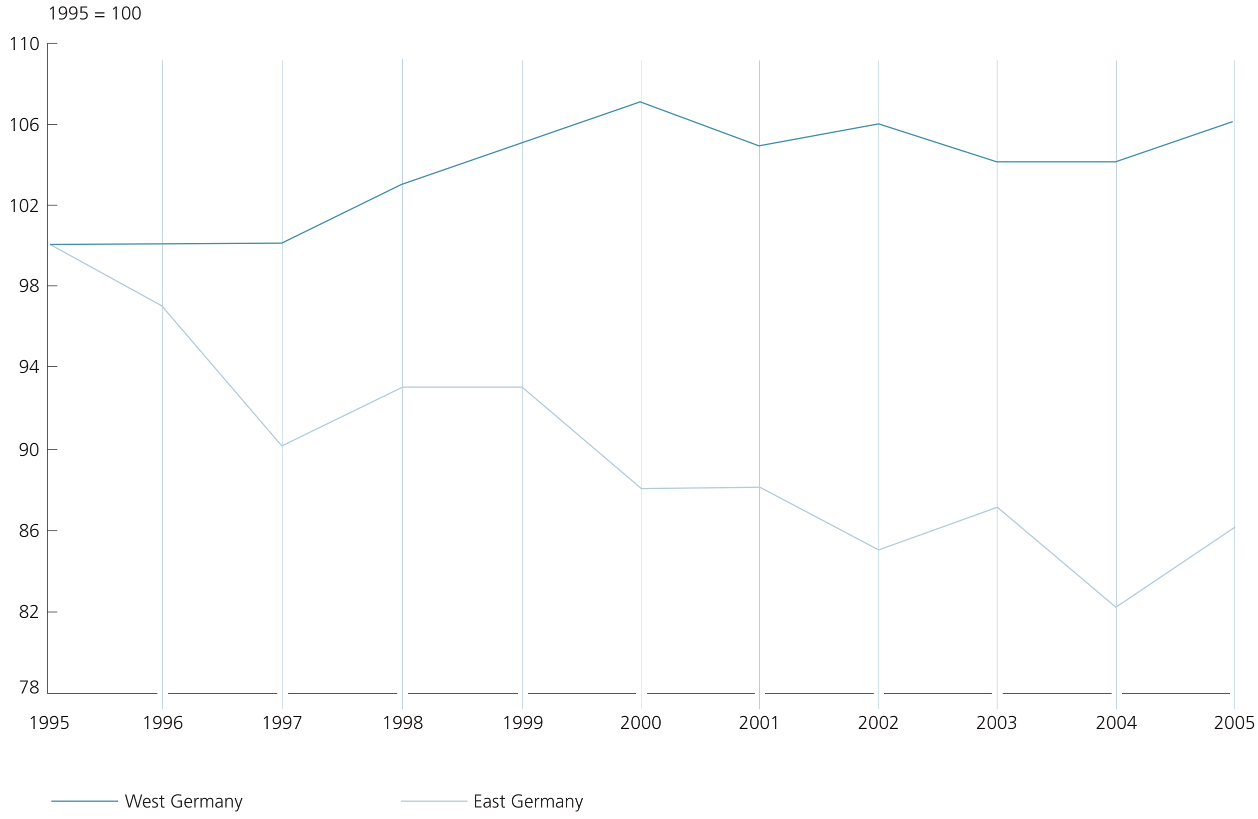
Against this background, residential real estate finance business in Germany is forecast to remain at a high level of between € 170 to 180 billion per annum. Given the stagnation in new construction activity, competitors are likely to focus on financing purchases or modernisation of properties. In this context, the emphasis will be on energy savings and changing environmental regulations, but also on higher expectations regarding housing standards and the specific needs of the fast-growing older generation group.

## DEVELOPMENT OF GERMANY'S AGE PYRAMID (1950–2050)




Source: German Federal Statistical Office, 2005

PRICE DEVELOPMENT FOR RESIDENTIAL REAL ESTATE IN GERMANY (1995–2005)



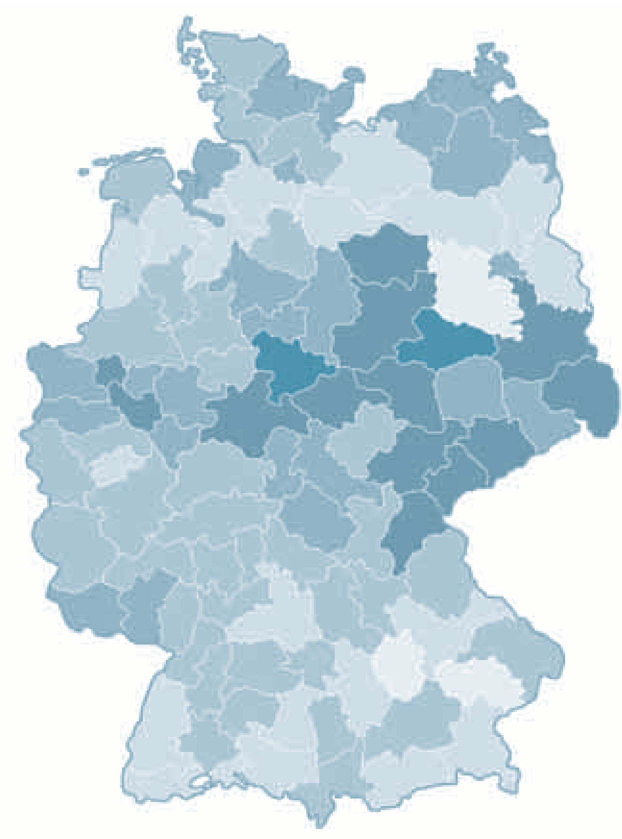

**The renaissance of German retail business – home loan financing as the anchor product**

Business with retail customers – which only a few years ago was regarded as not sufficiently profitable by various market players – has returned to the focus of all banking groups. In the course of this development, the enormous potential offered by the German retail market – which was disregarded for quite some time – is once again being recognised by banks competing for business. As one of the largest economies worldwide, with top rankings in terms of infrastructure and wealth, the requirements for financial services in Germany are quite demanding. The crisis surrounding inadequate social security systems (unemployment insurance, health cover and retirement provisions) will boost retail demand for products designed to secure the standard of living for the long term. Against this background, the retail business is currently experiencing an extraordinary boom, indicated for instance by the fast growth and fierce competition in the consumer credit business. Similarly, very attractive deposit rates or free current account offers were unheard of just a few years ago.

It is thus not surprising that new competitors are challenging the market presence of established financial services providers. Given Germany's economic power and its central location in Europe, for international players there is virtually no way around the German market. Accordingly, competition in retail banking is increasingly being driven by large international banks facing traditional providers such as savings banks or cooperative banks.

Home loan financing has traditionally been an anchor product in retail banking, as it offers the chance of tying in a long-term business relationship with customers, with the opportunity to cross-sell a diverse range of financial services. Alongside other forms of private retirement provision, real estate financing is a key anchor product for cross-selling and cultivating long-term relationships.

## DEVELOPMENT IN DEMAND FOR RESIDENTIAL SPACE



in %

| | | | |
|---|---|---|---|
| –5 | or lower | 5 | to below 10 |
| –5 | to below 0 | 10 | to below 15 |
| 0 | to below 5 | 15 | or more |

Source: BBR Housing Market Forecast 2020

Accordingly, the retail boom has also sharpened competition in home loan financing: besides established players and their direct banking subsidiaries, international providers also compete for stagnating market potential – alongside participants from outside the financial services sector, financial advisors and internet portals (the latter predominantly in an intermediary capacity). Direct banks and internet-based providers have gained significant market share, through a combination of standardised products, swift execution and attractive terms – pushed by high-profile marketing campaigns. In a stagnating market environment, the dynamic growth of these new entrants has been at the expense of established players – at the same time, it has also led to deteriorating real estate lending margins.

In today's globalised market, real estate buyers benefit from increasing pricing transparency through the internet, leading to more discerning demands on real estate financing service offers. Besides benchmark terms and swift execution, customers' focus is on flexibility regarding interest and principal payments.

Still, numerous financing requests are not properly met by standardised product offers, particularly where individual creditworthiness, specific target properties, or special term requirements need to be taken into account. Furthermore, in view of the size of the investment they are about to make, many real estate buyers are looking for advice – on the most appropriate product, on how the financing will be provided, or regarding alternative services. Providers that are purely web-based are generally not in a position to provide such advice. For this reason, direct banks and internet finance providers are increasingly establishing the resources to provide advice on private real estate finance, or they are in the process of expanding existing offers.

**DG HYP as a centre of competence for residential real estate finance within the cooperative banking sector**

With around 1,250 member banks, the cooperative banking sector is a core element of the German financial industry. Thanks to its proximity to approximately 30 million customers, the cooperative banking sector is a key player in the German retail business. Cooperative banks enjoy important competitive advantages thanks to their extensive advisory skills, customer proximity and strong regional presence. The market share of the cooperative banking sector in its core business of residential real estate finance stands at around 20 per cent. Due to fierce competition, however, it has come under massive pressure.

As the centre of competence for real estate finance within the German cooperative banking sector, and in its capacity of an international covered bond issuer, DG HYP is a key product supplier to cooperative banks in real estate finance. DG HYP has the ability to offer them highly flexible financing solutions, even for longer terms, with customised interest or redemption terms, or hedging features. Given their restricted funding resources, and the lack of asset/liability management geared to the capital markets, regional banks are generally unable to provide such products themselves. Moreover, given the large volume and broad diversification of its real estate financing portfolio, DG HYP is in a position to optimise the risk/return profile in real estate lending, actively deploying hedging techniques, and using portfolio purchases and sales. In this way, DG HYP is acting as a bridge to the capital markets, thus significantly broadening the product range and business potential that the cooperative banking sector has to offer in real estate finance.

As a key strategic element of the cooperative banking sector – combining decentralised market coverage of cooperative banks with innovative product development by specialist providers – customer proximity and capital market orientation are important success factors for a product and service offer tailored to market requirements. DG HYP is facing the challenge of developing innovative products to stay abreast with dynamic changes in the competitive real estate finance market. The bank's objective is to stabilise the overall market share held by the cooperative banking sector in this fiercely competitive segment – and to further boost it, in order to explore additional cross-selling opportunities.

Such innovative products not only need to match ever-changing customer needs – it is just as important to make sure they fulfil the requirements of credit risk management by deploying a risk-adjusted product and pricing policy. Given the focus on high-quality, expert advice (which cooperative banks have pursued for many years), predatory, purely price-oriented competition is not an option either. Instead, the objective must be to capitalise on, and further enhance the strengths of the cooperative banking sector, with a view to establishing a unique offer that is distinguished from the competition. Against this backdrop, DG HYP has developed a two-pronged strategy for the cooperative banking sector, comprising a standardised 'lighthouse' product and special products linked to the capital markets.

**Innovative solutions for residential real estate finance: the standardised 'lighthouse' product for the prime customer segment**

There is intense competition for customers with strong creditworthiness who are looking for financings with low loan-to-value ratios – DG HYP's immo express was developed specifically for this target group. This 'lighthouse' product is designed to provide cooperative banks with a high-profile solution helping them attract new customers, and enhance customer loyalty in the highly competitive refinancing business – with the objective of building market share. The key immo express success factors include

- a strong product brand with a high-profile advertising concept;
- straightforward, web-based handling with high service quality, delivered through an 'express check' with the option of contracting online, directly on the website of the relevant cooperative banks (with the additional option of advice provided by that bank's account executives);
- a focus on customers with strong creditworthiness and low loan-to-value ratios not exceeding 60 per cent, allowing the pricing of financings in line with the most aggressive competitors; and
- fast approval and execution within 48 hours.

Combined with the customer proximity and high-quality expert advisory skills of cooperative banks, this concept has set new standards for the home loan financing business offered by the German cooperative banking sector.

From DG HYP's perspective, immo express combines a state-of-the-art direct banking solution with the benefits of customer proximity, advisory skills and quality offered by cooperative banks, without threatening their market position through sheer price dumping. At the same time, the immo express brand provides the strategic basis from which further special products may be launched.

The new product was launched in November 2006, with a successful pilot phase during which eleven cooperative banks successfully tested the product, fine-tuning it for full market rollout. Another 150 banks were included at the beginning of 2007; as part of a second 'wave' to gradually implement immo express throughout the cooperative banking sector.

**A new dimension in residential real estate finance: capital market-oriented special products to enhance the product offer**

The second component of DG HYP's strategy is geared towards the so-called 'subprime' segment in residential real estate finance. Besides the core group of target customers with high creditworthiness, but low or no equity, this segment comprises investors purchasing a property (for example, as an investment forming part of their retirement provisions), or customers outside the traditional age groups for home loan financing. In particular, the latter group includes the target customer group of those aged 55 or over, who will gain in importance due to demographic changes.

These customer groups are outside the target matrix used for standardised products. As a result, price competition among banks is not quite as fierce in this segment. To retain its ability to offer products to this segment which are acceptable to credit risk managers, the bank must explore all options available within the scope of active portfolio management geared to the capital markets.

DG HYP has been building the requisite know-how for several years. The bank is a well-established market participant, leveraging its expertise gained in numerous securitisations and portfolio transactions concluded since 2000. Having bridged the credit and capital markets, DG HYP has the skills and ability to develop financing solutions with product specifications and terms to match the most diverse risk profiles. By ensuring that the product development process is in line with capital market requirements, a transfer of credit risks incurred – through insurance, securitisation, or portfolio transfer – is possible at adequate prices, at all times.

Building on this foundation, DG HYP has developed a range of special products which cooperative banks would not be able to realise themselves, given their lack of direct capital market access. Linking the distribution power of cooperative banks with DG HYP's portfolio management expertise has enabled the German cooperative banking sector to offer a comprehensive and competitive home loan financing product range.

## The outlook for competitive development of residential real estate finance in Germany

Thanks to its real estate know-how and its role as a firmly established intermediary between the credit and capital markets, DG HYP has the ability to recognise trends driven by demographic and social developments in Germany (together with demands in its international competitive environment), and to swiftly respond with new products and services. This includes higher demands regarding the flexibility of real estate loans, as well as the need for increased security in financing models. The increasing importance of residential real estate as a form of retirement provision, or the changing needs regarding a property during different stages in life, also need to be considered in this context.

The following key trends are discernible for the future development of the product range:

### More flexibility

Customers in international markets require a much higher degree of flexibility in residential real estate finance than in Germany. Real estate loans often have no fixed interest rates, and flexible real estate lending is much more prominent compared to the German market: this includes loans with early termination rights (without prepayment penalty), changes in the redemption schedule (including redemption breaks), or revolving loans which are increased or reduced according to the customer's needs.

Given increasing market transparency and the growing number of international competitors on the German market, being able to offer its own solutions for flexible product requirements will become increasingly important for the German cooperative banking sector.

### More refined hedging options

Being able to hedge against risks is not only becoming ever more important for banks, but just as much for their customers. Crucial risk factors affecting residential real estate finance include job loss or divorce.

Against this background, there may be scope in individual cases to minimise risks by adding product elements such as unemployment insurance, residual principal cover, building insurance or similar products, which may be integrated into the financing.

### Recognising demographic requirements

Demographic developments in Germany hold a major challenge for the retail business of banks and insurance companies, as their traditional target groups – those starting their careers – are declining significantly. New opportunities arise through the provisioning gap in state pension schemes, which means that young and old people alike need to take a more active role in securing their own retirement. Real estate plays a major role in this context, alongside life assurance and savings products.

Given the sheer dominance in numbers which '55+' customers are going to achieve, banks and insurance companies will be forced to scrutinise the circumstances and needs of this group, and to draw the right conclusions. As their working life is being extended (currently until the age of 67) and their financial situation is – generally – rather sound, this group holds significant potential through the changing use of properties in line with age requirements. This includes acquiring smaller residential units in central locations, investing in modernisation, switching or extending existing financings, or entering into innovative, communal forms of living. Financing products can be tailored to suit the needs of this group through new offers, such as using a property to generate a pension, or special loans for senior citizens.

### Active customer service – coverage from the first to the last property

Recognising the increasing importance of early planning for private retirement provisions, in conjunction with the still low proportion of owned residential properties in Germany, the active coverage of life planning concepts across different real estate 'stages' may indeed be an attractive proposition. This coverage may include first-time buyers making a limited investment early in their life (when they have less equity) to financing a larger family property (having established one's career), right through to financing a suitable residence for their later years (or generating a pension from it).

This means that real estate finance will evolve into a key component of customers' systematic retirement planning: using different product and pricing profiles during each financing phase. These requirements will place considerable demand on the bank's product development and credit risk management skills.

**Active portfolio management as a key element in the real estate finance process chain**
Actively managing products (and the portfolio) with a view to the capital markets is a key success factor for a specialist real estate finance house, in order to add value in the retail business. This includes providing access to capital market funding at attractive terms (through covered bond issues) as well as other forms of risk transfer (e.g. repackaging and placing loans through mortgage-backed securities), plus the purchase and sale of real estate loan portfolios, through 'true buy' and 'true sale' transactions. Individual loans provide the foundation (and the purchase of portfolios a sensible and sometimes necessary supplement) for (re-)structuring risk profiles to match capital market needs, in order to create attractive portfolio investment opportunities for a highly diverse investor base.

For DG HYP, these key trends are the groundwork from which the bank is developing customised financing solutions to match the projected demand structure, feeding the products into the cooperative banking sector to support member banks in their regional market coverage and exploration.

In conjunction with immo express, it will be possible to conduct the retail business in a flexible manner, ensuring long-term sustainability in terms of risks and returns even in an environment of increasing competition and throughout various interest rate and real estate market cycles.

**Conclusion**

DG HYP aligned its strategic focus to optimising risks and returns in real estate finance through active portfolio management at an early stage. In this way, the bank has acquired the know-how required to support the German cooperative banking sector with an extensive and attractive product portfolio, especially designed for the sector's anchor product of residential real estate finance. In a phase of increasing predatory competition for retail customers, DG HYP's strategic focus is bearing fruit, creating a 'win-win' situation for all parties involved: customers, cooperative banks, and DG HYP itself.

Resolving the potential conflict between standardised and special products, which will characterise future developments in the residential real estate finance market, DG HYP's specialist know-how in developing innovative products that match the needs of target groups will be increasingly sought after. With their strong customer proximity, cooperative banks provide the perfect complement to build a strong distribution platform.

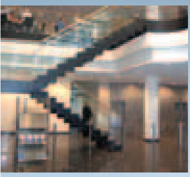
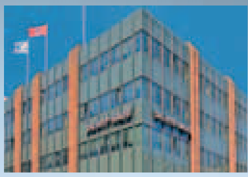
# DG HYP – A MEMBER OF THE DZ BANK GROUP AND A PARTNER FOR THE GERMAN COOPERATIVE BANKING SECTOR

With total assets of € 86 billion and a real estate lending portfolio of € 24 billion, DG HYP – established 1921 – is one of Germany’s leading real estate banks. As the largest issuer of *Pfandbriefe* – German covered bonds – within the German cooperative banking sector, DG HYP offers attractive financing solutions to retail customers, commercial investors, and public-sector entities. In addition, the bank’s range of activities includes loan portfolio deals, syndicated loans, and structured financing solutions. With roughly € 64 billion in securities outstanding, DG HYP is one of Germany’s regular issuers of mortgage bonds and public-sector covered securities.

As a member of the DZ BANK Group, DG HYP is affiliated with Bausparkasse Schwäbisch Hall, DZ BANK International, DZ PRIVATBANK Switzerland, R+V Insurance, TeamBank, Union Investment Group, VR LEASING, and various other specialist financial services providers. The various DZ BANK Group entities and its strong brands are the cornerstones of a comprehensive range of financial services offered to (and through) the German cooperative banking sector. Within this strong network, DZ BANK Group entities work together to optimise the products and services delivered to cooperative banks and their roughly 30 million customers.

DZ BANK Group is a part of the German cooperative banking sector, which comprises approximately 1,250 individual cooperative banks. In terms of aggregate total assets, the cooperative banking sector ranks among the largest financial services organisations in Germany. Within this sector, DZ BANK AG acts as the central institution for more than 1,000 cooperative banks with a total of 12,000 outlets – at the same time however, it is a commercial bank with international reach, having a particular focus on Europe.

Combining banking services with insurance products and asset management has a long tradition within the German cooperative banking sector. The specialist institutions within the DZ BANK Group each offer highly competitive, top quality products in their respective area of competence. This allows Germany’s cooperative banks to offer their customers an end-to-end range of prime financial services.


# MANAGEMENT REPORT

Key strategic development milestones reached.

# ECONOMIC ENVIRONMENT AND STRATEGIC DEVELOPMENT

**Positive economy – real estate markets brightening**

Germany's economy improved substantially in 2006, with GDP growing by more than 2 per cent. This growth was primarily driven by dynamic corporate investments. As a result, the construction sector also grew again for the first time in many years. There are clear signs that the protracted structural problems seen in recent years have mostly been overcome. However, this does not change the fact that it is the big cities that benefit most from this development – for both residential and commercial properties. The trend towards increasing regional differentiation between prosperous and structurally weak locations continued unchanged.

There is stronger demand for both residential and commercial property, in particular from foreign investors. In contrast, demand for private properties has tended to stabilise. Depending on the specific region, growth is very varied in this sector.

The foreign real estate markets served by DG HYP recorded very positive growth. This applies to both London and the US market, which benefited from the strong economic growth – defying many forecasts.

**Significant increase in competition for real estate financing**

Growth on the real estate markets has, on the whole, been positive – accompanied by a substantial increase in competition for real estate financing. In the retail sector, direct banks and internet-based providers are forcing their way onto the market with fervent marketing, and offering attractive terms and conditions. In the commercial real estate financing sector, all of the competitors who had focused on foreign markets in recent years have now returned to the German market. This has placed margins in the real estate lending sector under pressure. Growth in new commitments and loan extensions demands increased efforts from product development and sales.

There is also increased competition for international real estate financing. However, the margins that can be obtained in this sector are still more attractive than for German business.

**Key strategic development milestones reached**

The tasks that DG HYP set itself in the 2006 financial year for the strategic further development of the bank called for drilling down the market orientation coupled with decisions on direction, further steps to optimise credit workflows, and reworking credit risk strategies.

**Reorientation of sales in the cooperative banking sector.** One of the key tasks included in the decision to reorganise VR-Immobilien AG was to anchor responsibility for retail sector sales and marketing with DG HYP. A key objective in this regard was to sustainably bolster DG HYP's image as a centre of competence for real estate and public sector financing.

As a result, we have thus fundamentally remodelled our sales structure in the cooperative banking sector. Our strong sales team offers cooperative banks and Bausparkasse Schwäbisch Hall end-to-end advice and support from a single source. This includes support for fundamental issues regarding the strategic orientation of cooperative banks in the real estate financing business, and – in addition – the entire range of products and services that DG HYP offers via all of its divisions for real estate and public sector financing as well as portfolio management. This means that DG HYP has taken a key step towards further expanding its position as the largest real estate bank in the German cooperative banking sector.

**Residential real estate finance – strategic initiatives, process optimisation and adjustment of credit risk strategy.** DG HYP has developed strategic initiatives to sustainably reinforce the cooperative banking sector's position on the residential real estate finance market compared to direct banks and internet-based providers. This includes immo express, a standardised lighthouse product successfully launched in the autumn of 2006 in an initial pilot stage; and innovative special products – for example financing solutions to accommodate higher loan-to-value ratios – that have been launched on the market at the start of 2007.

The sales drive for residential real estate finance is accompanied by systematic optimisation of credit workflows and an adjustment to the credit risk strategy. Credit workflows in the retail business have been fundamentally reworked in cooperation with our processing partner, VR Kreditwerk, in order to reduce processing time and substantially improve quality and service.

Finally, based on a systematic analysis of the retail portfolio for credit scorings, loan-to-value ratios and property credit ratings, the credit risk strategy in the retail sector has been optimised. DG HYP has thus put additional measures in place to actively manage the risk structure of its retail portfolio.

**Foreign strategy for commercial real estate finance up and running.** DG HYP has enjoyed dynamic growth for commercial real estate finance in Germany over the past few years, and we have now gained a foothold in foreign business with a substantial increase in new commitments. We believe that commercial real estate finance outside of Germany is an attractive supplement to our business, allowing us to benefit from different economic cycles in different markets, thus specifically diversifying risks and spreading our earnings base.

**Portfolio management product range expanded.** Further developments in portfolio management were primarily characterised by the growing importance of true sale and true buy transactions. The market for real estate credit portfolio purchases and sales is currently enjoying dynamic growth, and we believe that this will continue in the coming years. DG HYP has systematically further expanded its activities in this area – both for its own business as well as consulting for third parties – with a range of transactions in the 2006 financial year. With its first 'true buy' portfolio purchase, DG HYP has positioned itself as an active player on this market.

**Basel II successfully implemented.** DG HYP successfully implemented Basel II in the 2006 financial year – thus reaching a further key milestone. We believe that fulfilling the requirements of Basel II is primarily a strategic investment to future-proof the bank. The associated systematic expansion of risk management provides key impulses when it comes to aligning business strategies, structures and workflows. The acceptance audit for the first entry level in the Foundation Internal Rating Based Approach (FIRB) by the supervisory authorities was conducted in the autumn of 2006, and successfully completed with confirmation of admission.

**DG HYP rating again upgraded**

DG HYP's ratings also developed positively in the 2006 financial year, allowing us to further bolster our positioning as a real estate bank geared to the capital markets. Standard & Poor's upgraded the long-term rating for DZ BANK, and thus also DG HYP, in December 2006 from A/positive to A+/stable. The rating awarded by Fitch Ratings for the entire cooperative banking sector, and thus also DG HYP, was confirmed at A+/stable. The two rating agencies upheld their AAA ratings for DG HYP public-sector covered bonds and mortgage bonds (*Hypothekenpfandbriefe*).



# RESIDENTIAL REAL ESTATE FINANCE

Strategic initiatives for a superior competitive position.

# RESIDENTIAL REAL ESTATE FINANCE

Despite favourable underlying conditions, such as unchanged low interest rates, there was no sustained revitalisation in demand for financing for private purchases of residential property during the 2006 financial year. The volume of new construction, and the market volume for the purchase and modernisation of private real estate, were both stable year-on-year. In contrast, there was pronounced momentum in loan extensions, where the impact of the strong real estate financing business at the end of the 1990s made itself felt.

**Challenges in retail business**

At the same time, competition for residential real estate financing once again got significantly hotter from the start of the 2006 financial year. Direct banks and internet-based providers in particular went on the offensive, with intensive marketing and attractive product offers in a bid to win retail customers in the German banking market.

In particular, it can be seen that our sales partners, the cooperative banks, were increasingly geared to their own business rather than acting as agents for real estate loans during 2006. However, we succeeded in increasing the proportion of loan extensions, which is highly attractive business, thanks to joint sales drives with our partner banks.

In total, DG HYP's new commitments and loan extensions for residential real estate finance totalled € 1,750 million in 2006, and is thus down from last year's high level (€ 1,973 million). Residential real estate loans totalled € 16.1 billion on 31 December 2006.

**Future-oriented further development of residential real estate finance – strategic initiatives for the cooperative banking sector**

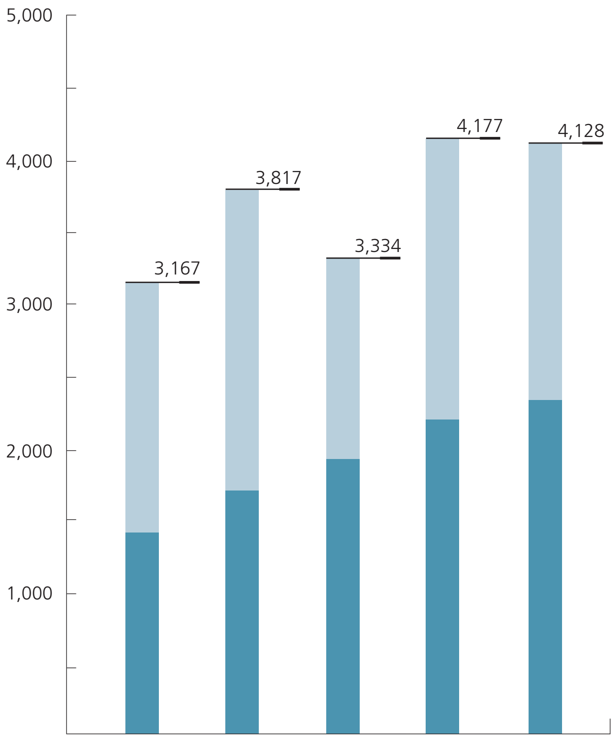
In view of the difficult competitive situation, DG HYP launched strategic initiatives in the 2006 financial year to further develop and future-proof residential real estate financing together with its partners in the German cooperative banking sector. A first key step was to re-orient our sales activities in the cooperative banking sector.

Residential real estate finance is part of the cooperative banks' core business, and is a key anchor business line for the long-term loyalty of retail customers. As an issuer of *Pfandbriefe* – German covered bonds – DG HYP is a major partner in this regard, allowing them to cover the entire bandwidth of residential real estate financing based on low-cost refinancing and active portfolio management via the capital market. Correspondingly, our sales activities place a particular focus on developing strategies for a successful presence on these markets in this area of business together with the cooperative banks.

In line with this, DG HYP has developed strategic initiatives geared to sustainably reinforcing the German cooperative banking sector's presence in the residential real estate financing market. Our lighthouse product immo express is an initial response to the heightened competition. This was piloted in Q4 2006 with some cooperative banks, and will be successively expanded at the start of 2007 to span more than 100 banks within the sector. DG HYP offers cooperative banks a highly competitive, standardised product that is geared to customers with an excellent credit rating and loan-to-value ratios of up to 60 per cent, backed by regional advertising campaigns, attractive terms and service-oriented, simple execution via participating banks' websites.

## NEW PROPERTY LENDING BUSINESS (INCLUDING: LOAN EXTENSIONS)

€ mn



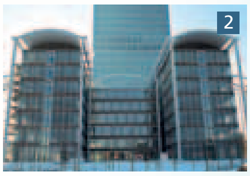

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| Retail RE Finance | 1,755 | 2,111 | 1,407 | 1,973 | 1,750 |
| Commercial RE Finance | 1,412 | 1,706 | 1,927 | 2,204 | 2,378 |

Retail RE Finance     Commercial RE Finance

The graphs do not form part of the Management Report

DG HYP will also launch special products at the start of 2007 to supplement these activities. These will offer attractive solutions for target customer groups with a special risk profile (for instance, higher loan-to-value ratios for borrowers with high creditworthiness, capital investors). In line with its credit risk strategy, DG HYP will actively manage the special product range, and will leverage all of the opportunities for specific placement and hedging of credit risks.

DG HYP aims to leverage these strategic initiatives to create opportunities for its partners in the cooperative banking sector, enabling them to acquire customers for this central anchor business for residential real estate finance, and thus to grow market share.



1 Office Building "Kant Dreieck" in Berlin,
Financing Concept: Real Estate Centre Berlin

2 Office Building "Uptown Munich Ensemble" in Munich,
Financing Concept: Real Estate Centre Munich

3 Shoppingcenter in Essen,
Financing Concept: Real Estate Centre Hamburg

# COMMERCIAL REAL ESTATE FINANCE

On track for growth –
in Germany and abroad.

# COMMERCIAL REAL ESTATE FINANCE

On the whole, the market for commercial real estate in Germany enjoyed positive growth in the 2006 financial year. The most important trend compared to previous years is the significantly greater proportion of foreign investors. Last year, for the first time, they invested more than all of the German investor groups together. At the start of this shift, these investors were mostly US or UK funds; however, investors actively participating in the German market now include players from a range of other European countries (including Scandinavian nations, France, Spain and Switzerland) as well as Australia and Canada.

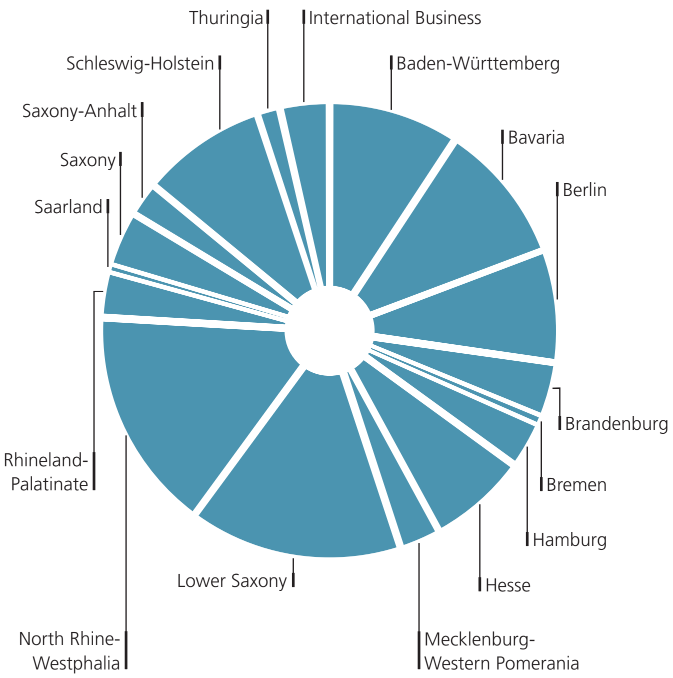
At the same time, competition between banks for commercial real estate finance heated up once again. Several German competitors have returned to the German real estate market. In addition, international competitors are increasingly forcing their way onto the market, with the aim of gaining a foothold as the commercial sector in Germany takes an upturn. Given this background, latitude was limited in terms of both volume and margins.

**Office buildings**

The European market for office properties benefited from positive economic growth in the euro zone and in the United Kingdom. After the difficulties of the past few years, this positive market growth is characterised by increasing prices, high office space turnover and the lowest vacancy levels since 2003.

On the German market in particular, in top locations such as Hamburg, vacancy rates are falling slightly and top-of-the-range rent is rising. In total, it can be seen that the positive trend enjoyed in 2005 continued during the 2006 financial year.

## REAL ESTATE LENDING PORTFOLIO, BY REGION (31 DEC 2006)

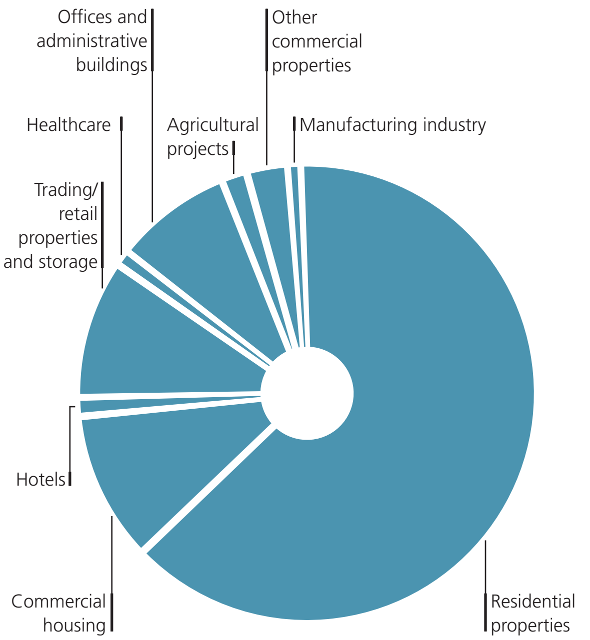



| | in % |
|---|---|
| Baden-Württemberg | 9.4 |
| Bavaria | 10.0 |
| Berlin | 7.8 |
| Brandenburg | 3.9 |
| Bremen | 0.5 |
| Hamburg | 3.4 |
| Hesse | 7.7 |
| Mecklenburg-Western Pomerania | 2.9 |
| Lower Saxony | 14.9 |
| North Rhine-Westphalia | 15.3 |
| Rhineland-Palatinate | 3.3 |
| Saarland | 0.4 |
| Saxony | 3.9 |
| Saxony-Anhalt | 2.3 |
| Schleswig-Holstein | 8.8 |
| Thuringia | 1.6 |
| International Business | 3.9 |
| TOTAL | 100.0 |

**Commercial buildings**

Despite the increase in prices, there is continued high demand from international investors for commercial properties in Germany and Europe. This trend is mostly driven by the fact that attractive returns can still be generated as a result of the current favourable financing conditions. US investors clearly dominate the market, accounting for 66 per cent of the volume of transactions. Buyers from the United Kingdom (12 per cent) and Germany (6 per cent) accounted for a far lower proportion of the total investments.

## REAL ESTATE LENDING PORTFOLIO, BY TYPE OF PROPERTY (31 DEC 2006)




| | in % |
|---|---|
| Manufacturing industry | 0.9 |
| Residential properties | 63.3 |
| Commercial housing | 10.7 |
| Hotels | 1.3 |
| Trading/retail properties and storage | 9.3 |
| Healthcare | 1.2 |
| Offices and administrative buildings | 8.8 |
| Agricultural projects | 1.7 |
| Other commercial properties | 2.8 |
| TOTAL | 100.0 |

In this regard, investors are increasingly focusing on smaller and medium-sized towns with good connections to the big cities, which enjoy comparatively modest rents and purchase price multiples. Demand is focusing on individual properties in 1a locations as well as shopping centres, specialist retail store centres, business parks and supermarket portfolios.

**Commercial housing**

In view of demographic growth, the centres of Germany's big cities in particular are increasingly attractive for commercial housing. Investor interest is focused less on the new construction of apartment blocks, but rather on existing housing properties. Here, there is demand from foreign investors in particular for portfolios, with larger deals having become more scarce and the number of small transactions increasing. Modernisation activities are being driven further by the commercial housing sector. Profit opportunities can be found, particularly in top quality stocks of housing suitable for retired persons.

**Logistics properties**

The European logistics property market has gained significantly in importance over the past few years. The volume of transactions increased, from € 3.8 billion in 2000 to more than € 10 billion in 2006 – up 160 per cent in six years. Germany benefits from its location at the heart of Europe. In the first three quarters of 2006, € 1.7 billion was invested in German logistics properties, almost the same amount as in the whole of 2005. Hamburg holds the top rank for sales of logistics space, with significantly in excess of 400,000 $m^2$. This is followed by Frankfurt (around 300,000 $m^2$), Munich (approx. 250,000 $m^2$) and Dusseldorf (around 260,000 $m^2$).

**Growth of foreign markets**

The foreign real estate markets in which DG HYP has representative offices once again enjoyed positive growth in 2006. London in particular continues to be at the European forefront with high rental figures, double-digit rent increases and significant reductions in vacancy levels.

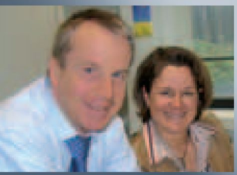
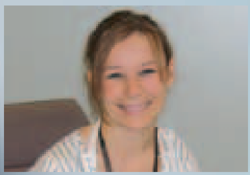
In the US, growth on the real estate markets was very pleasing in 2006 – defying many forecasts. As a result of increasing employment figures, demand for office space is increasing again. Vacancy rates are falling and prices are increasing, especially where levels of new construction are failing to meet demand.

**Continuation of expansion for commercial real estate finance**

For commercial real estate finance, DG HYP leverages its market and product expertise for both direct business with real estate investors on its core German market as well as in its cooperation with cooperative banks via syndicated loans for primary banks' commercial customers.

DG HYP was able to use this as its foundation for its strategic expansion over the past few years in commercial real estate finance: this has continued in 2006. New business and loan extensions reached € 2,378 million during 2006, which equates to a 7.9 per cent year-on-year increase (2005: € 2,204 million). DG HYP has thus succeeded in successfully positioning itself on the market with its decentralised structure of six Real Estate Centres in Germany's main financial cities.

International business also enjoyed pleasing growth. The proportion of foreign finance to new business increased perceptibly, from 6.3 per cent last year to 19.1 per cent in 2006. DG HYP has representative offices in London and New York: these locations form the focus of DG HYP's involvement in international real estate finance.



# CREDIT TREASURY

Portfolio transfers and services: expanding our position as an active manager of real estate loan portfolios.

# CREDIT TREASURY

In the Credit Treasury division, active management of DG HYP's real estate financing portfolio was consistently developed further during the 2006 financial year. To manage the portfolio, the bank's risk management team constantly monitors exposure, with the objective of optimising the risk/return profile of our assets and thus achieving a more efficient use of our capital. In addition to buying, selling and hedging real estate financing portfolios, DG HYP is increasingly leveraging its competence in this field to offer portfolio management consulting services for third parties. We are thus also expanding, in particular, our range of services as a centre of competence for real estate financing in the German cooperative banking sector.

**Loan securitisations and portfolio transfers continue to grow**

Securitisation markets continued to grow in the 2006 financial year, particularly for real estate assets under RMBS and CMBS. This shows that the importance of actively transferring risk in real estate lending is continuing to grow.

At the same time, direct purchases and sales of real estate financing portfolios are growing dynamically. In the past few years, vibrant trading in non-performing loans has developed. This is primarily driven by international investors, and mostly comprises large-volume deals. This market already reached a high degree of maturity in Germany in a relatively short period, with record transaction volumes seen in 2005 and 2006. In the meantime, average transaction sizes are starting to decrease, with an increasing number of smaller banks joining the fray to reduce their stocks of non-performing loans. This sector continues to offer substantial business potential – in particular with regard to the German cooperative banking sector – which means that annual transaction volumes will decrease over the coming years, alongside an increasing number of transactions.

We also believe that buying and selling problem-free real estate financing portfolios (performing loans) offers interesting potential for business. Equity management, which is enjoying additional impetus at present thanks to Basel II, and strategic considerations (such as reducing non-strategic portfolios, focusing on target customers and core business) means that the real estate lending sector is increasingly focusing on this option. Lending and capital markets are merging, which is creating the latitude needed to further expand active portfolio management.

**Further growth for active portfolio management**

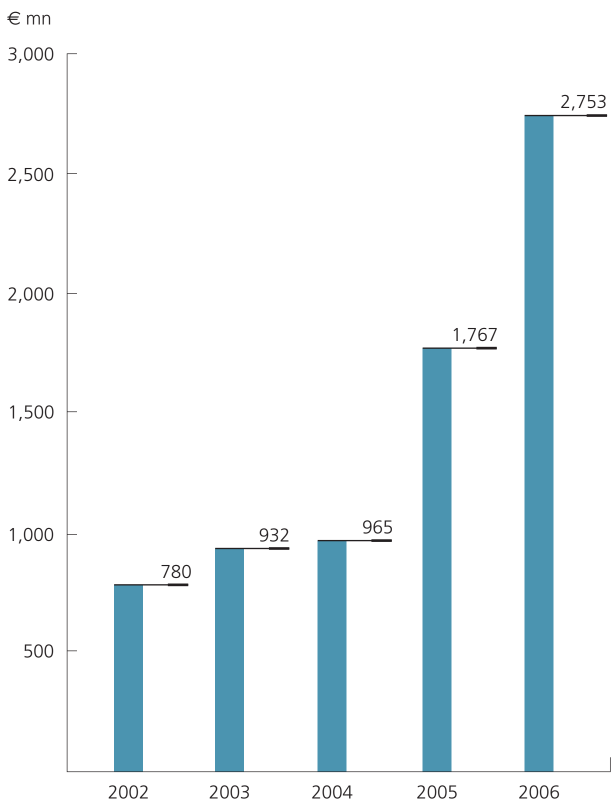
In view of these developments, DG HYP further increased its transaction volumes on the credit and capital markets during the 2006 financial year. DG HYP also further increased investment in structured credit products during the year: in this area, our exposure to MBS purchases on the secondary market is with a selective investment strategy. In addition, DG HYP further expanded its involvement in real estate lending portfolios by buying retail portfolios in the rest of Europe, based on synthetic structures, with an initial true buy transaction in October 2006. In so doing, DG HYP took 1,590 private mortgage loans in Germany onto its own books from Antwerp-based Argenta Spaarbank N.V., with a total volume of € 162 million.

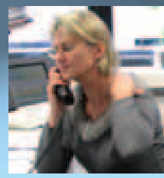
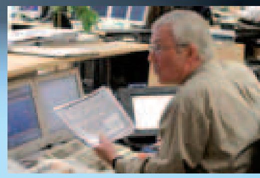
Overall, new portfolio investments of € 2,753 million were up 55.8 per cent on the previous year's figure (€ 1,767 million). Our MBS portfolio totalled € 4.9 billion on the reporting date.

We took a further key step in placing credit risks to optimise our own portfolio structure with the successful sale (true sale) of non-strategic commercial real estate loans (€ 422 million) in March 2006. We already sold a retail portfolio comprising 3,000 non-performing real estate loans, with a volume of € 300 million, to an international investor in December 2005.

DG HYP provides the expertise it has accumulated to the cooperative banking sector, and also supports placements of NPL portfolios for cooperative banks. There was also dynamic growth in services related to the servicing and placement of non-performing loans. In this context, DG HYP's wholly-owned subsidiary IMMOFORI Gesellschaft für Immobilien Forderungsinkasso mbH has successfully positioned itself not only with third parties, but also in the German cooperative banking sector, as a servicer and advisor for the realisation and sale of non-performing real estate loans.

## NEW PORTFOLIO INVESTMENTS



# TREASURY

Loans to local authorities continue to grow, rising to even higher levels.

Top Pfandbrief issuer.

# LOCAL AUTHORITY LENDING AND PUBLIC FINANCE

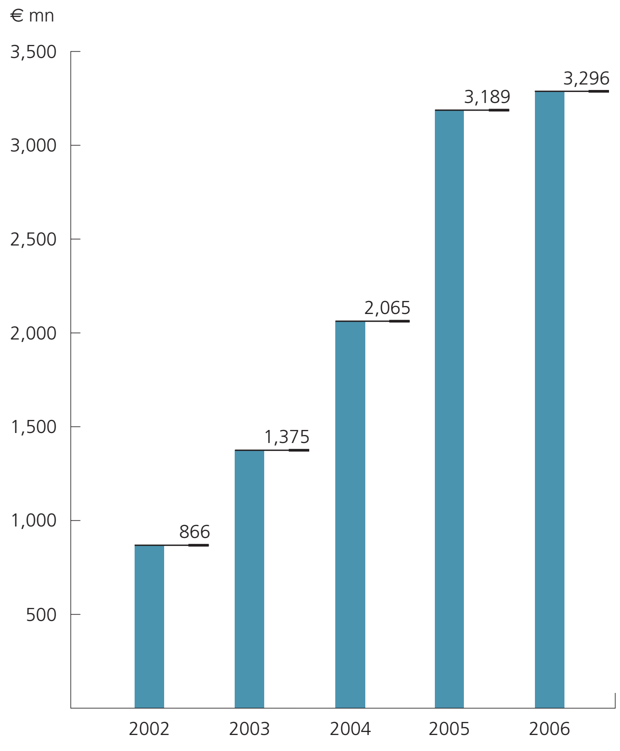
Amongst the mortgage banks, DG HYP is one of the largest providers of local authority lending and public finance in Germany. At present, around 45 per cent of all local authorities use our standardised financial services. DG HYP enjoys a leading role in the German cooperative banking sector with more than 8,000 customers from the *Bund*, states, regions and local authorities.

The value of our public sector lending business can be clearly seen from current developments: new business and loan extensions for original local authority business (direct financing for local authorities in Germany) totalled € 3,296 million on the reporting date, and was thus again up year-on-year (2005: € 3,189 million).

This growth documents DG HYP's market lead in the German cooperative banking sector, and underscores the bank's close links with the 1,200 cooperative banks nationwide. It is strongly anchored in the regions, which offers strong foundations for in-depth market development in this division. We support the cooperative banks when advising local authorities, cities and municipalities for all financing issues.

We were able to increase the numbers of transactions concluded for promissory notes (€ 942 million) and securities eligible for inclusion as cover assets (€ 7,107 million) by a total of 14.6 per cent year-on-year, which means that the volume of business for public finance and originated local authority lending is up by a total of 11.1 per cent, to € 11,345 million.

## ORIGINATED LOANS TO LOCAL AUTHORITIES – NEW BUSINESS AND LOAN EXTENSIONS



# REFINANCING

With issuing volume of over € 11 billion, DG HYP maintained its presence as an active player on the capital market throughout the 2006 financial year. Given the bank's core business, its refinancing activities centre on mortgage bonds (*Hypothekenpfandbriefe*) and public-sector covered bonds (*Öffentliche Pfandbriefe*). Within this context, our objective is also to increase the share of international placements through our debt issuance programme (DIP) and to meet the investors' requirements accordingly. We can respond to individual demands from our wide-ranging, international investors thanks to our traditional issuing business and private placements, including structured issues.

In total, public-sector covered bonds accounted for € 7.5 billion and mortgage bonds accounted for € 1.7 billion of the covered issues. We again benefited this year from favourable spread developments and the positive overall performance of the *Pfandbrief* market. Unsecured refinancing through bearer bonds and promissory notes accounted for € 2.5 billion.

**Triple-A rating for DG HYP *Pfandbriefe***

With roughly € 63.9 billion in securities outstanding, DG HYP is one of Germany's regular issuers of *Pfandbriefe*. DG HYP *Pfandbriefe* are rated AAA by the rating agencies Standard & Poor's and Fitch Ratings, and thus offer institutional investors an extremely solid investment. Separate cover assets pools are managed as collateral pools for mortgage bonds and public-sector covered bonds. These are exclusively backed by senior charges on real property, or by loans to public-sector entities, respectively. By computerising the active management of the *Pfandbriefe* cover assets pool, we ensure compliance with the provisions of the German *Pfandbrief* Act as well as the requirements of the rating agencies.

**Jumbo *Pfandbrief* issues**

One pillar of our refinancing strategy is issuing jumbo-sized *Pfandbriefe*. In contrast to previous years, DG HYP only placed its first jumbo *Pfandbrief* of the year on the market at the end of October 2006. The announced volume of € 1.5 billion for the 10-year public bond was reached very shortly after the order book was opened. Demand totalled around € 3.5 billion.

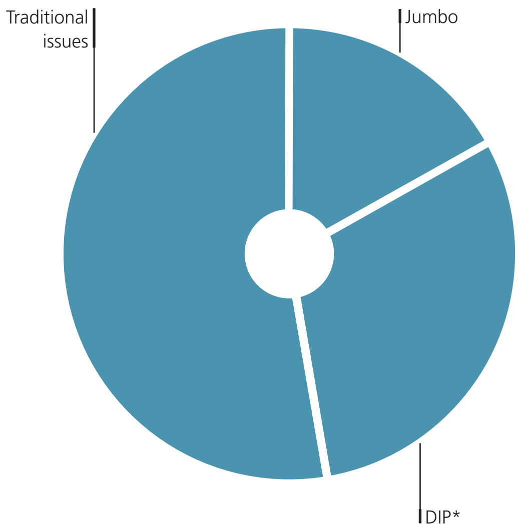
The level of interest shown by international investors has allowed us to increase the amount allocated from € 1.5 billion to € 2 billion. 60 per cent of this amount was placed abroad. DG HYP was again able to generate a refinancing advantage, with pricing of two basis points below mid-market swaps, compared to equivalent capital market transactions. The price level generated reflects the high quality of the cover assets pool and excellent acceptance from international and institutional investors. DG HYP has again proved its benchmark position on the *Pfandbrief* market with this jumbo-sized issue.

The volume of outstanding DG HYP jumbo *Pfandbriefe* is currently about € 30.4 billion. A series of DG HYP jumbos is traded on the electronic trading platform EuroCreditMTS. In order to facilitate placement worldwide, we brought two global issues to the market with a total volume of € 4.75 billion.

## DG HYP RATINGS

| | Public-sector covered bonds | Mortgage bonds | Long-term debt (counterparty rating)/ outlook | Short-term debt (counterparty rating) | Subordinated debt |
|---|---|---|---|---|---|
| **Standard & Poor's** | AAA | AAA | A+/stable | A-1 | A |
| **FitchRatings** | AAA | AAA | A+/stable | F1 | A |

## REFINANCING STRUCTURE FOR 2006




| | € mn | % |
|---|---|---|
| Jumbo | 2,000 | 17.1 |
| DIP* | 3,595 | 30.7 |
| Traditional issues | 6,119 | 52.2 |
| | 11,714 | 100.0 |

* Debt Issuance Programme (DIP)

**Demand-oriented funding**

In addition to standardised, large-volume *Pfandbriefe*, DG HYP also placed smaller individually-structured issues in the form of registered securities. Such private placements are explicitly structured to meet specific investor requirements. Given the ongoing low interest rate environment, we saw particular demand for floating rate issues (FRNs).

**Placement in the German cooperative banking sector**

During the period under review, a total of € 2.4 billion was placed in bonds and promissory notes in the German cooperative banking sector, which represents an important investor base for DG HYP. This corresponds to 21 per cent of placements of DG HYP issues.

**Debt Issuance Programme**

The standardised DIP documentation is a key tool in the funding process, given the increasing internationalisation of our investor base. In the 2006 financial year, the debt issuance program was adapted to the amended European Prospectus Directive. DG HYP thus fulfils the requirements to continue to comply with strategic diversification on the international capital market. Issues brought to the market within the scope of this standardised programme accounted for 31 per cent of the refinancing volume. The issuing programme comprises covered bearer bonds in the form of large-volume jumbo *Pfandbriefe* and smaller public-sector covered bonds and mortgage bonds. Uncovered bearer bonds complete the opportunities offered by the DIP.

**Derivatives**

New derivatives business comprises Eonia swaps and interest rate swaps. Interest rate swaps are used to hedge the liabilities side of the balance sheet, as well as to neutralise risks from assets. The nominal volume of derivatives outstanding as at 31 December 2006 was € 209 billion.

# KEY STRATEGIC SHAREHOLDINGS

The participating interests that are of key importance for DG HYP's strategic orientation include the two wholly owned subsidiaries VR WERT – Gesellschaft für Immobilienbewertungen mbH and IMMOFORI Gesellschaft für Immobilien Forderungsinkasso mbH.

VR WERT was formed in 1999. The company's central tasks are to prepare and audit lending and market valuations. Service is offered nationwide in Germany from seven locations – Hamburg, Berlin, Cologne, Dresden, Frankfurt/Main, Stuttgart and Munich. Competition on the market is increasing, and VR WERT is supported in Germany and abroad by around 100 cooperation partners.

In the past, VR WERT successfully established itself on the market as a specialist for property valuations, and slightly exceeded last year's operating result (€ 947,000) with € 958,000 in the 2006 financial year. Another positive highlight is the increased proportion of revenues stemming from outside the German cooperative banking sector.

IMMOFORI Gesellschaft für Immobilien Forderungsinkasso mbH was formed in 2005, as a spin-off from DG HYP servicing NPL portfolios (non-performing loans). The range of services as a special servicer comprises reviewing and managing non-performing real estate loans as well as conducting negotiations with the debtors, including exploiting land rights and other collateral. Its tasks also focus on competent advice prior to the purchase or sale of an NPL portfolio, and spans from preparation for auctions to due diligence support and tying up the purchase agreement.

Based on the expertise contributed by DG HYP and the continued close cooperation with DG HYP, IMMOFORI has many years of experience in loan redemption, the requirements of the international capital market, and the national property market. Its expertise is rounded out by its specialist knowledge of real estate markets, covering Germany's urban conurbations as well as rural areas.

IMMOFORI has become established in the market after a relatively short period, in particular within the German cooperative banking sector, with a large number of consulting mandates and servicing for various portfolios. This is reflected both in the significant increase in revenues, from € 1.5 million to € 3.0 million in the 2006 financial year, as well as in the pleasing result of € 956,000 (previous year: € 115,000). DG HYP has thus rounded out the range of forward-looking services it offers in the active management of real estate credit portfolios.

# FINANCIAL SITUATION AND RESULTS OF OPERATIONS

**Financial situation**

DG HYP's total assets as at the reporting date stood at € 85.7 billion, an 8.3 per cent increase over 31 December 2005. Our stock of loans increased by a total of € 3.0 billion to € 73.0 billion. Although the volume of real estate loans fell by € 1.3 billion as a result of portfolio sales and continued redemption, we were able to increase our MBS holdings by 45.0 per cent to € 4.9 billion thanks to growth in new commitments. In the public-sector lending segment, at € 22.6 billion, securities held for investment were € 2.4 billion higher than at the end of 2005. Loans to local authorities were up slightly year-on-year at € 22.0 billion. The securities portfolio used for yield and liquidity management rose by € 2.3 billion to € 9.2 billion.

New issues in the 2006 financial year made themselves felt, showing a € 4.8 billion increase to € 27.9 billion in liabilities to banks and customers. The volume of securitised liabilities rose by € 1.3 billion to € 54.1 billion.

**Own funds and risk-weighted assets**

DG HYP's core capital was reinforced, and its quality was improved, by increasing capital reserves in the amount of € 30 million (and by € 154 million in perpetual silent contributions) to replace the limited-term silent partnership contributions that no longer qualified as core capital.

Risk-weighted assets, as defined by the capital ratio according to the German Banking Act (*Grundsatz I*) amounted to € 23.2 billion as at the balance sheet date. The core capital ratio as of 31 December 2006 is thus 6.4 per cent; the equity ratio is 9.6 per cent.

## DEVELOPMENT OF LENDING VOLUME

| | | | Change from the previous year | |
|---|---|---|---|---|
| **€ mn** | **31 Dec 2006** | **31 Dec 2005** | **€ mn** | **%** |
| **Real estate lending** | 23,531 | 24,790 | – 1,259 | – 5.1 |
| **MBS** | 4,923 | 3,396 | 1,527 | 45.0 |
| **Public-sector lending (total)** | 44,588 | 41,833 | 2,755 | 6.6 |
| **– loans to local authorities** | 21,975 | 21,616 | 359 | 1.7 |
| **– Securities** | 22,613 | 20,217 | 2,396 | 11.9 |
| **Total portfolio** | 73,042 | 70,019 | 3,023 | 4.3 |

## RISK-WEIGHTED ASSETS, AS DEFINED BY THE CAPITAL RATIO ACCORDING TO THE GERMAN BANKING ACT (*GRUNDSATZ I*) AS AT 31 DECEMBER 2006

**€ mn**

| **Risk weighting** | 100 % | 50 % | 25 % | 20 % | 10 % | Total |
|---|---|---|---|---|---|---|
| **Balance sheet items** | 9,827 | 8,589 | – | 3,097 | 454 | 21,967 |
| **Off-balance sheet items** | 711 | 245 | 1 | 73 | – | 1,030 |
| **Derivatives** | – | 8 | – | 165 | – | 173 |
| **Total** | 10,538 | 8,842 | 1 | 3,335 | 454 | 23,170 |

## OWN FUNDS

| € mn | 31 Dec 2006 | 31 Dec 2005 | Change from the previous year € mn | % |
|---|---|---|---|---|
| Issued share capital | 90 | 90 | – | – |
| Reserves | 647 | 617 | 30 | 4.9 |
| Silent partnership contributions | 774 | 774 | – | – |
| Special item for general banking risks | 24 | 13 | 11 | 84.6 |
| Items not eligible for inclusion | – 42 | – 40 | – 2 | – 5.0 |
| Core capital | 1,493 | 1,454 | 39 | 2.7 |
| Supplementary capital | 734 | 757 | – 23 | – 3.0 |
| Deductibles pursuant to section 10 (6) of KWG | – 13 | – 14 | 1 | – 7.1 |
| Liable capital | 2,214 | 2,197 | 17 | 0.8 |
| | | | | in percentage points |
| Equity ratio | 9.6 | 10.6 | | – 1.0 |
| Core capital (Tier 1) ratio | 6.4 | 7.0 | | – 0.6 |

**Results of operations**

DG HYP's earnings in the 2006 financial year were characterised by an increase in gross profits, from € 289.6 million to € 296.6 million.

Net interest income in 2006 was up year-on-year at € 327.8 million (2005: € 325.6 million). Our net commission result is characterised mostly by commission expenses as part of our cooperation with sales partners in the cooperative banking sector. The net commission result, which is normally negative, was thus improved in 2006 from € – 58.5 million to € – 46.4 million. The driving force behind this change was our lower issuing activities in 2006 for refinancing via jumbo *Pfandbriefe* and loan securitisation. In contrast, commission expense incurred for intermediation in our lending business was up only slightly year-on-year. In 2005, other operating income included a one-off premium from the start-up phase of VR IMMO and this year's figure is thus lower year-on-year.

## OVERVIEW OF THE PROFIT AND LOSS ACCOUNT

| € mn | 2006 | 2005 | Change from the previous year € mn | % |
|---|---|---|---|---|
| Net interest income | 327.8 | 325.6 | 2.2 | 0.7 |
| Net commission result | – 46.4 | – 58.5 | 12.1 | 20.7 |
| Other operating income | 15.2 | 22.8 | – 7.6 | – 33.3 |
| Gross profit | 296.6 | 289.9 | 6.7 | 2.3 |
| Administrative expenses | 191.4 | 178.1 | 13.3 | 7.5 |
| Other operating expenses | 12.7 | 4.5 | 8.2 | n/a |
| Revaluation results | 24.2 | 42.1 | – 17.9 | – 42.5 |
| Provisions for loan losses | – 84.1 | – 98.0 | 13.9 | 14.2 |
| Operating profit | 32.6 | 51.4 | – 18.8 | – 36.6 |
| Net extraordinary income/expenses | – | – 1.3 | 1.3 | n/a |
| Taxes | – 2.4 | 0.0 | – 2.4 | n/a |
| Partial profit transfer | 59.1 | 39.2 | 19.9 | 50.8 |
| Change in the fund for general banking risks | 24.1 | – 10.9 | 35.0 | n/a |
| Profit transfer | 0.0 | 0.0 | – | – |

**Costs development**

Administrative expenses in the 2006 financial year were up year on year at € 191.4 million (2005: € 178.1 million). This increase is primarily due to a one-off factor of € 11.3 million in connection with increasing provisions for pensions and other personnel provisions. We reduced the discount factor used to calculate all personnel provisions, to 4.5 per cent as a result of ongoing low interest rates. Further increases in personnel expenses were due to the new sales structure for the German cooperative banking sector, as well as re-integrating specific IT application developers from VR Kreditwerk. However, we were able to further reduce the other administrative expenses, so that material costs were down € 2.5 million year-on-year.

The increase in other operating expenses is attributable to one-off costs incurred in the course of the re-orientation of VR-Immobilien AG.

**Risk provisioning**

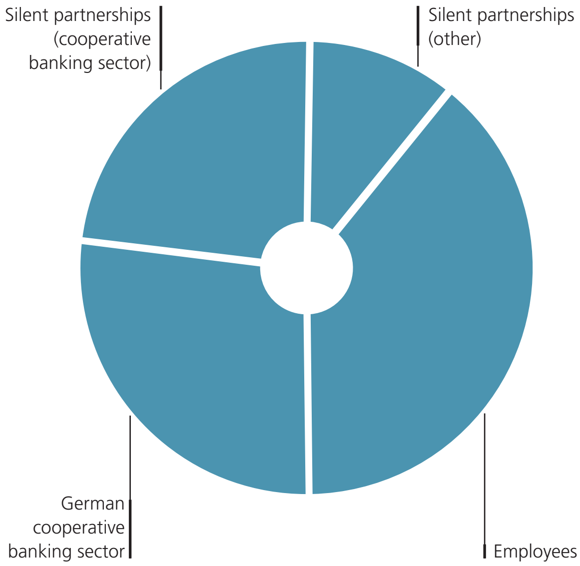
We were able to record a scheduled reduction in provisions for loan losses to € 84.1 million (2005: € 98.0 million). Following the sale of part of our non-performing loans at the end of 2005, together with further portfolio adjustments our provisions for loan losses declined in 2006.

Revaluation gains totalled € 24.2 million in the 2006 financial year. The prior year's figure of € 42.1 million was impacted by the sale of securities as part of management of the cover assets pool and the sale of our equity participation in VR Kreditwerk to DZ BANK.

**Net income**

The total operating result for the financial year 2006 was € 32.6 million. The improvement in core capital from perpetual silent contributions, which were newly concluded at the end of 2005 and start of 2006, led to an increase in the partial profits transferred to the silent partners in the amount of € 59.1 million. After the fund for general banking risks was reversed within the meaning of Section 340g of the *Handelsgesetzbuch* (HGB – German Commercial Code) in the amount of € 24.1 million, we recorded balanced net income.

## VALUE GENERATED AND BREAKDOWN OF CONTRIBUTIONS 2006




| | € mn | % |
|---|---|---|
| Employees | 67.8 | 39.0 |
| German cooperative banking sector* | 47.1 | 27.1 |
| Silent partnerships (cooperative banking sector) | 40.6 | 23.3 |
| Silent partnerships (other) | 18.4 | 10.6 |
| TOTAL | 173.9 | 100.0 |

* Levies paid to associations plus commissions paid

# RISK REPORT

## I) Risk management – objectives and organisation

### a) Objectives of risk management

DG HYP's risk management process is geared towards exploiting the business potential within the scope of the bank's capacity to carry and sustain risk, emphasising profitability. Within this context, we follow the guidelines of optimising the risk/return profile of the lending business, with respect to individual transactions as well as within the framework of active management of the entire portfolio. The individual types of risk in the lending and securities business are standardised to permit comparison, in order to provide a basis on which capital allocation throughout the entire bank is managed, with an emphasis on risk and return.

### b) Responsibilities

The organisation and assignment of responsibilities for DG HYP's risk management is focused on the requirements of the bank's business model, within the framework of applicable regulatory requirements, in particular, the Minimum Requirements for Risk Management (*Mindestanforderungen an das Risikomanagement – "MaRisk"*). DG HYP has also developed and implemented risk management and risk controlling systems that take into account all market and competitive requirements. This forms the basis that ensures the proper operation and efficiency of the risk management process.

**Management Board.** All members of the Management Board are jointly responsible for risk management at DG HYP. The Management Board determines the risk policy with regard to defining the business and risk strategies, determining the types of business pursued, and defining the justifiable overall risk level, in line with the bank's capacity to carry and sustain risk.

**Risk/Return Management Committee.** The Risk/Return Management Committee is the central body for risk management across the entire bank. Besides including the members of the Management Board as committee members carrying voting rights, the heads of Finance/Controlling, Credit Treasury and Treasury are also members of the Committee, but have no voting rights. The Committee generally convenes fortnightly, and concerns itself in particular with the management of the risks of the entire bank at a portfolio level as well as the allocation of capital.

**Credit Committee.** The Credit Committee is responsible for managing and monitoring all of DG HYP's credit risks. It comprises the entire Management Board and the heads of Front Office, Back Office and Finance/Controlling. The Credit Committee deals with individual credit decisions and fundamental issues regarding the bank's lending business. In addition, the Credit Committee is responsible for dealing with strategic credit issues. These include, in particular, the credit risk strategy, current risk events and risk provisioning, credit portfolio management and income optimisation as well as credit workflow optimisation.

**Risks and Participations Committee of the Supervisory Board.** This Committee comprises up to four of the bank's twenty-one Supervisory Board members. It is responsible for the decision-making regarding certain loan exposures, portfolio transactions and participating interests which – in line with the Internal Rules of Procedure – are not within the remit of the Management Board.

**Supervisory Board.** The entire Supervisory Board decides on the acquisition or disposal of participating interests in the event of changes exceeding € 500,000 in the carrying amount of such interests, as well as on the establishment or disposal of business lines, establishing branches and representative offices, the internal rules of procedure of the Management Board, the business distribution plan, and on material issues related to loans or participations that are not explicitly assigned to the Risk and Participations Committee of the Supervisory Board.

### c) Functions

**Risk Planning.** Planning, as a bank-wide exercise, comprises the planning of income and costs, as well as the risks associated with DG HYP's individual business activities. Based on the strategic business orientation as part of a 5-year plan, the bank carries out operative planning on an annual basis. Within this planning process, risk limits and earnings projections are determined in the respective business units on the basis of the bank's capacity to carry and sustain risk.

**Risk Management.** Risk Management is structured in line with the front office. As part of the credit risk strategy defined in each case, the credit risk management departments are responsible for managing the risk of counterparty default for an individual exposure and at portfolio level. This comprises both the implementation and active management of provisions within the scope of the credit risk strategy, monitoring the counterparty risk within the scope of granting and processing loans, early identification of potential risks in the lending business and intensified handling of distressed loans, plus restructuring and recovery of lending exposures through the corresponding procedures and control systems. Credit Treasury is responsible for credit risk management on a portfolio level. The management of market and liquidity risks is the responsibility of Treasury, within the scope of asset/liability management.

**Risk Controlling.** Risk Controlling is responsible for current reporting and – together with the respective risk management unit – for monitoring risk on a portfolio level. This comprises quantifying the risk exposure, monitoring the quality and accuracy of data relevant to the risk exposure, monitoring the limit utilisations, and risk reporting to the Management Board. For this purpose, Risk Controlling prepares a *MaRisk*-compliant credit risk report on a quarterly basis, which outlines the key structural features of the lending business. A specific monitoring report for the retail business is produced on a quarterly basis, using scoring data generated from new business and behavioural scoring of the existing portfolio. An overall risk report is drafted monthly, which illustrates current credit risks as well as market risks and operational risk. Furthermore, Risk Controlling also carries out daily risk reporting on the market risks to which DG HYP is exposed, in accordance with *MaRisk*. Risk Controlling's key findings are regularly reported to the Supervisory Board, or to the Risk and Participations Committee of the Supervisory Board. The regular portfolio evaluations are used to recognize abnormalities in the portfolio at an early state and counter these if required. In addition, portfolio evaluations form the basis for the annual review of the credit risk strategy.

**Internal Audit.** The internal audit examines whether the demands on the internal controlling systems, the risk management and controlling systems, and the necessary reporting, are adequately met.

**d) Basel II**

The new Basel Capital Accord (commonly referred to as "Basel II"), implemented in the German Solvability Ordinance (*Solvabilitätsverordnung – "SolvV"*), which has come into effect as of 1 January 2007, is focused on securing the stability of the banking system and promoting banking supervision with greater qualitative focus.

The core element of Basel II is greater risk-adjusted differentiation of the regulatory capital requirements for loans, depending on the credit quality of the borrower.

All told, the planned regulations of the Basel Committee confirm our approach to a risk/return-oriented business and portfolio management. DG HYP will implement the Foundation Internal Rating Based Approach (FIRB) as part of Basel II. Developing our internal rating systems to implement the requirements of the Basel II Accord remains on schedule. In 2005, we concluded the implementation of all the internal rating and scoring processes required for adopting the FIRB.

All projects involved in preparing for the introduction of Basel II have been run in close cooperation with the corresponding requirements for the DZ BANK Group since 2003. They also correlate closely with the cross-institutional Basel II projects carried out by the Federal Association of German Credit Unions and Rural Banking Cooperatives (*Bundesverband der Deutschen Volksbanken und Raiffeisenbanken – „BVR"* and the Association of German *Pfandbrief* Banks (*Verband deutscher Pfandbriefbanken – „vdp"*).

The acceptance audit for the first entry level of FIRB from 1 January 2007 by the Bundesbank and the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht – "BaFin"*) took place in the autumn of 2006 and was successfully completed, with confirmation of admission.

**II) Counterparty risk**

Counterparty risk denotes the risk that a business partner has defaulted on a major liability for more than 90 days, or can only partially repay liabilities, or not at all, without activities having to be implemented such as exploiting collateral. Due to the particular relevance of real estate lending as DG HYP's core business, credit risk is at the forefront of our observations. The management of credit risk is conducted largely as follows:

- rating and portfolio-oriented management of new business and loan extensions;
- credit pricing that is in line with the associated risks;
- active portfolio management (constant portfolio monitoring and management);
- active management of problem loans (early warning process, intensified handling, restructuring and settlement).
- annual review of credit risk strategy.

**a) Lending process**

The lending process for high-volume/smaller-sized retail business is based on a largely standardised application scoring system that corresponds to the requirements of *MaRisk* as well as to the Basel II regulations. Processing for this lending business is outsourced to VR Kreditwerk, observing the provisions of Section 25a of the KWG. Depending on the relevant score, incoming loan applications up to € 400,000 are either approved automatically, approved or rejected on the basis of a separate manual review within DG HYP, or are automatically rejected. In the retail lending business, lending decisions for loans exceeding € 400,000 are always based on a manual review, as well as on a scoring model. DG HYP carries out the entire loan processing for retail loans of between € 500,000 and € 1,000,000.

The loan application process for high-volume retail lending business was fundamentally reworked and modified during the 2006 financial year, in cooperation with VR Kreditwerk. The changes made are geared to reducing processing time, increasing the quality of decisions and significantly improving service.

The front and back offices for commercial real estate finance are located in DG HYP's Real Estate Centres. Key workflow stages include the credit rating, which is identified using rating systems that comply with Basel II, and also property and project assessments. In the latter case, DG HYP benefits from the proximity of its Real Estate Centres and surveyors – who are also decentralized – to its customers. Each lending decision requires a separate vote by the market unit as well as by the back-office unit. The loan application is authorised on the basis of lending volume and risk classification. The corresponding parameters are laid down in the credit and portfolio strategies.

The credit workflow for Credit Treasury includes processing new commitments and portfolios, including analysis, credit decisions, portfolio monitoring and regular reporting on real estate lending portfolios for RMBS, CMBS as well as true buy and synthetic transactions. In addition, structured credit financing is also processed, to the extent that the item financed is large real estate financing.

**b) Limit system**

DG HYP has a limit system in place to manage and monitor counterparty and country risks. This system calculates the utilisation of external limits (country risk limits in the DZ BANK Group, and default risks in accordance with section 13 of the KWG), setting internal limits for country and default risks simultaneously and independently of one another. The respective limits must be upheld and can be viewed at any time via an online system.

During the back-office monitoring processes, the utilisation of the individual limits is monitored daily, and these are escalated if the limits are exceeded. As part of this escalation, support is provided to ensure that the limit is returned to, and that suitable measures are implemented.

Internal individual risk limits are identified depending on the individual counterparty risk of the business partner. Limits are issued for banks and states, based on the corresponding VR rating method established within the cooperative banking sector.

**c) Credit scoring/rating**

DG HYP uses a scoring system to assess and decide on new business applications in the retail lending business. Thanks to this process, decisions regarding applications can be largely automated and therefore conducted in an efficient manner. Furthermore, risk assessment can be differentiated in line with a consistent and active business management policy.

Loan applications are thus assessed in terms of customer, property and loan product specification, using a scorecard. A score is calculated for each loan on this basis, and can subsequently be displayed in a rating class on the 20-level VR master scale that was developed for the cooperative banking sector. Furthermore, an additional assessment is carried out through the Strategy Management™ business management system, according to management criteria applicable to new business (such as loan-to-value ratio, type of usage, regional aspects). This management tool is based on a strategy tree, whose parameters can be adjusted in the event of changes in market conditions or in response to knowledge gained from the continuous monitoring of new business from the scenario analyses carried out. Continuous backtesting of the implemented strategies ensures targeted management of the retail business.

A continuous assessment of the retail loan portfolio is performed on the basis of a so-called 'behaviour scoring' that can also be displayed in the rating classes of the VR master scale. This scoring process facilitates a regular portfolio assessment, which is updated monthly. The bank can thus identify rating migrations in the retail lending business at a much earlier stage than was previously feasible, and take them into account within the scope of new business and portfolio management as well as processing the portfolio.

In order to manage the credit risks inherent in commercial real estate finance, DG HYP calculates a credit rating for the borrower within the scope of the credit analysis, along with a total property rating (macro/micro location and property rating) and a loan-to-value ratio for the individual exposure. The calculated data forms the basis for the lending decision and pricing. The borrower's rating, as well as the property's ability to cover interest and principal repayments, is at the forefront of DG HYP's forward-looking credit analysis.

In order to take the particular demands on DG HYP's commercial real estate lending business into account, we also developed (in cooperation with the central institutions of the German cooperative banking sector and BVR) and implemented a special Basel-II compliant rating system for specialised lending (SLRE – Specialised Lending Real Estate). These rating procedures apply to the following customer groups: real estate developers, residential property developers, development companies, closed-end funds, project developers and commercial real estate investors. In order to better deal with the specific opportunities and risks in these customer segments/industries, DG HYP introduced so-called segment guidelines and centres of competence in 2006. These bundle detailed industry expertise, so that specific segment knowledge is actively used in addition to the regional structure.

For local authority lending, credit ratings are also estimated based on a rating method that complies with Basel II. DG HYP played a major role in developing the municipal rating system, particularly within the scope of a cooperative project where *vdp* joined forces with S&P Risk Solutions. We use the VR rating procedures implemented in DZ BANK within the framework of a 'rating desk' solution for the rating of sovereigns, banks and key accounts.

We use the MoriX™ market and property analysis rating system, for the purpose of classifying the properties serving as collateral. For loans in excess of € 400,000 the MoriX™ results are merged with further estimates of the property to form a market and property rating by our subsidiary VR WERT – Gesellschaft für Immobilienbewertung mbH. This provides major support when the value is surveyed as part of the preparation of a valuation survey. A simplified process will be used for loans of less than € 400,000, where only the market assessment from MoriX™ will be taken into account.

As part of the implementation of Basel II, the review of loan exposure – including a rating update demanded by Section 18 of the KWG – has been expanded for all customer categories registered for IRBA. In addition, monitoring documents are prepared regularly for exposures exceeding € 2.5 million per primary obligor group. The monitoring comprises the rating analysis and other customer records, an assessment of the current rental situation, and the tenant ratings. The property or other collateral is revalued if deemed necessary.

**d) Management of problem loans**

DG HYP has developed an early warning system for its investors. This uses a variety of indicators to highlight the necessity for more intensive handling of the loan account. A differentiation is made between compulsory and optional requirements, as a result of the parameter weighting. The effectiveness of the indicators is reviewed on a quarterly basis. All cases of intensified handling are reported on a quarterly basis. In addition, all borrowers under intensive handling with a volume of more than € 10 million are reported once per month. Within the scope of monitoring, as a rule, a checklist is maintained for all such exposures subject to intensive handling, which provides information on the renewed review of collateral, the property and rating assessment, as well as measures that have already been initiated. At the same time, the outcome of this intensive review forms the basis for the decision on further support measures (normal or intensified handling, or restructuring). The intensive handling phase is generally limited to twelve months. This is followed by a review as to whether a return to normal coverage is possible, or if a handover to the restructuring/workout division is required.

Those problem credit exposures whose economic perspective can be assessed as positive are processed in the restructuring department, which forms part of the back-office. Submitting a concept that must comprise a differentiated analysis and assessment of the overall situation of the exposure and a cost-benefit analysis, as well as a comprehensive restructuring plan, forms the basis for a restructuring decision. Loan exposures are transferred to workout if restructuring has failed or if this is deemed to be fruitless from the outset.

Non-performing retail loan exposure is included in an integrated reminder and restructuring process within DG HYP at an early stage. Initial telephone contact with the borrower is made two to four weeks after the first reminder. If standardised activities (e. g. short-term postponement of the outstanding instalment) are unsuccessful, the non-performing loan exposures are transferred to the restructuring department. The probability of successful restructuring is then assessed in detail, and further action implemented based on the results. The focus is on stabilising the customer and recovering the outstanding amounts. If it is not possible to restructure the exposure, the loan exposures are transferred to workout for rapid liquidation of the collateral.

**e) Portfolio management**

Besides the management of individual credit risks, active portfolio management is central to DG HYP's risk management process. This comprises both the assessment of individual exposures from a portfolio perspective and the risk/return-oriented management of the overall portfolio through securitisations, MBS purchases, and the acquisition and disposal of loan portfolios. Risk Management and Credit Treasury are jointly responsible for portfolio management, while Credit Treasury alone is charged with implementing the approved strategy.

Credit Risk Controlling uses a credit risk model (based on CreditRisk+TM) to measure the counterparty risks on the basis of a portfolio analysis involving all asset classes. A Credit Value at Risk (CVaR), calculated with a confidence interval of 99.9 per cent and a one-year holding period, serves as the basis for limiting counterparty risk across the entire bank as well as for portfolio management in Credit Treasury. This process allows the bank (amongst other things) to calculate the risk contribution of individual exposures in terms of diversification within the overall portfolio, and the ensuing utilisation of economic capital. The results of credit risk modelling are used particularly efficiently, as part of the so-called CVaR analysis. In this analysis, which is conducted monthly, the impact of current transactions – for example placements or portfolio purchases – are ascertained and reported as part of the overall risk report, as are all material changes to the risk structure at an individual customer level and division level, as well as changes to the ten largest risk drivers. The results of this regular analysis are continuously integrated in the credit risk strategy, and are taken into consideration as an additional parameter in the process of granting large-volume loans (upwards of € 25 million).

## DG HYP VaR (10-DAY HOLDING PERIOD, 99 PER CENT CONFIDENCE INTERVAL) DEVELOPMENT IN 2006


Special analyses can be used to actively manage portfolio structures through the purchase and sale of identified credit risks. This applies on the one hand to lending decisions for individual exposures, for example for large-volume loans in the syndicated lending business. On the other hand, we have already undertaken placed credit risks with external third parties in full, by way of synthetic securitisations.

At the same time, DG HYP invests in third-party MBS transactions. The duality of placing credit risks with third parties and investing in other portfolio structures offers better risk diversification in the overall portfolio – which we can thus manage in a targeted manner. Credit Risk Controlling regularly prepares portfolio reports from the credit risk model for this purpose. These include (amongst other things) expected and unexpected loss data calculated for the overall portfolio, and a breakdown of the credit value at risk (CVaR) across the business divisions.

### III) Market risks

For us, the concept of 'market risks' comprises the risks associated with fluctuations in market prices (market risks in the narrower sense), and liquidity risk. Market risk is the impact of interest rate fluctuations on the money and capital markets, and changes in exchange rates. Liquidity risk comprises the threat that DG HYP is unable to borrow the funds required to maintain payments, or the risk of only being able to do so at considerably less favourable terms.

#### a) Risks associated with market price fluctuations

DG HYP uses various hedging tools in its dynamic management of interest rate risk and currency risk for the bank as a whole. This consists mainly of macro hedge transactions employing interest-rate swaps and caps; options on interest-rate swaps (so-called swaptions) are also concluded occasionally, albeit to a limited extent. In addition, a number of large-sized transactions, such as granting promissory note loans to institutional clients, are hedged regularly through micro hedges against the particular interest rate risk. Interest-rate swaps and swaptions are also used for this purpose.

In order to quantify the bank's market price risk, DG HYP calculates two VaR figures daily using a variance/co-variance procedure for all positions in each of the portfolios. The following parameters are used in the calculations, in accordance with section 32 of the provisions governing the use of internal models for the capital ratio according to the KWG:

- 250-day history;
- ten-day holding period and one-day holding period;
- 99 per cent confidence interval.

The forecasting quality of our internal VaR model is checked daily. We apply the assumptions in the Basel Committee publication on market risk as model parameters for this backtesting process:

- preceding 250-day period;
- one-day holding period;
- 99 per cent confidence interval.

Market Risk Controlling compares the projected changes in present value that are calculated according to these parameters, with the negative changes in present value that actually occur the following day. On this basis, we determine how often the actual negative changes in the present value exceeded the VaR figures in the risk model.

Market Risk Controlling informs the Management Board (as well as the Treasury) on the day-to-day Treasury performance and utilisation of the VaR limit. The Management Board decides on the management of the risk structure for the entire bank at the regular meetings of the Risk/Return Management Committee.

#### b) Liquidity risk

The bank's liquidity situation is determined daily in line with the regulatory and daily business requirements. For this purpose, Market Risk Controlling provides Treasury with a differentiated overview on a daily basis, indicating future liquidity flows resulting from the individual positions in the portfolio. At its meetings, the Risk/Return Management Committee is provided with an overview of the short- and long-term liquidity projection. Liquidity is managed on the basis of this overview, with the dual objectives of securing the bank's long-term liquidity and achieving compliance with the liquidity principle in accordance with section 11 of the KWG (*Grundsatz II*).

A liquidity controlling system was implemented in 2006, in line with the requirements of Basel II for measuring and reporting on liquidity risk. On the basis of the short- and long-term liquidity projection, a limit system was implemented on a daily basis and integrated in the risk monitoring process. The results from the scenarios are included in the presentations.

### IV) Operational risks

The Basel Committee defines operational risks as "the risk of direct or indirect losses resulting from inadequate or failed internal processes, people and systems, or from external events". DG HYP has adopted this definition, albeit with marginal changes to detail in order to adjust it to the bank's own special interests. According to the Basel II regulations, banks have been subject to capital requirements for operational risks since 1 January 2007. DG HYP has adopted the standardised approach for quantification since 2003, and has notified *BaFin* accordingly.

A system for collecting and recording loss data has already been in place since 2002. Incoming loss reports are collected systematically in a database arranged according to predefined categories: they are subsequently used as indicators for further improving the operating processes, and hence for reducing operational risks.

In addition, all of DG HYP's organisational units have regularly conducted self-assessments since 2004. Current risks are estimated using a standardised electronic questionnaire. In addition, Risk Controlling carries out continuous plausibility and consistency checks.

In order to also be able to identify operational risks in good time, an early warning system regularly records various risk indicators (such as system failures, fraud, and staff fluctuation). The agreed risk indicators and the collated reports are submitted anonymously within the scope of group-wide reporting to DZ BANK.

VR Kreditwerk is responsible for credit processing in the retail business and for the provision of IT services. The operational risks inherent to DG HYP from these activities are taken into consideration in the systems of VR Kreditwerk and of DG HYP. This knowledge is enhanced by expertise gained in the controlling of outsourced activities.

The emphasis is on business continuity measures addressing operational risks that arise from the use of the bank's property and of the IT system. The key measures for dealing with such risks are laid down in the emergency handbook. From an organisational perspective, DG HYP's Risk Controlling is responsible for measuring operational risks. Risk Controlling reports regularly on operational risk issues to DG HYP's Management Board, and on the activities for further developing the quantification approach, within the scope of the Risk/Return Management Committee meetings.

**V) Strategic risks**

Strategic risks include the threat of losses arising from management decisions regarding DG HYP's business policy. Strategic risks can also include long-term success factors in DG HYP's environment. These include, for example, changes to the legal or corporate environment, changes to the market and competitive conditions, customers or re-financing parameters. We also include planning and reputation risks in this risk category.

In order to reduce planning risks, variance analyses are prepared as a basis for continuously reviewing planning data and assumptions.

Reputation risk concerns direct or indirect losses incurred by the erosion of DG HYP's reputation among shareholders, staff, customers, business partners and the general public. All activities and events that can affect the bank's reputation are identified in both the Corporate Communications and Strategy organisational units, and in the market units concerned. They are evaluated in close cooperation with the Management Board, in order to mitigate their impact as early as possible.

DG HYP generally uses, amongst other things, investment calculations and projections, business plans including scenario-based simulations, cost/benefit analyses, and risk analyses as the basis for strategic decisions, in order to identify and minimise strategic risks. In addition, all decision proposals submitted that may involve or induce strategic risks include a statement by the responsible organisational unit on the risk content, which is taken into account in the resolution passed.

Given that, as a rule, strategic risks are subject to very complex and irregular factual connections, they cannot be included in an integrated system as special risks. They are therefore specially monitored by the Management Board; they are also monitored and continuously analysed by the respective individual organisational units responsible. The regular review of business unit strategies is also a core element of the continuous process of business unit planning and control.

# OUR STAFF

Organisational and strategic changes at DG HYP also placed high demands on HR management in the 2006 financial year. This relates, in particular, to restructuring sales activities for the German cooperative banking sector as well as taking on employees from VR Kreditwerk as part of the re-integration of special IT application developments. On balance, the average number of active employees in the 2006 financial year increased from 545.4 as of 31 December 2005, to 577.7 as of 31 December 2006.

**HR and management development as a strategic factor for success**

Our HR development focuses on individual qualification activities geared to practical work. During the annual target agreement and assessment discussion that managers hold with each of their staff, individual requirements for development and qualifications will receive particular attention. A total of 283 staff members took part in 42 internal training programmes. Another key issue is to identify and promote high potential, and we use assessment centres and management audits for this purpose.

**State-of-the-art performance management instruments**

An assessment system and target agreements are elementary components of our performance management. Concluding a company agreement on the introduction of a performance and results-oriented bonus system was a key step towards a human resources policy that is geared to performance. We constantly review operating workflows and organisational structures to enhance our competitive position. The employee survey conducted in this regard offers an excellent basis for specific activities to improve workflows, structures and quality.

**Successful vocational trainees and acquisition of trainee managers**

Ensuring a supply of new managers from among DG HYP's own staff is one of our HR department's core tasks. Out of every eight of our vocational trainees, we hire seven after they complete their training – initially on a temporary contract. We recruit external management candidates at events including the graduates congress in Cologne, where we present our company together with our partners in the cooperative banking sector. Nine young people started new vocational training programmes with DG HYP on 1 August 2006. As at 31 December 2006, 22 young people were employed as vocational trainees by DG HYP.

In this connection, we would like to offer particular thanks to VR Kreditwerk and our partners in the German cooperative banking sector. They make a major contribution in vocational training – bolstering specialist competence and sales-oriented abilities, thus benefiting our new recruits with successful end-to-end training.

**Cooperation with the Works Council**

Our cooperation with employee representatives was once again professional and constructive in the 2006 financial year. We would like to thank the members of the Works Council for their vital work.

## NUMBER OF EMPLOYEES

| Number of active employees | 31 Dec 2006 | 31 Dec 2005 |
|---|---|---|
| **Management Board** | 3 | 2 |
| **Salaried employees** | 577 | 545 |
| **Vocational trainees** | 22 | 23 |
| **Total** | 602 | 570 |
| **Weighted staff capacity** | 577.7 | 545.4 |

In addition, 56.8 employment relationships (based on weighted staff capacity numbers) were inactive as at 31 December 2006 (e.g. due to maternity leave; long-term sickness; or employees having entered the 'passive phase' of partial retirement).

## NUMBER OF RECIPIENTS OF RETIREMENT BENEFITS

| | 31 Dec 2006 | 31 Dec 2005 |
|---|---|---|
| **Retired employees** | 228 | 225 |
| **Surviving dependants** | 50 | 41 |

# OUTLOOK

**Market environment**

We believe the positive performance of the overall economy will continue over the next two financial years in Germany – even though the economic growth will not again reach the growth recorded in 2006, due to factors including the VAT increase. With regard to Germany's real estate markets, we believe that the main structural problems seen in previous years have been overcome. However, the real growth prospects are primarily in the big cities, which are flourishing financially. The trend towards a more pronounced differentiation of the real estate markets will continue. In total, the German real estate market continues to offer attractive potential for the real estate financing business.

In all of the foreign property markets in which DG HYP is active, we believe that there continues to be attractive market potential in the United Kingdom and USA in particular. In the coming years, the urban centres of business in these countries will continue to offer real estate investors attractive returns and opportunities for growth – despite possible dangers from strong increases in property prices over the past few years.

German local authorities will have to face major challenges in the coming years with high requirements for investments and financing, however the situation is expected to relax a little as a result of the forecast additional tax income. In view of cost structures in public budgets, active alliances with companies in the private sector (in the form of public-private partnerships) will continue to gain in importance. We see continuing substantial growth potential in this regard.

We believe that there will continue to be very attractive opportunities for growth in structured financing and portfolio management. Germany has not yet succeed in finally implementing the so-called German Real Estate Investment Trusts (G-REIT) by means of government legislation; however, we believe that excluding stocks of rented residential properties from this type of listed real estate investment will restrict the dynamic growth in the formation of G-REITs in Germany. At the same time, the currently planned implementation of the G-REIT initiative is a key step – driving the transfer of real estate portfolios, and offering attractive investment opportunities for international real estate investors.

Buying and selling real estate financing portfolios will continue to gain importance in the coming years. This will offer opportunities in particular for smaller banks, such as cooperative banks, to implement active portfolio management, thus reducing cluster risks.

Overall, we see continued excellent business opportunities for our activities in real estate and public-sector finance. At the same time, we believe that competition will continue to be intense in our core German market – for both residential as well as commercial real estate finance.

**Business Development**

In view of the existing opportunities and risks that the economic environment offers, we will continue to further drive the systematic further development of our product offering in the German cooperative banking sector and in our direct business, as well as the expansion of our active portfolio management and structured financing.

Recognising the impact of the combination of intensified competition and margin pressure which has characterised the real estate finance business in Germany – affecting commercial, but in particular residential real estate finance – we launched a project designed to assess strategic development options across all of DG HYP's business segments in November 2006. The prime objective of this project is to achieve a sustained improvement in the bank's financial performance.

We already took several key steps, within a range of strategic initiatives launched during the financial year 2006, to proactively approach market challenges, and strengthen DG HYP's competitive position. On this basis, we are forecasting continuous growth in new business and loan extensions in residential and commercial real estate finance in the years ahead. Based on this outlook for growth, we are forecasting a constant increase in net interest income. This also applies to gross profit.

We will also invest in expertise and personnel for the future, within the scope of the bank's strategic development framework. This relates, in particular, to expanding our sales activities in the German cooperative banking sector, pending investments in IT systems as well as further steps that have to be taken in implementing regulatory requirements. At the same time, we will continue to focus on costs, and these activities will be supported by tight cost management. As a result, we believe that the growth of our administrative costs will be stable – on the whole – over the coming years.

The portfolio adjustments we carried out in 2005 and 2006, together with the optimisation of our lending workflows and amendments to our credit risk strategy, have built the foundation for a reduction in our risk provisioning requirements. With this in mind, we also expect loan loss provisioning to fall successively in the years ahead.

On this basis, we expect to be able to constantly increase DG HYP's operating result. On the whole, we thus believe that we are right on track to further develop DG HYP as a state-of-the-art real estate bank.

# FINANCIAL STATEMENTS

# BALANCE SHEET
# AS AT 31 DECEMBER 2006

## ASSETS

| | € 000's | Note # | € 000's | € 000's | 31 Dec 2005 € 000's |
|---|---|---|---|---|---|
| **Cash Funds** | | | | **23,528** | **13,115** |
| a) Cash on hand | | | 7 | | 1 |
| b) Balance with central banks | | | 23,521 | | 13,114 |
| of which: with Deutsche Bundesbank | 23,521 | | | | (13,114) |
| **Loans and advances to banks** | | **(5)** | | **6,678,607** | **5,811,488** |
| a) Loans secured by property mortgages | | | 217,394 | | 236,882 |
| b) Loans to local authorities | | | 4,399,784 | | 4,609,192 |
| c) Other loans and advances | | | 2,061,429 | | 965,414 |
| of which: Payable on demand | 759,485 | | | | (551,635) |
| Collateralised by pledged securities | – | | | | (–) |
| **Loans and advances to customers** | | **(5)** | | **41,145,849** | **41,857,146** |
| a) Loans secured by property mortgages | | | 23,313,614 | | 24,553,159 |
| b) Loans to local authorities | | | 17,574,705 | | 17,006,381 |
| c) Other loans and advances | | | 257,530 | | 297,606 |
| of which: Collateralised by pledged securities | – | | | | (–) |
| **Bonds and other fixed-income securities** | | **(6)** | | **36,710,923** | **30,499,880** |
| a) Bonds and debt securities | | | (36,457,592) | | (30,244,301) |
| aa) Public-sector issuers | | | 16,062,014 | | 14,726,283 |
| of which: Securities eligible as collateral with Deutsche Bundesbank | 15,267,336 | | | | (12,297,922) |
| ab) Other issuers | | | 20,395,578 | | 15,518,018 |
| of which: Securities eligible as collateral with Deutsche Bundesbank | 15,892,570 | | | | (14,004,347) |
| b) Own bonds issued | | | 253,331 | | 255,579 |
| Nominal amount | 251,791 | | | | (253,010) |
| **Equities and other non-fixed income securities** | | **(6)** | | **2,109** | **16** |
| **Participations** | | **(6)** | | **926** | **2,958** |
| of which: Interests in banks | – | | | | (264) |
| Interests in financial services providers | – | | | | (–) |
| **Investments in affiliated companies** | | **(6)** | | **3,319** | **3,991** |
| of which: Interests in banks | – | | | | (–) |
| Interests in financial services providers | – | | | | (–) |
| **Trust assets** | | **(7)** | | **746,539** | **598,633** |
| of which: Trustee loans | 713,829 | | | | (564,901) |
| **Intangible fixed assets** | | **(8)** | | **33,249** | **40,212** |
| **Tangible fixed assets** | | **(8)** | | **3,302** | **3,391** |
| **Other assets** | | **(23)** | | **51,686** | **25,034** |
| **Deferred taxes** | | | | **0** | **5,925** |
| **Prepaid expenses** | | **(10)** | | **270,622** | **277,840** |
| a) From new issues and lending | | | 269,500 | | 276,586 |
| b) Other | | | 1,122 | | 1,254 |
| **Total assets** | | | | **85,670,659** | **79,139,629** |

# AS AT 31 DECEMBER 2006

## LIABILITIES AND EQUITY

| | € 000's | Note # | € 000's | € 000's | 31 Dec 2005 € 000's |
|---|---|---|---|---|---|
| **Liabilities to banks** | | **(13)** | | **13,551,619** | **11,271,650** |
| a) Outstanding registered mortgage bonds (*Hypotheken-Namenspfandbriefe*) | | | 1,167,644 | | 1,080,043 |
| b) Outstanding registered public-sector covered bonds (*öffentliche Namenspfandbriefe*) | | | 3,857,618 | | 3,828,018 |
| c) Other liabilities | | | 8,526,357 | | 6,363,589 |
| of which: Payable on demand | 225,145 | | | | (205,333) |
| Registered mortgage bonds | 515 | | | | (4) |
| and registered public-sector covered bonds | 13,394 | | | | (15,531) |
| surrendered to lenders as collateral for borrowings | | | | | |
| **Liabilities to customers** | | **(13)** | | **14,350,893** | **11,869,677** |
| a) Outstanding registered mortgage bonds (*Hypotheken-Namenspfandbriefe*) | | | 2,977,079 | | 3,060,433 |
| b) Outstanding registered public-sector covered bonds (*öffentliche Namenspfandbriefe*) | | | 8,564,451 | | 6,009,026 |
| c) Other liabilities | | | 2,809,363 | | 2,800,218 |
| of which: Payable on demand | 218,421 | | | | (165,982) |
| Registered mortgage bonds | 30,678 | | | | (39,369) |
| and registered public-sector covered bonds | 12,226 | | | | (26,031) |
| surrendered to lenders as collateral for borrowings | | | | | |
| **Securitised liabilities** | | **(13)** | | **54,138,868** | **52,811,923** |
| Bonds issued | | | | | |
| a) Mortgage bonds (*Hypothekenpfandbriefe*) | | | 13,219,103 | | 14,344,290 |
| b) Public-sector covered bonds (*Öffentliche Pfandbriefe*) | | | 35,553,395 | | 33,472,276 |
| c) Other debt securities | | | 5,366,370 | | 4,995,357 |
| **Trust liabilities** | | **(7)** | | **746,539** | **598,633** |
| of which: Trustee loans | 713,829 | | | | (564,901) |
| **Other liabilities** | | **(24)** | | **106,368** | **75,452** |
| **Deferred income** | | **(10)** | | **130,576** | **111,148** |
| a) From new issues and lending | | | 130,468 | | 111,024 |
| b) Other | | | 108 | | 124 |
| **Provisions** | | | | **95,833** | **83,495** |
| a) Provisions for pensions and similar obligations | | | 68,691 | | 56,746 |
| b) Provisions for taxes | | | 456 | | 450 |
| c) Other provisions | | | 26,686 | | 26,299 |
| **Subordinated liabilities** | | **(14)** | | **731,375** | **658,985** |
| **Profit-participation certificates** | | **(15)** | | **153,643** | **153,643** |
| of which: Due within two years | 43,715 | | | | (7,925) |
| **Fund for general banking risks** | | | | – | **24,078** |
| **Equity capital** | | | | **1,664,945** | **1,480,945** |
| a) Subscribed capital | | **(16)** | (1,017,687) | | (863,687) |
| aa) Share capital | | | 90,000 | | 90,000 |
| ab) Silent partnership contributions | | | 927,687 | | 773,687 |
| b) Capital reserves | | **(17)** | 554,113 | | 524,113 |
| c) Retained earnings | | **(17)** | (93,145) | | (93,145) |
| ca) Legal reserves | | | 945 | | 945 |
| cb) Other retained earnings | | | 92,200 | | 92,200 |
| **Total equity and liabilities** | | | | **85,670,659** | **79,139,629** |
| **Contingent liabilities** | | **(18)** | | | |
| Liabilities from guarantees and indemnity agreements | | | | 632,873 | 720,973 |
| **Other commitments** | | | | | |
| Irrevocable loan commitments | | | | 1,663,041 | 987,249 |

# PROFIT AND LOSS ACCOUNT
# FOR THE PERIOD FROM 1 JANUARY TO 31 DECEMBER 2006

# PROFIT AND LOSS ACCOUNT
# FOR THE PERIOD FROM 1 JANUARY TO 31 DECEMBER 2006

| | € 000's | Note # | € 000's | € 000's | 2005<br>€ 000's |
|---|---|---|---|---|---|
| **Interest income from** | | | | | |
| a) Lending and money market transactions | | | 2,518,410 | | 2,801,661 |
| b) Fixed-income securities and debt register claims | | | 1,405,970 | | 1,083,799 |
| | | | | 3,924,380 | 3,885,460 |
| **Interest expense** | | | | 3,598,451 | 3,561,020 |
| | | | | 325,929 | 324,440 |
| **Current income from** | | | | | |
| a) Participating interests | | | 68 | | 35 |
| b) Interests in affiliated companies | | | 0 | | 10 |
| | | | | 68 | 45 |
| **Income from profit-pooling, profit transfer, and partial profit transfer agreements** | | | | 1,818 | 1,108 |
| **Commission income** | | | 16,842 | | 19,491 |
| **Commission expense** | | | 63,293 | | 77,994 |
| **Net commission result** | | | | – 46,451 | – 58,503 |
| **Other operating income** | | **(27)** | | 15,244 | 22,780 |
| **General administrative expenses** | | | | | |
| a) Personnel expenses | | | | | |
| aa) Wages and salaries | | | 45,112 | | 41,125 |
| ab) Compulsory social security contributions and expenses for pensions and other employee benefits | | | 22,666 | | 10,842 |
| | | | 67,778 | | 51,967 |
| of which: Pension expenses | 16,344 | | | | (4,897) |
| b) Other administrative expenses | | | 112,559 | | 115,156 |
| | | | | 180,337 | 167,123 |
| **Amortisation/depreciation and write-downs of intangible and tangible fixed assets** | | | | 11,104 | 10,976 |
| **Miscellaneous other operating expenses** | | **(28)** | | 12,646 | 4,548 |
| **Amortisation and write-downs of receivables and specific securities, as well as additions to loan loss provisions** | | | | 73,913 | 92,715 |
| **Income from write-ups on participations, interests in affiliated companies, and investment securities** | | | | 14,047 | 36,984 |
| **Expenses for losses assumed under profit-transfer and similar agreements** | | | | 42 | 141 |
| **Profit from ordinary activities** | | | | **32,613** | **51,351** |
| **Extraordinary income** | | | – | | – |
| **Extraordinary expenses** | | | – | | 1,318 |
| **Net extraordinary income/expenses** | | | | – | – 1,318 |
| **Taxes on income** | | **(29)** | – 2,368 | | – |
| **Other taxes not disclosed under "Miscellaneous other operating expenses"** | | | 2 | | – |
| | | | | – 2,366 | – |
| **Profits transferred under partial profit transfer agreements** | | | | 59,057 | 39,133 |
| **Profits transferred under profit transfer agreements** | | | | – | – |
| **Change in the fund for general banking risks** | | | | 24,078 | – 10,900 |
| **Net income** | | | | **–** | **–** |

# Notes to the Financial Statements

## General Notes

### (1) General information on the preparation of financial statements

The financial statements of DG HYP for the financial year 2006 have been prepared in accordance with the provisions of the German Commercial Code (*Handelsgesetzbuch – "HGB"*) and the German Accounting Directive for Banks (*Verordnung über die Rechnungslegung der Kreditinstitute – "RechKredV"*). They also comply with the requirements set out in the German Public Limited Companies Act (*Aktiengesetz – "AktG"*), and the German Pfandbrief Act (*Pfandbriefgesetz – "PfandBG"*).

Given the non-materiality of all subsidiaries, in accordance with section 296 (2) of the HGB, the company has not prepared consolidated financial statements.

All amounts have been quoted in euros, in accordance with section 244 of the HGB.

### (2) Accounting policies

**Loans and advances to banks/to customers**

Loans and advances to banks and customers are recognised at nominal value, in accordance with section 340e (2) of the HGB. Where their stated value of the loans differs from the amount disbursed, or cost, the amount of the difference is reported under deferred items and amortised in interest income over the term of the transaction.

Loans and advances which are fully classified as current assets are valued strictly at the lower of cost or market. All existing individual lending risks are covered by specific loan loss provisions. Existing risks of default in the retail lending business are covered by recognising specific provisions at a flat rate. We have formed a tax-deductible general loan loss provision to cover expected loan losses which have been incurred but not identified as such at the balance sheet date. Special risks arising from banking operations are accounted for by the fund for general banking risks pursuant to section 340f of the HGB.

Following the revocation of Statement 3/1977 issued by the Institute of Public Auditors in Germany (*Institut der Wirtschaftsprüfer – "IdW"*), we have adapted the procedure for recognising interest income on non-performing loans and advances during the year under review. Whilst in previous periods, our policy was to recognise interest claims until collateral had been realised in full, we now no longer recognise interest income where it becomes obvious during execution proceedings that the realisable proceeds will fall short of the carrying amount. The change in policy will result in a € 9.4 million shortfall in net interest income, with a corresponding reduction in loan loss provisions.

Early repayment penalties charged for loan repayments or extensions during the fixed-interest term of a loan are fully recognised in interest income.

**Bonds and other fixed-income securities**

Securities issued by public-sector entities, or by banks under public-law, acquired within the scope of the bank's public finance business, as well as Mortgage Backed Securities (MBS) held for investment, were accounted for as fixed assets. Premiums and discounts are amortised in interest income over the term of the securities. Other debt securities and other fixed-income securities are allocated to liquidity reserves, and valued strictly at the lower of cost or market, pursuant to section 253 (3) of the HGB.

Securities transferred under repurchase agreements are accounted for, and valued (including accrued economic benefits) in line with their original classification, simultaneously recognising a liability equivalent to the agreed repurchase amount. The difference between the repurchase amount and the amount received is reported under deferred items and amortised in interest income over the term of the transaction.

**Participations and interests in affiliated companies**

Participations and interests in affiliated companies are carried at amortised cost.

**Intangible and tangible fixed assets**

Fixed assets are carried at cost less regular straight-line depreciation, where applicable. Movable fixed assets are predominantly depreciated on a straight-line basis, using the maximum rates permissible under tax laws, or degressively with a subsequent transfer to straight-line depreciation. Low-value assets are written off in full during their year of purchase. Standard software is reported under intangible assets, as prescribed by accounting standard HFA 11 issued the Main Committee of the *IdW* (*IDW RS HFA 11*).

Goodwill capitalised upon the merger with Schleswig-Holsteinische Landschaft Hypothekenbank Aktiengesellschaft Kiel (*"SHL HYP"*) is amortised over the expected useful life (15 years), pursuant to section 255 (4) sentence 3 of the HGB, and in line with applicable tax rules.

**Liabilities**

Liabilities are shown on the balance sheet at the amount due for repayment. The difference between the nominal value and the initial carrying amount of liabilities is recognised under deferred items and amortised over the term of the transaction.

Liabilities classified as structured products (as defined in Accounting Note BFA 1.003 issued by the Banking Committee of the *IdW*) are accounted for as uniform liabilities as they only contain embedded interest rate derivatives. Such liabilities are grouped with corresponding hedge transactions, to form valuation units.

Following a contractual amendment, partial profit transfers made on silent partnership contributions are reported in full, regardless of their tax treatment; this is a change of policy compared to the previous year. Where such partial profit transfers are not tax-deductible as business expenses in accordance with section 8a of the German Corporation Tax Act (*Körperschaftssteuergesetz – "KStG"*), the expense is offset by a claim under Group tax overheads, which neutralises the tax effect. This change in policy has no impact on income, and is designed to enhance transparency in reporting profit and loss components.

**Provisions**

Contingent liabilities are covered by provisions equalling the anticipated amount of the liability, on the basis of prudent business judgement. Provisions for pensions are determined using the cost (*"Teilwert"*) method in accordance with actuarial principles, using the actuarial tables 2005 G by Dr. Klaus Heubeck. The imputed interest rate used for discounting was reduced from 6.0 per cent to 4.5 per cent during the year under review. In this connection, we have also set the discount rate for the other provisions for personnel at 4.5 per cent. The resulting one-off factor from this change led to an increase in administrative expenses of € 11.3 million in the 2006 financial year.

**Derivative financial instruments**

Financial derivatives are accounted for separately in auxiliary ledgers. These instruments are generally used to hedge against the interest rate and currency risk exposure of on-balance sheet transactions. Current interest payments are amortised and recorded in net interest income.

Income from the disposal (close-out) of interest rate-based derivative financial instruments are generally recognised in interest income. Where interest rate swaps are grouped with securities, to form valuation units (asset swaps), income realised upon closing out swaps are recognised in line with the recognition of income of the underlying transaction, in the net result on financial assets, or in the net risk provisioning balance, respectively.

Premiums paid or received for credit default swaps are amortised in commission income over the terms of the transactions.

Premium payments for swaptions entered into as a hedge against the impact of statutory loan termination rights pursuant to section 489 of the German Civil Code (*Bürgerliches Gesetzbuch – "BGB"*) are generally amortised over the term of the transactions. In view of the non-recognition for tax purposes of this pro rata distribution, these swaptions, allocated to the investment portfolio, are now carried at cost. The deferred taxes formed in this connection within the meaning of section 274 (2) of the HGB was reversed in full during the year under review. This change to the valuation method impacted earnings in the net amount of € 8.8 million during the year under review.

**(3) Currency translation**

Assets and liabilities from foreign exchange transactions are translated in line with section 340h of the HGB and Statement BFA 3/1995 issued by the *IdW*. Book receivables, securities, liabilities and unsettled spot transactions are generally translated using the ECB reference rate prevailing on the balance sheet date. Income and expenses from currency translation are recognised in the income statement in accordance with section 340h of the HGB. Income and expenses from foreign exchange forwards which were entered into exclusively as a hedge of interest-bearing balance sheet items are recognised in interest income.

## Notes to the Balance Sheet

**(4) Loans and advances to banks/to customers**

As in the previous year, no subordinated receivables were outstanding at the balance sheet date.

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## (5) Lending business

| Mortgage loans | Principal € mn | Carrying amount € mn |
|---|---|---|
| to banks | 217 | 217 |
| to customers | 23,122 | 23,314 |
| **Total** | **23,339** | **23,531** |

| Portfolio development (principal) | € mn | € mn |
|---|---|---|
| Balance at 31 Dec 2005 | | 24,564 |
| Additions during the financial year 2006 | | 2,085 |
| Disbursements | 2,058 | |
| Transfers | 27 | |
| Other additions | – | |
| Disposals during the financial year 2006 | | 3,310 |
| Scheduled repayments | 910 | |
| Unscheduled repayments | 2,174 | |
| Transfers | 226 | |
| Other disposals | – | |
| Balance at 31 Dec 2006 | | 23,339 |

| Loans to local authorities | Principal € mn | Carrying amount € mn |
|---|---|---|
| to banks | 4,280 | 4,400 |
| to customers | 17,395 | 17,575 |
| **Total** | **21,675** | **21,975** |

| Portfolio development (principal) | € mn | € mn |
|---|---|---|
| Balance at 31 Dec 2005 | | 21,333 |
| Additions during the financial year 2006 | | 3,935 |
| Disbursements | 3,932 | |
| Transfers | 3 | |
| Other additions | – | |
| Disposals during the financial year 2006 | | 3,593 |
| Scheduled repayments | 2,939 | |
| Unscheduled repayments | 650 | |
| Transfers | 4 | |
| Other disposals | – | |
| Balance at 31 Dec 2006 | | 21,675 |

## (6) Negotiable securities

| Balance sheet item | Listed | | Unlisted | | Amount of negotiable securities not valued at the lower of cost or market | |
|---|---|---|---|---|---|---|
| | 31 Dec 2006 € 000's | 31 Dec 2005 € 000's | 31 Dec 2006 € 000's | 31 Dec 2005 € 000's | 31 Dec 2006 € 000's | 31 Dec 2005 € 000's |
| Bonds and other fixed income securities | 34,086,245 | 27,864,744 | 2,624,678 | 2,635,136 | 9,383,908 | 1,951,852 |
| Equities and other non-fixed income securities | – | 16 | 2,109 | – | – | – |
| Participations | – | – | – | 2,150 | – | – |
| Interests in affiliated companies | – | – | – | – | – | – |

## (7) Trust business

| | 31 Dec 2006 € 000's | 31 Dec 2005 € 000's |
|---|---|---|
| Assets held in trust comprise: | | |
| – Loans and advances to banks | – | – |
| – Loans and advances to customers | 713,829 | 564,901 |
| – Participations | 32,710 | 33,732 |
| | 746,539 | 598,633 |
| Trust liabilities are carried vis-á-vis: | | |
| – Banks | 565,451 | 564,901 |
| – Customers | 181,088 | 33,732 |
| | 746,539 | 598,633 |

## (8) Breakdown of, and statement of changes in fixed assets

| | Purchase or production cost | | | | Depreciation and amortisation | | | | Carrying amounts | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1 Jan 2006 € 000's | Additions € 000's | Reclassifications € 000's | Disposals € 000's | Financial year € 000's | Transfers € 000's | Disposals € 000's | Total € 000's | 31 Dec 2006 € 000's | 1 Jan 2006 € 000's |
| I. Intangible assets | **86,973** | **1,634** | **–** | **10,920** | **8,465** | **–** | **10,788** | **44,438** | **33,249** | **40,212** |
| II. Tangible fixed assets | | | | | | | | | | |
| 1. Land and buildings | 51 | – | – | – | – | – | – | 51 | – | – |
| 2. Office furniture and equipment [1] | 44,286 | 2,719 | – | 21,945 | 2,639 | – | 21,776 | 21,758 | 3,302 | 3,391 |
| | **44,337** | **2,719** | **–** | **21,945** | **2,639** | **–** | **21,776** | **21,809** | **3,302** | **3,391** |
| | | Net change | | | | | | | | |
| III. Financial assets | | | | | | | | | | |
| 1. Participations | 5,042 | | | | – 4,116 | | | | 926 | 2,958 |
| 2. Investments in affiliated companies | 5,483 | | | | – 2,164 | | | | 3,319 | 3,991 |
| 3. Equities and other non-fixed income securities | 16 | | | | 2,093 | | | | 2,109 | 16 |
| 4. Investment securities [2] | 20,417,773 | | | | 3,163,447 | | | | 23,581,220 | 20,819,388 |

[1] Fully used for the bank's own operations.

[2] Given the temporary impairment of securities usually held to maturity, a € 243,936,000 write-down to the fair value of € 23,337,284,000 was not recognised in line with section 253 (2) of the HGB. The hidden reserves for these securities totalled € 589,425,000 on the balance sheet date.

### (9) List of investments pursuant to sections 285 no. 11 and 340a of the HGB

| Minimum stake of 20% Name/registered office | Equity interest % | Equity capital € 000's | Results € 000's |
|---|---|---|---|
| Landschaftliche Grundstücksgesellschaft mbH, Kiel | 100.0 | 800 | – 42 *) |
| VR WERT Gesellschaft für Immobilienbewertungen mbH, Hamburg | 100.0 | 100 | 958 *) |
| IMMOFORI Gesellschaft für Immobilien Forderungsinkasso mbH, Hamburg | 100.0 | 475 | 956 *) |
| MAROLA Grundstücksgesellschaft mbH & Co. KG, Grünwald | 100.0 | 3 | – 1 |
| MALEA Grundstücksgesellschaft mbH & Co. KG, Schwabhausen | 100.0 | 10 | 8 |
| VR HYP GmbH, Hamburg | 100.0 | 25 | 0 |
| TXS Financial Products GmbH, Ellerau | 26.0 | 282 | 14 |

*) Profit and loss transfer agreement with DG HYP

### (10) Prepaid expenses and deferred income

| | 31 Dec 2006 € 000's | 31 Dec 2005 € 000's |
|---|---|---|
| **Assets** | | |
| Sub-item a) From new issues and lending comprises | | |
| – Difference between the nominal amount and the higher disbursement amount of receivables | 26,073 | 34,100 |
| – Difference between the nominal amount and the lower issuing amount of liabilities | 166,729 | 196,735 |
| **Liabilities and equity** | | |
| Sub-item a) From new issues and lending comprises | | |
| – Difference between the nominal amount and the lower disbursement amount of receivables | 43,837 | 55,969 |

### (11) Open-market transactions

| | 31 Dec 2006 € 000's | 31 Dec 2005 € 000's |
|---|---|---|
| Open-market transactions entered into with Deutsche Bundesbank | 4,258,579 | 3,766,926 |

### (12) Securities repurchase agreements

There were no securities repurchase agreements on the balance sheet date.

### (13) Breakdown of, and statement of changes in debt securities and borrowed funds

| | Principal € mn | Carrying amount € mn |
|---|---|---|
| Registered mortgage bonds | | |
| to banks | 1,136 | 1,168 |
| to customers | 2,905 | 2,977 |
| Mortgage bonds | 12,927 | 13,219 |
| | 16,968 | 17,364 |
| Registered public-sector covered bonds | | |
| to banks | 3,769 | 3,858 |
| to customers | 8,379 | 8,565 |
| Public-sector covered bonds | 34,744 | 35,553 |
| | 46,892 | 47,976 |
| Other debt securities | 5,294 | 5,366 |
| Borrowed funds | | |
| from banks | 1,470 | 1,496 |
| from customers | 2,506 | 2,583 |
| | 3,976 | 4,079 |
| **Total** | **73,130** | **74,785** |

**Development** (principal)

| | Balance on 31 Dec 2005 € mn | Additions € mn | Disposals € mn | Balance on 31 Dec 2006 € mn |
|---|---|---|---|---|
| Mortgage bonds and registered mortgage bonds | 18,075 | 1,744 | 2,851 | 16,968 |
| Public-sector covered bonds and registered public-sector covered bonds | 42,258 | 7,484 | 2,850 | 46,892 |
| Other debt securities | 4,924 | 2,187 | 1,817 | 5,294 |
| Borrowed funds | 4,059 | 352 | 435 | 3,976 |
| **Total** | **69,316** | **11,767** | **7,953** | **73,130** |

## (14) Subordinated liabilities

| | 31 Dec 2006<br>€ 000's | 31 Dec 2005<br>€ 000's |
|---|---|---|
| Subordinated | | |
| other debt securities | 183,008 | 188,121 |
| borrowed funds | 548,367 | 470,864 |
| | **731,375** | **658,985** |
| Expenses incurred | 35,827 | 34,996 |

The terms of subordinated liabilities comply with the provisions of section 10 (5a) of the German Banking Act (*Kreditwesengesetz – "KWG"*), and do not provide for any early repayment obligations. There are no provisions or plans for a conversion of such funds to capital, or into another form of debt.

No individual subordinated liability amounts to 10.0 per cent or more of the aggregate amount of subordinated liabilities. Subordinated liabilities carry an average interest of 5.3 per cent, and have original maturities of between 5 and 23 years.

## (15) Profit-participation certificates

| Issuer | Year of issue | Amount<br>€ mn | Coupon<br>% | Repayment* |
|---|---|---|---|---|
| DG HYP | 1993 | 51.1 | 7.25 | 1 Jun 2009 |
| DG HYP | 1993 | 51.1 | 7.00 | 1 Jun 2014 |
| DG HYP | 1994 | 25.5 | 6.50 | 1 Jun 2008 |
| DG HYP | 1999 | 1.5 | 6.20 | 1 Jun 2007 |
| DG HYP | 1999 | 5.1 | 6.79 | 1 Jun 2011 |
| DG HYP | 1999 | 2.6 | 6.63 | 1 Jun 2009 |
| SHL HYP/DG HYP | 1996 | 2.6 | 7.20 | 28 Jun 2007 |
| SHL HYP/DG HYP | 1996 | 2.0 | 7.24 | 28 Jun 2007 |
| SHL HYP/DG HYP | 1996 | 1.8 | 7.24 | 28 Jun 2007 |
| SHL HYP/DG HYP | 1997 | 2.6 | 6.90 | 28 Jun 2008 |
| SHL HYP/DG HYP | 1997 | 2.6 | 6.95 | 15 Jun 2008 |
| SHL HYP/DG HYP | 1997 | 5.1 | 6.95 | 15 Jun 2008 |
| | | 153.6 | | |

* The term of profit-participation certificates ends on 31 December of the preceding year.

Profit-participation certificates qualify as liable capital pursuant to section 10 (5) of the KWG. The holders of profit-participation certificates receive an annual distribution in the amount of the respective coupon, which takes precedence over the profit entitlements of shareholders.

**(16) Subscribed capital**

| | 31 Dec 2006<br>€ 000's | 31 Dec 2005<br>€ 000's |
|---|---|---|
| Issued share capital | 90,000 | 90,000 |
| Silent partnership contributions | 927,687 | 773,687 |
| Total | 1,017,687 | 863,687 |

The issued share capital amounts to € 90,000,000 and is divided into 3,500,000 notional no-par value shares ("unit shares"). VR-Immobilien GmbH, Frankfurt/Main ("VR IMMO") holds 3,321,500 shares (94.9 per cent), of which 1,131,320 shares are held in trust by other entities. The remaining 178,500 shares (5.1 per cent) are held by DZ BANK AG Deutsche Zentral-Genossenschafts-bank, Frankfurt/Main.

The silent partnership contributions are partial profit transfer agreements within the meaning of section 292 (1) no. 2 of the AktG. Of the silent contributions, € 334.0 million are unlimited, the remaining € 593.7 million are available through to the end of financial years 2007-2009. Of the silent contributions, € 773.9 million correspond to the provisions of Section 10 (4) of the KWG on the balance sheet date.

**(17) Breakdown of, and statement of changes in reserves**

| | Balance on 31 Dec 2005<br>€ 000's | Additions<br>€ 000's | Disposals<br>€ 000's | Balance on 31 Dec 2006<br>€ 000's |
|---|---|---|---|---|
| Capital reserve | 524,113 | 30,000 | – | 554,113 |
| Retained earnings | (93,145) | | | (93,145) |
| – Legal reserves | 945 | – | – | 945 |
| – Other retained earnings | 92,200 | – | – | 92,200 |
| Total | 617,258 | 30,000 | – | 647,258 |

The contribution to the capital reserve was shared between VR IMMO (94.9 per cent) and DZ BANK AG (5.1 per cent), in line with their respective shareholding.

**(18) Contingent liabilities**

This item includes predominantly € 563 million in loan guarantees extended to DZ BANK AG as cover for new commercial real estate finance exposures extended by DZ BANK AG and guaranteed by DG HYP.

**(19) Revaluation reserves**

No revaluation reserves pursuant to section 10 (2b) sentence 1 no. 6 of the KWG were included in liable capital.

### (20) Relationships with affiliated enterprises and subsidiaries

**Affiliated enterprises**

| | 31 Dec 2006<br>€ 000's | 31 Dec 2005<br>€ 000's |
|---|---|---|
| Loans and advances to | | |
| – banks | 1,492,412 | 603,349 |
| – customers | 29,447 | 53,490 |
| Bonds and other fixed-income securities | – | – |
| Liabilities to | | |
| – banks | 5,211,916 | 3,989,360 |
| – customers | 1,008,212 | 1,046,840 |
| Securitised liabilities | 10,920,688 | 8,666,818 |
| Subordinated liabilities | – | – |

**Subsidiaries**

There were no loans and advances, or liabilities, to subsidiaries at the reporting date.

### (21) Breakdown of maturities for receivables and liabilities

| | 31 Dec 2006<br>€ 000's | 31 Dec 2005<br>€ 000's |
|---|---|---|
| **Assets** | | |
| Loans and advances to banks | | |
| Remaining term – payable on demand | 759,485 | 551,635 |
| – up to three months | 1,094,736 | 741,378 |
| – between three months and one year | 974,791 | 241,524 |
| – between one year and five years | 2,758,705 | 3,343,985 |
| – more than five years | 1,090,890 | 932,966 |
| | 6,678,607 | 5,811,488 |
| Loans and advances to customers | | |
| Remaining term – payable on demand | 110,246 | 49,434 |
| – up to three months | 1,622,457 | 1,372,582 |
| – between three months and one year | 2,280,348 | 2,010,232 |
| – between one year and five years | 8,498,022 | 8,288,162 |
| – more than five years | 28,634,776 | 30,136,736 |
| | 41,145,849 | 41,857,146 |
| Bonds and other fixed-income securities maturing in the following year | 2,913,595 | 1,636,253 |
| **Liabilities and equity** | | |
| Liabilities to banks | | |
| Remaining term – payable on demand | 225,145 | 205,333 |
| – up to three months | 5,090,755 | 4,840,938 |
| – between three months and one year | 2,368,340 | 396,579 |
| – between one year and five years | 1,593,081 | 1,588,193 |
| – more than five years | 4,274,298 | 4,240,607 |
| | 13,551,619 | 11,271,650 |
| Liabilities to customers | | |
| Remaining term – payable on demand | 218,421 | 165,982 |
| – up to three months | 569,353 | 536,776 |
| – between three months and one year | 534,164 | 593,366 |
| – between one year and five years | 3,499,558 | 3,132,656 |
| – more than five years | 9,529,397 | 7,440,897 |
| | 14,350,893 | 11,869,677 |
| Certificated liabilities maturing in the following year | 5,952,584 | 7,601,891 |

**(22) Assets and liabilities in foreign currencies**

| | 31 Dec 2006<br>€ 000's | 31 Dec 2005<br>€ 000's |
|---|---|---|
| Assets include foreign-currency receivables in the total amount of | 3,443,294 | 2,325,994 |
| Liabilities and equity include foreign-currency liabilities in the total amount of | 3,823,767 | 2,361,542 |

**(23) Other assets**

Other assets include interest rate options with a carrying amount of € 29.6 million.

**(24) Other liabilities**

This item includes mainly € 59.1 million in profits to be transferred under partial profit transfer agreements.

### (25) Forward contracts not reflected in the balance sheet

The following types of forward transactions based on foreign currencies, interest rates or other underlying instruments were outstanding as at the balance sheet date:

| € mn | Nominal amounts by residual term ≤ 1 year | > 1–5 yrs | > 5 yrs | Total 2006 | Total 2005 | Fair value 2006 positive | 2006 negative | 2005 positive | 2005 negative |
|---|---|---|---|---|---|---|---|---|---|
| **Interest rate instruments** | **71,639** | **62,617** | **71,595** | **205,851** | **150,322** | **1,833** | **3,219** | **2,499** | **4,009** |
| **OTC products** | | | | | | | | | |
| **Interest rate swaps*)** | **68,406** | **61,308** | **71,583** | **201,297** | **145,981** | **1,725** | **3,209** | **2,329** | **4,003** |
| including: Forward swaps | – | 35 | 394 | 429 | 883 | 5 | 18 | 9 | 27 |
| including: With embedded caps/floors | 33 | 143 | 121 | 297 | 347 | 1 | 16 | 17 | 8 |
| including: With embedded puts/calls | – | 10 | 422 | 432 | 361 | 13 | 2 | – | – |
| **Interest rate options** | **3,233** | **1,309** | **12** | **4,554** | **4,341** | **108** | **10** | **170** | **6** |
| including: Swaptions bought | 1,199 | 1,299 | 12 | 2,510 | 2,557 | 108 | – | 170 | – |
| including: Swaptions sold | 2,034 | 10 | – | 2,044 | 1,784 | – | 10 | – | 6 |
| **Exchange-traded products** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** | **–** |
| **Currency-related instruments** | **–** | **130** | **265** | **395** | **900** | **16** | **5** | **9** | **109** |
| Cross-currency swaps | – | 130 | 265 | 395 | 900 | 16 | 5 | 9 | 109 |
| Foreign exchange forwards | – | – | – | – | – | – | – | – | – |
| Foreign exchange swaps | – | – | – | – | – | – | – | – | – |
| **Credit-related transactions** | **3** | **1,435** | **1,337** | **2,775** | **2,683** | **55** | **32** | **–** | **2** |
| **Credit default swaps** | **3** | **1,435** | **957** | **2,395** | **2,683** | **14** | **4** | **–** | **2** |
| including: Protection seller | – | 92 | 130 | 222 | 235 | – | – | – | – |
| including: Protection buyer | 3 | 1,343 | 827 | 2,173 | 2,448 | 14 | 4 | – | 2 |
| **Total return swaps** | **–** | **–** | **380** | **380** | **–** | **41** | **28** | **–** | **–** |
| including: Protection seller | – | – | 380 | 380 | – | 41 | 28 | – | – |
| including: Protection buyer | – | – | – | – | – | – | – | – | – |
| **Forward transactions exposed to other price risks** | – | – | – | – | – | – | – | – | – |
| **Total** | **71,642** | **64,182** | **73,197** | **209,021** | **153,905** | **1,904** | **3,256** | **2,508** | **4,120** |

*) Including interest rate swaps with identical foreign currency

The forward transactions identified above are used to manage interest rate, currency and counterparty risk exposure. As a rule, counterparties are OECD banks or central governments. In addition, borrowers also appear as counterparties (market value € –0.3 million) in connection with loan agreements. Interest rate swaps are valued using present values, determined by discounting cash flows using market interest rates in line with the credit risk and maturities concerned, as indicated by the yield curve prevailing on the balance sheet date.

Options are valued using option pricing models. These are applied on the basis of generally recognised assumptions regarding valuation parameters, in particular the value and volatility of the underlying instrument, the agreed exercise price (interest rate), the remaining lifetime of the contract, as well as the risk-free interest rate for that lifetime.

Credit derivatives are valued on an individual basis, predominantly on the basis of the default probability of the reference obligations concerned.

Market values are determined without consideration of netting agreements. No add-ons or credit quality weightings – as defined pursuant to the capital ratio according to the German Banking Act (*Grundsatz I*) – are taken into account. Negative market values of derivatives are offset by positive market values of the related hedged balance sheet items.

# Notes to the Profit and Loss Account

**(26)** There is no **breakdown according to geographic markets within the meaning of Section 34 (2) no. 1 of the RechKredV** as a result of the fact that, as a whole, DG HYP's activities on foreign markets are not material.

**(27) Other operating income**

Other operating income totalling € 15.2 million includes mainly € 5.3 million in rental income, € 2.3 million in income on services rendered, and cost refunds totalling € 2.2 million in connection with costs incurred in 2005 for the sale of a portfolio realised in 2006.

**(28) Other operating expenses**

Other operating expenses totalling € 12.6 million were mostly characterised by one-off expenses totalling € 10.0 million incurred as part of the re-orientation of VR IMMO.

**(29) Taxes on income**

The tax income recorded in the year under review is due to the tax overhead credit related to partial profit transfers, covered by section 8a of the KStG. This effect is partially compensated for by the full reversal of deferred tax assets.

# Cash flow statement

## (30) Cash flow statement

| € mn | | | 2006 | 2005 |
|---|---|---|---|---|
| **1.** | | **Net income for the period (including income/loss portion attributable to minority shareholders) excluding extraordinary items and taxes** | **33** | **51** |
| | | ***Non-cash items included in net income and reconciliation to cash flow from operating activities*** | | |
| 2. | +/– | Depreciation, write-downs and additions on receivables, tangible fixed assets and financial assets | 89 | 104 |
| 3. | +/– | Increase/decrease in provisions | 12 | 1 |
| 4. | +/– | Other non-cash expenses/income | 4 | 1 |
| 5. | –/+ | Profits/losses from the disposal of tangible fixed assets and financial assets | – 14 | – 37 |
| 6. | –/+ | Other adjustments (net balance) | – 328 | – 325 |
| **7.** | **=** | **Subtotal** | **– 204** | **– 205** |
| | | ***Net changes in cash funds/assets and liabilities from operating activities*** | | |
| 8. | | Loans and advances | | |
| 8a. | +/– | – to banks | – 846 | – 202 |
| 8b. | +/– | – to customers | 638 | 39 |
| 9. | +/– | Securities (excluding financial assets) | – 3,414 | – 2,321 |
| 10. | +/– | Other assets from operating activities | – 167 | – 100 |
| 11. | | Liabilities | | |
| 11a. | +/– | – to banks | 2,248 | – 297 |
| 11b. | +/– | – to customers | 2,448 | – 41 |
| 12. | +/– | Securitised liabilities | 1,353 | 5,236 |
| 13. | +/– | Other liabilities from operating activities | 139 | 87 |
| 14. | + | Interest and dividends received | 3,813 | 3,890 |
| 15. | – | Interest paid | – 3,560 | – 3,522 |
| 16. | + | Extraordinary cash receipts | – | – |
| 17. | – | Extraordinary cash payments | – | – 1 |
| 18. | +/– | Income tax payments | 8 | – |
| **19.** | **=** | **Cash flow from operating activities** | **2,456** | **2,563** |
| 20. | | Receipts from the disposal of | | |
| 20a. | + | – financial assets | 64 | 66 |
| 20b. | + | – tangible fixed assets | – | – |
| 21. | | Payments for investments in | | |
| 21a. | – | – financial assets | – 2,762 | – 2,881 |
| 21b. | – | – tangible fixed assets | – 3 | – 1 |
| 22. | + | Cash receipts from the disposal of consolidated companies and other business units | – | – |
| 23. | – | Cash payments for the acquisition of consolidated companies and other business units | – | – |
| 24. | +/– | Changes in cash funds due to other investing activities (net balance) | – 1 | – 4 |
| **25.** | **=** | **Cash flow from investing activities** | **– 2,702** | **– 2,820** |
| 26. | + | Cash receipts from issue of capital | 30 | 30 |
| 27. | | Cash payments to owners and minority shareholders | | |
| 27a. | – | – Dividends paid | – | – |
| 27b. | – | – Other distributions/cash payments | – 59 | – 39 |
| 28. | +/– | Changes in cash funds due to other capital movements (net balance) | 286 | 260 |
| **29.** | **=** | **Cash flow from financing activities** | **257** | **251** |
| **30.** | | **Cash funds at the beginning of the period** | **13** | **19** |
| 31. | +/– | Cash flow from operating activities | 2,456 | 2,563 |
| 32. | +/– | Cash flow from investing activities | – 2,702 | – 2,820 |
| 33. | +/– | Cash flow from financing activities | 257 | 251 |
| 34. | +/– | Effect on cash funds of exchange rate movements, changing in reporting entity structure and revaluation | – | – |
| **35.** | **=** | **Cash funds at the end of the period** | **24** | **13** |

## Coverage

### (31) Coverage by balance sheet item

| | Mortgage bonds 31 Dec 2006 € mn | Public-sector covered bonds 31 Dec 2006 € mn |
|---|---|---|
| **Ordinary cover** | **18,286** | **47,429** |
| **Loans and advances to customers** | **18,178** | **16,528** |
| Loans secured by property mortgages to customers | 18,178 | 293 *) |
| Communal loans to customers | – | 16,235 |
| **Loans and advances to banks** | **108** | **5,128** |
| Loans secured by property mortgages to banks | 108 | 848 *) |
| Loans to local authorities, to banks | – | 4,280 |
| **Bonds and other fixed-income securities** | **–** | **25,773** |
| **Extended cover** | **394** | **1,661** |
| **Loans and advances to banks** | **–** | **600** |
| Balances held with banks | – | 600 |
| **Bonds and other fixed-income securities** | **394** | **1,011** |
| **Derivatives in cover** | **–** | **50** |
| **Total** | **18,680** | **49,090** |
| Market value of hedging derivatives**) | – | – 4 |

*) under a municipal guarantee

**) negative market value of a cross currency swap employed to hedge the outstanding *Pfandbriefe*

### (32) Details pursuant to section 28 of the German Pfandbrief Act

### Outstanding *Pfandbriefe* and related cover assets

| a) Total amount of outstanding | Nominal amount 31 Dec 2006 € mn | Nominal amount 31 Dec 2005 € mn | Present value 31 Dec 2006 € mn | Present value 31 Dec 2005 € mn | Risk-adjusted present value*) 31 Dec 2006 € mn | Risk-adjusted present value*) 31 Dec 2005 € mn |
|---|---|---|---|---|---|---|
| Mortgage bonds | 16,999 | 18,114 | 17,538 | 19,209 | 17,103 | 18,691 |
| Cover assets pool | 18,680 | 19,257 | 19,545 | 21 122 | 18,778 | 20,335 |
| *of which: Derivatives* | *0* | *0* | *0* | *0* | *0* | *0* |
| **Excess cover** | **1,681** | **1,143** | **2,007** | **1,913** | **1,675** | **1,644** |
| **Excess cover (%)** | **9.9** | **6.3** | **11.4** | **10.0** | **9.8** | **8.8** |

*) When calculating stress scenarios, the static method is used for currencies and the dynamic method for interest rates.

| ad a) Maturity structure | Mortgage bonds 31 Dec 2006 € mn | Mortgage bonds 31 Dec 2005 € mn | Cover assets pool 31 Dec 2006 € mn | Cover assets pool 31 Dec 2005 € mn |
|---|---|---|---|---|
| up to 1 year | 2,373 | 2,877 | 2,313 | 2,875 |
| > 1 year to 5 years | 10,844 | 10,985 | 7,252 | 8,421 |
| > 5 years to 10 years | 3,459 | 4,191 | 7,808 | 7,134 |
| > 10 years | 323 | 61 | 1,307 | 827 |
| **Total** | **16,999** | **18,114** | **18,680** | **19,257** |

| b) Total amount of outstanding | Nominal amount 31 Dec 2006 € mn | Nominal amount 31 Dec 2005 € mn | Present value 31 Dec 2006 € mn | Present value 31 Dec 2005 € mn | Risk-adjusted present value*) 31 Dec 2006 € mn | Risk-adjusted present value*) 31 Dec 2005 € mn |
|---|---|---|---|---|---|---|
| Public-sector covered bonds | 46,896 | 42,280 | 47,890 | 44,694 | 45,913 | 42,843 |
| Cover assets pool | 49,090 | 43,832 | 50,800 | 47,159 | 48,696 | 45,073 |
| *of which: Derivatives* | *50* | *51* | *– 4* | *1* | *– 4* | *– 3* |
| **Excess cover** | **2,194** | **1,552** | **2,910** | **2,465** | **2,783** | **2,230** |
| **Excess cover (%)** | **4.7** | **3.7** | **6.1** | **5.5** | **6.1** | **5.2** |

*) When calculating stress scenarios, the static method is used for currencies and the dynamic method for interest rates.

| ad b) Maturity structure | Public-sector covered bonds 31 Dec 2006 € mn | Public-sector covered bonds 31 Dec 2005 € mn | Cover assets pool 31 Dec 2006 € mn | Cover assets pool 31 Dec 2005 € mn |
|---|---|---|---|---|
| up to 1 year | 6,829 | 2,842 | 6,475 | 4,544 |
| > 1 year to 5 years | 17,938 | 21,636 | 18,848 | 17,713 |
| > 5 years to 10 years | 15,119 | 11,490 | 16,292 | 16,109 |
| > 10 years | 7,010 | 6,312 | 7,475 | 5,466 |
| **Total** | **46,896** | **42,280** | **49,090** | **43,832** |

## Assets included in cover for mortgage bonds, by loan amount

| | Mortgages serving as cover 31 Dec 2006 € mn | Mortgages serving as cover 31 Dec 2005 € mn |
|---|---|---|
| up to € 300,000 | 14,429 | 15,120 |
| > € 300,000 to € 5 million | 2,278 | 2,435 |
| > € 5 million | 1,973 | 1,307 |
| **Total** | **18,680** | **18,862** |

**Assets included in cover for mortgage bonds, by country where real property collateral is located, and by type of property**

| € mn | Financial year | Austria | Belgium | Denmark | Federal Republic of Germany | France | Greece | Luxembourg | Netherlands | Norway | Portugal | Spain | Sweden | United Kingdom | **Total** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Commercial properties | 2006 | – | – | – | 7.7 | – | – | – | – | – | – | – | – | – | **7.7** |
| | 2005 | – | – | – | 6.1 | – | – | – | – | – | – | – | – | – | 6.1 |
| Commercial housing properties | 2006 | – | – | – | – | – | – | – | – | – | – | – | – | – | **–** |
| | 2005 | – | – | – | – | – | – | – | – | – | – | – | – | – | – |
| Residential properties | 2006 | 0.1 | 0.1 | – | 2,500.1 | 1.5 | – | – | 0.1 | – | – | – | – | 0.3 | **2,502.2** |
| | 2005 | 0.1 | 0.1 | – | 2,637.2 | 1.8 | – | – | – | – | – | – | – | 0.4 | 2,639.6 |
| Single-family homes | 2006 | 0.3 | 0.3 | 0.1 | 8,350.8 | 23.7 | – | – | 0.9 | – | 0.1 | – | – | 0.2 | **8,376.4** |
| | 2005 | 0.5 | 0.3 | 0.1 | 8,607.7 | 28.6 | – | – | 9.9 | – | – | – | – | 0.2 | 8,647.3 |
| Multi-family homes | 2006 | 0.1 | – | – | 2,999.0 | 0.4 | – | – | – | – | – | – | – | – | **2,999.5** |
| | 2005 | 0.1 | – | – | 3,243.8 | 0.6 | – | – | – | – | – | – | – | – | 3,244.5 |
| Office buildings | 2006 | 12.3 | – | 0.1 | 1,361.7 | 268.2 | – | 20.1 | 32.0 | – | – | – | 3.6 | 43.7 | **1,741.7** |
| | 2005 | 13.3 | – | 0.1 | 1,150.1 | 267.5 | – | 20.1 | 17.4 | – | – | – | 3.4 | – | 1,471.9 |
| Commercial buildings | 2006 | – | – | – | 596.8 | – | – | – | – | – | – | – | – | – | **596.8** |
| | 2005 | – | – | – | 318.5 | 8.2 | – | – | – | – | – | – | – | – | 326.7 |
| Industrial buildings | 2006 | – | – | – | 104.4 | – | – | – | – | – | – | – | – | – | **104.4** |
| | 2005 | – | – | – | 59.8 | – | – | – | – | – | – | – | – | – | 59.8 |
| Other ommercial properties | 2006 | – | – | – | 1,840.9 | 31.4 | – | – | – | – | – | – | 25.3 | – | **1,897.6** |
| | 2005 | – | – | – | 2,303.0 | 31.4 | – | – | 6.7 | – | – | 0.4 | – | – | 2,341.5 |
| Unfinished new buildings not yet yielding returns | 2006 | – | – | – | 59.4 | 0.5 | – | – | – | – | – | – | – | – | **59.9** |
| | 2005 | – | – | – | 124.2 | 0.7 | – | – | – | – | – | – | – | – | 124.9 |
| Securities | 2006 | – | – | – | 281.6 | – | 112.0 | – | – | – | – | – | – | – | **393.6** |
| | 2005 | – | – | – | 295.0 | – | 100.0 | – | – | – | – | – | – | – | 395.0 |
| **Total** | **2006** | **12.8** | **0.4** | **0.2** | **18,102.4** | **325.7** | **112.0** | **20.1** | **33.0** | **–** | **0.1** | **–** | **28.9** | **44.2** | **18,679.8** |
| | 2005 | 14.0 | 0.4 | 0.2 | 18,745.4 | 338.8 | 100.0 | 20.1 | 34.0 | – | – | 0.4 | 3.4 | 0.6 | 19,257.3 |

**Assets included in cover for mortgage bonds**
**Aggregate payments which are at least 90 days overdue**

| | 31 Dec 2006<br>€ mn | 31 Dec 2005<br>€ mn |
|---|---|---|
| France | 0.84 | 0.67 |
| Germany | 88.38 | 82.42 |
| Netherlands | – | 0.01 |
| **Total** | **89.22** | **83.10** |

**Assets included in cover for mortgage bonds**
**Forced sales/forced administration**

| | Commercial properties | | Housing properties | |
|---|---|---|---|---|
| | 2006<br>Number | 2005<br>Number | 2006<br>Number | 2005<br>Number |
| **No. 3a** | | | | |
| Forced sales pending | 281 | 287 | 1,141 | 1,063 |
| Forced administrations pending | 171 | 142 | 560 | 568 |
| of which: Included in forced sales pending | 100 | 122 | 493 | 462 |
| Forced sales executed | 72 | 128 | 696 | 1,628 |
| | Number | Number | Number | Number |
| **No. 3b** | | | | |
| Purchases of properties to prevent losses (foreclosed assets) | 1 | 1 | 4 | 9 |
| of which: Still part of cover assets | – | – | – | – |
| | € mn | € mn | € mn | € mn |
| **No. 3c** | | | | |
| Total arrears | 21.5 | 33.3 | 81.4 | 69.8 |
| of which: on interest due | 2.5 | 3.5 | 14.5 | 13.8 |
| | € mn | € mn | € mn | € mn |
| **No. 3d** | | | | |
| Repayments of mortgage loans | | | | |
| through redemption | 192.3 | 183.2 | 483.7 | 233.2 |
| through other forms of repayment | 501.8 | 294.9 | 1,649.0 | 648.8 |

**Assets included in cover for public-sector covered bonds,**
**by country of domicile of the borrower and, in the case of full guarantee, of the guarantor**

| € mn | Sovereign borrowers | | Regional public-sector entities | | Local public-sector entities | | Other borrowers | | **Total** | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 | **2006** | 2005 |
| Austria | 468 | 522 | 210 | – | – | – | 610 | 720 | **1,288** | 1,242 |
| Belgium | 340 | 340 | 98 | 15 | – | – | 15 | 74 | **453** | 429 |
| Canada | – | – | 537 | 318 | – | – | – | – | **537** | 318 |
| Cyprus | 7 | 7 | – | – | – | – | – | – | **7** | 7 |
| Czech Republic | 50 | 50 | – | – | – | – | – | – | **50** | 50 |
| Denmark | – | – | – | – | – | – | 44 | – | **44** | – |
| Finland | 157 | 157 | – | – | – | – | 115 | – | **272** | 157 |
| Federal Republic of Germany | 298 | 699 | 9,795 | 9,734 | 12,044 | 11,698 | 11,726 | 12,230 | **33,863** | 34,361 |
| France | 200 | 200 | 225 | 225 | – | – | 641 | 241 | **1,066** | 666 |
| Greece | 1,109 | 824 | 200 | – | – | – | – | – | **1,309** | 824 |
| Hungary | 82 | 82 | – | – | – | – | – | – | **82** | 82 |
| Iceland | 30 | 24 | – | – | – | – | – | – | **30** | 24 |
| Ireland | 100 | 100 | – | – | – | – | 95 | – | **195** | 100 |
| Italy | 985 | 988 | 771 | 434 | 125 | 25 | 123 | 57 | **2,004** | 1,504 |
| Latvia | 25 | 25 | – | – | – | – | – | – | **25** | 25 |
| Lithuania | – | – | 23 | 23 | – | – | – | – | **23** | 23 |
| Luxembourg | – | – | – | – | – | – | 201 | 200 | **201** | 200 |
| Netherlands | 150 | 150 | – | – | – | 8 | 353 | – | **503** | 158 |
| Norway | – | – | – | – | – | – | 118 | 20 | **118** | 20 |
| Poland | 83 | 83 | – | – | – | – | – | – | **83** | 83 |
| Portugal | 698 | 650 | 75 | – | – | – | 196 | – | **969** | 650 |
| Slovakia | 35 | 35 | – | – | – | – | – | – | **35** | 35 |
| Slovenia | 65 | 5 | – | – | – | – | – | – | **65** | 5 |
| Spain | 272 | 303 | 3,572 | 2,223 | 31 | 21 | 1,085 | 142 | **4,960** | 2,689 |
| Switzerland | – | – | 177 | 64 | – | – | 150 | – | **327** | 64 |
| United Kingdom | – | – | – | – | – | – | 414 | – | **414** | – |
| USA | – | – | 103 | 90 | 19 | 26 | 45 | – | **167** | 116 |
| **Total** | **5,154** | **5,244** | **15,786** | **13,126** | **12,219** | **11,778** | **15,927** | **13,684** | **49,090** | **43,832** |

**Assets included in cover for public-sector covered bonds**
**Aggregate payments which are at least 90 days overdue**

| | 31 Dec 2006<br>€ mn | 31 Dec 2005<br>€ mn |
|---|---|---|
| Germany | | |
| Sovereign states | – | – |
| Regional public-sector entities | 33.1 | – |
| Local public-sector entities | 0,4 | – |
| Other | – | 0.1 |
| **Total** | **33.5** | **0.1** |

# Other Information on the Annual Financial Statements

**(33) Other financial obligations as defined in section 285 no. 3 of the HGB**

Real estate leasing contracts entered into within the scope of sale-and-lease-back transactions involve leasing obligations in an aggregate amount of € 154.4 million until 2019.

**(34) Audit and consulting fees within the meaning of Section 285 no. 17 of the HGB**

In the 2006 financial year, € 1,301,000 was recorded as fee expenses for the auditor within the meaning of section 319 (1) sentences 1 and 2 of the HGB. Of this amount, € 1,237,000 is due to auditing services for the annual and six-month financial reports under HGB and IFRS (consolidated reporting package) and € 64 thousand is due to other consulting services.

**(35) Executive bodies of DG HYP**

**Supervisory Board**

Wolfgang Kirsch
Bank director
– Chairman (from 8 Mar 2006) –
(Deputy Chairman until 8 Mar 2006)

Dr. Alexander Erdland
Bank director
– Chairman –
(until 14 Feb 2006)

Dr. Christopher Pleister
President of the Federal Association of German Credit Unions and Rural Banking Cooperatives (BVR)
– Deputy Chairman –
(from 8 Mar 2006)

Dagmar Mines
Bank employee
– Deputy Chairman –

Peter Bade
Bank director

Maik Brammer
Bank employee

Hans-Jürgen Buhlert
Bank employee

Carl-Christian Ehlers
Bank director

Norbert Flaig
Bank director
(until 24 Jan 2006)

Heinz Gommans
Bank director
(until 8 Mar 2006)

Ralph Gruber
Bank employee

Rainer Kattinger
Bank director
(from 8 Mar 2006)

Klaus Kohlmorgen
Employee

Dietmar Küsters
Bank director

Dr. Matthias Metz
Bank director
(8 Mar 2006 to 7 May 2006)

Jens Meyer
Bank employee

Thomas Müller
Bank director

Manfred Nüssel
President of the German Raiffeisen Federation

Erich Schaller
Bank director

Herbert Schindler
Director Badischer Genossenschaftsverband e.V.
(*Association of Cooperative Banks in Baden*)

Martin Schmitt
Bank director

Diedrich Taaken
Bank director

Dietrich Voigtländer
Bank director

Frank Westhoff
Bank director
(from 01 Jul 2006)

Winfried Willer
Employee

**Management Board**

Hans-Theo Macke
Chairman (since 16 Nov 2006)
(Speaker until 15 Nov 2006)

Friedrich Piaskowski

Christian Sewing

**(36) Remuneration of the executive bodies**

| | 2006<br>€ 000's | 2005<br>€ 000's |
|---|---|---|
| Supervisory Board | 288 | 292 |
| Management Board | 1,813 | 1,675 |
| Former members of the Management Board or their surviving dependants | 1,596 | 1,601 |
| Provisions for current pensions and pension commitments for former members of the Members of the Management Board or their surviving dependants | 18,518*) | 16,008 |

* Increase mostly due to reduced discount interest rate

**(37) Loans to members of executive bodies**

| | 31 Dec 2006<br>€ 000's | 31 Dec 2005<br>€ 000's |
|---|---|---|
| Supervisory Board | 1,769 | 1,378 |
| Advisory Council | 2,357 | 2,401 |
| Management Board | 1,137 | 1,253 |

**(38) Offices held by members of the Management Board or members of staff in supervisory bodies of large limited companies**

As at 31 December 2006, members of the Management Board held the following offices in supervisory bodies of large limited companies:

**Hans-Theo Macke**

Bausparkasse Schwäbisch Hall AG, Schwäbisch-Hall: member of the Supervisory Board
VR Kreditwerk Hamburg – Schwäbisch Hall AG, Hamburg/Schwäbisch Hall: member of the Supervisory Board

**(39) Average number of employees**

| | Male | Female | 2006 Total | Male | Female | 2005 Total |
|---|---|---|---|---|---|---|
| **Total number of employees *)** | **371** | **223** | **594** | **343** | **239** | **582** |
| of which: Full-time employees | 367 | 188 | 555 | 341 | 207 | 548 |
| Part-time employees | | | | | | |
| Number | (7) | (61) | (68) | (5) | (58) | (63) |
| weighted | 4 | 35 | 39 | 2 | 32 | 34 |
| Vocational trainees (not included in total) | 13 | 8 | 21 | 13 | 9 | 22 |

*) Weighted in line with the hours worked.

**(40) Information about the parent company pursuant to section 285 no. 14 of the HGB**

The DZ BANK AG Deutsche Zentral-Genossenschaftsbank, Frankfurt/Main, prepares consolidated financial statements which incorporate the financial statements of DG HYP. The consolidated financial statements of DZ BANK are published in the electronic German Federal Gazette (*elektronischer Bundesanzeiger*).

Hamburg – Berlin, 15 February 2007

**Deutsche Genossenschafts-Hypothekenbank Aktiengesellschaft**

Macke Piaskowski Sewing

The following is an English translation of the Audit Opinion, which has been prepared on the basis of the German language version of the Financial Statements and the Management Report. The translation of the Financial Statements, the Management Report, and the Audit Opinion are provided for convenience; the respective German versions shall be exclusively valid for all purposes.

# AUDIT OPINION

We have audited the Financial Statements of Deutsche Genossenschafts-Hypothekenbank Aktiengesellschaft, Hamburg – Berlin (comprising the Balance Sheet, Profit and Loss Account, and the Notes to the Financial Statements), together with the accounting records, and the Management Report for the business year from 1 January to 31 December 2006. The company's statutory representatives are responsible for the accounting and the preparation of the Financial Statements and the Management Report in accordance with the German Commercial Code. Our responsibility is to express an opinion, having conducted an audit which included the accounting records, on the Financial Statements and the Management Report.

We conducted our audit in accordance with section 317 of the German Commercial Code, observing the generally accepted German auditing principles laid down by the Institute of Public Auditors in Germany (IDW). These standards require that we plan and perform the audit to obtain reasonable assurance on whether the Financial Statements (based on generally accepted accounting principles) and the Management Report are free of material misrepresentations and present a true and fair view of the net worth, financial position and results of the company. In determining specific actions within the scope of our audit, we considered the company's business activities as well as its economic environment and legal structure. Expectations regarding potential sources of error were also taken into account. The conduct of an audit includes examining the efficiency of the company's internal controlling mechanisms for its accounting system, as well as, on a sample basis, evidence supporting the disclosures in the accounting records, the Financial Statements and the Management Report. The scope of an audit also includes assessing the accounting principles used and significant estimates of the company's statutory representatives, as well as evaluating the overall presentation of the Financial Statements and the Management Report. We believe that our audit provides a sufficiently sound basis on which to make an assessment.

Our audit led to no objections.

In our opinion, which is based on the findings of our audit, the Financial Statements present, in compliance with applicable law and generally accepted accounting principles, a true and fair view of the company's net worth, financial position and results. The Management Report is in accordance with the Financial Statements, and gives a true and fair overall view of the company's situation and of any risks inherent to future developments.

Hamburg, 15 February 2007

**Ernst & Young AG**
**Wirtschaftsprüfungsgesellschaft**
**Steuerberatungsgesellschaft**

| | |
|---|---|
| Müller-Tronnier | Bühring |
| Wirtschaftsprüfer | Wirtschaftsprüfer |
| (German Chartered Accountant) | (German Chartered Accountant) |

# REPORT OF THE SUPERVISORY BOARD

In the 2006 financial year, the Supervisory Board and its committees monitored the Management Board’s management of the bank according to statutory regulations and those set out in the bank’s articles of association, and also took decisions on those transactions required to be presented to the Supervisory Board.

In fulfilling its tasks, and in accordance with statutory requirements, the Supervisory Board formed a Human Resources Committee, an Audit Committee and a Risk and Participations Committee. These Committees convened several times in 2006.

The Management Board reported to the Supervisory Board on the bank’s situation and growth and on general business regularly, in good time and comprehensively, both in writing and in verbal reports. In addition, the Management Board reported regularly to the Supervisory Board on ongoing business and future business policy including the bank’s strategic and organisational orientation.

The Supervisory Board also dealt with the bank's risk situation, as well as the further development of systems and methods to control market, counterparty and operating risks as well as additional key typical banking risks.

The Supervisory Board convened four times last year. In these meetings, the Supervisory Board received reports on the current situation of DG HYP via scheduled reports, and on work in the Committees in two of these meetings. In its constituting meeting on 8 March 2006, the Supervisory Board appointed Mr. Wolfgang Kirsch as its Chairman with immediate effect. In its ordinary meeting on 16 November 2006, the Supervisory Board appointed Mr. Hans-Theo Macke as Chairman of the Management Board (*Vorsitzender des Vorstands*); previously, Mr. Macke had chaired the Management Board in the capacity of its speaker (*Sprecher des Vorstands*).

Between meetings of the Supervisory Board, the Management Board informed it in writing of key transactions. In urgent cases, the Supervisory Board approved key transactions between its meetings by passing written resolutions.

In regular discussions with the Chairman of the Management Board outside the meetings, the Chairman of the Supervisory Board and the Chairman of the Audit Committee and the Risk and Participations Committee also discussed key decisions, particular transactions and the bank's business growth.

Ernst & Young AG Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft, Hamburg, presented a declaration of independence to the Supervisory Board and audited the annual financial statements as of 31 December 2006, including the accounting and management report of DG HYP for the 2006 financial year from 1 January 2006 to 31 December 2006 presented to it by the Management Board, and found these to be in line with statutory requirements. It issued an unqualified audit opinion. The audit reports were submitted to members of the Supervisory Board, and were discussed in detail. The Supervisory Board agreed to the results of the audit by the auditors.

The auditor participated in the Supervisory Board Meeting to adopt the annual financial statements according to section 171 (1) sentence 2 of the *Aktiengesetz* (AktG – German Public Limited Companies Act), and in the preparatory meetings of the Audit Committee and the Risk and Participations Committee, and reported on the key audit findings. He was available to answer the Supervisory Board's questions.

The Supervisory Board, and the Audit Committee formed from amongst its number, reviewed in detail the annual financial statements of DG HYP and the management report of DG HYP in their meetings, and acknowledged and approved the findings of the auditor's audit. They did not have any objections to the annual financial statements and the annual report, which includes the management report.

The Supervisory Board approved the financial statements of DG HYP prepared by the Management Board in its meeting on 8 March 2007. The financial statements are thus confirmed.

The Supervisory Board would like to thank the Management Board and all of the company's employees for their work during 2006.

Hamburg – Berlin, 8 March 2007

**Deutsche Genossenschafts-Hypothekenbank**
**Aktiengesellschaft**

The Supervisory Board

Wolfgang Kirsch
Chairman of the Supervisory Board

# CORPORATE BODIES AND COMMITTEES; EXECUTIVES

## Supervisory Board

**Wolfgang Kirsch**
Chairman of the Board of
Managing Director
DZ BANK AG Deutsche
Zentral-Genossenschaftsbank,
Frankfurt/Main,
Chairman

**Dr. Christopher Pleister**
President of the Federal Association
of German Credit Unions and
Rural Banking Cooperatives (BVR),
Berlin,
Deputy Chairman

**Dagmar Mines**
Deutsche Genossenschafts-
Hypothekenbank AG,
Hamburg,
Deputy Chairman

**Peter Bade**
Member of the Management Board,
Volksbank Lüneburger Heide eG,
Soltau

**Maik Brammer**
Deutsche Genossenschafts-
Hypothekenbank AG,
Hamburg

**Hans-Jürgen Buhlert**
Deutsche Genossenschafts-
Hypothekenbank AG,
Hamburg

**Carl-Christian Ehlers**
Chairman of the Management Board,
Kieler Volksbank eG,
Kiel

**Ralph Gruber**
Deutsche Genossenschafts-
Hypothekenbank AG,
Hamburg

**Jürgen Handke**
Member of the Management Board,
VR Bank Hof eG,
Hof

**Rainer Kattinger**
Chairman of the Board
of Management,
Stuttgarter Volksbank AG,
Stuttgart

**Klaus Kohlmorgen**
VR Kreditwerk
Hamburg – Schwäbisch Hall AG,
Hamburg

**Dietmar Küsters**
Chairman of the Management Board,
Volksbank Straubing eG,
Straubing

**Jens Meyer**
Deutsche Genossenschafts-
Hypothekenbank AG,
Hamburg

**Thomas Müller**
Chairman of the Management Board,
Dresdner Volksbank
Raiffeisenbank eG,
Dresden

**Manfred Nüssel**
President of the German
Raiffeisen Federation,
Berlin

**Herbert Schindler**
Director
Badischer Genossenschafts-
verband e.V.
(*Association of
Cooperative Banks in Baden*),
Karlsruhe

**Martin Schmitt**
Chairman of the Management Board,
Kasseler Bank eG Volksbank
Raiffeisenbank,
Kassel

**Diedrich Taaken**
Chairman of the Management Board,
Volksbank Esens eG,
Esens

**Dietrich Voigtländer**
Member of the Board
of Managing Directors,
DZ BANK AG Deutsche
Zentral-Genossenschaftsbank,
Frankfurt/Main

**Frank Westhoff**
Member of the Board of
Managing Directors,
DZ BANK AG Deutsche
Zentral-Genossenschaftsbank,
Frankfurt/Main

**Winfried Willer**
VR Kreditwerk
Hamburg – Schwäbisch Hall AG,
Hamburg

Updated: 1 April 2007

## Management Board, Department Heads

**Management Board**
and distribution of responsibilities

**Hans-Theo Macke**
Chairman

- Sales – Cooperative Sector
- Product Management & Control – Cooperative Sector Sales/Retail
- Corporate Communications and Strategy
- Human resources
- Internal Audit
- Legal
- Information Technology
- Organisation and Cost Management

**Friedrich Piaskowski**

- Commercial Real Estate Finance
- Treasury
- Credit Treasury
- Product Management and Research – Commercial Real Estate Finance/ Capital Markets
- Acquisition Sales Partners
- Administration

**Manfred Salber**

- Credit Risk Management Commercial Real Estate Finance/ Credit Treasury
- Credit Risk Management Retail
- Credit Coordination
- Finance/Controlling
- Treasury Settlements

**Department Heads**

**Markus Bolder**
Credit Treasury

**Sibylle von Brunn**
Human resources

**Georg Friedrich Doll**
Commercial Real Estate Finance

**Oliver Eulrich**
Credit Coordination

**Detlef Gäßler**
Credit Risk Management
Retail

**Sven Henkel**
Organisation/
Information Technology

**Stefan Lachnit**
Sales – Cooperative Sector

**Dr. Thomas Müller**
Finance/Controlling

**Hartmut Rahner**
Treasury

**Dr. Cornelius Riese**
Organisation and
Cost Management

**Jan-Uwe Schadendorf**
Acquisition Sales Partners

**Siegfried Schneider**
Treasury Settlements

**Oliver Schwier**
Product Management & Control –
Cooperative Sector Sales/Retail

**Gerd Speckmann**
Administration

**Frank Stöfer**
Credit Risk Management
Commercial Real Estate Finance/
Credit Treasury

**Dr. Olaf Streuer**
Corporate Communications and
Strategy

**Peter Vögelein**
Internal Audit

**Eckhard Wulff**
Legal

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## Trustees, Advisory Council

### Trustees

**Dr. Michael Labe**
Judge at the Hamburg
Higher Regional Court
(*Hanseatisches Oberlandesgericht Hamburg*),
Hamburg

**Volker Thilo**
Deputy trustee, certified public accountant and tax adviser,
Hamburg
(from 1 May 2006)

**Hans-Georg Herrmann**
Deputy Trustee
Member of the Management Board (rtd.) of the State Central Bank for the Free Hanseatic City of Hamburg, Mecklenburg-West Pomerania and Schleswig-Holstein
(Main Office of Deutsche Bundesbank),
Hamburg
(until 30 Apr 2006)

**Dr. Peter Lassen**
Deputy Trustee
Presiding Judge at the Hamburg
Higher Regional Court
(*Hanseatisches Oberlandesgericht Hamburg*),
Hamburg

### Advisory Council

**Meinolf Bäcker**
Member of the Management Board,
Volksbank Arnsberg-Sundern eG,
Arnsberg

**Dr. Dr. Claus Becker**
Chairman of the Management Board,
Volksbank Darmstadt eG,
Darmstadt

**Willi Braun**
Member of the Management Board,
Aachener Bank eG,
Aachen

**Bernhard Carl**
Member of the Management Board,
H + G Bank Heidelberg Kurpfalz eG,
Heidelberg

**Wolfgang Eckert**
Member of the Management Board,
VR-Bank eG,
Regen

**Enno Emmerinck**
Member of the Management Board,
Volksbank Hamburg Ost-West eG,
Hamburger Bank von 1861
Volksbank eG,
Hamburg

**Dr. Rolf Flechsig**
Member of the Management Board,
Berliner Volksbank eG,
Berlin

**Alfred Foistner**
Chairman of the Management Board,
Raiffeisenbank Oberschleißheim eG,
Oberschleißheim

**Klaus Geurden**
Chairman of the Management Board,
Volksbank Krefeld eG,
Krefeld

**Manfred Geyer**
Chairman of the Management Board
RaiffeisenVolksbank eG
Gewerbebank,
Ansbach

**Willi Göttsche**
Member of the Management Board,
Raiffeisenbank eG,
Bad Bramstedt

**Peter Heinrich**
Chairman of the Management Board,
Münchner Bank eG,
Munich

**Dietmar Herderich**
Chairman of the Management Board,
Raiffeisenbank Mutlangen eG,
Mutlangen

**Ulrich Jakobi**
Chairman of the Management Board,
Volksbank Wetzlar-Weilburg eG,
Wetzlar

**Michael Joop**
Member of the Management Board,
Volksbank Hameln-Stadthagen eG,
Hameln

**Dr. Franz G. Leitner**
Chairman of the Management Board,
Volksbank Freiburg eG,
Freiburg

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## Advisory Council

**Andreas Mann**
Member of the Management Board,
Volksbank Regensburg,
Regensburg

**Rudolf Müller**
Chairman of the Management Board,
Volksbank Bonn Rhein-Sieg eG,
Bonn

**Lothar Peters**
Member of the Management Board,
Raiffeisenbank Ratzeburg eG,
Ratzeburg

**Hans-Werner Reuter**
Member of the Management Board,
Dithmarscher Volks- und
Raiffeisenbank eG,
Heide

**Wilhelm Rippen**
Member of the Management Board,
Raiffeisenbank Wesermarsch-Süd eG,
Brake

**Tilman Römpp**
Member of the Management Board,
Volksbank Bautzen eG,
Bautzen

**Alfred Salz**
Member of the Management Board,
Volksbank Rhein-Wupper eG,
Leverkusen

**Elmar Stender**
Chairman of the Management Board,
Volksbank Marl-Recklinghausen eG,
Marl

**Gerd Streuber**
Member of the Management Board,
Volksbank Hildesheimer Börde eG,
Söhlde-Hoheneggelsen

**Günther Wainowski**
Member of the Management Board,
Vereinigte Volksbank AG
Böblingen/Sindelfingen –
Schönbuch – Calw/Weil der Stadt,
Sindelfingen

**Horst Weyand**
Chairman of the Management Board,
Volksbank Nahetal eG,
Bad Kreuznach

**Rolf Witezek**
Member of the Management Board,
Volksbank Mittelhessen eG,
Gießen

Updated: 1 April 2007

# DG HYP OFFICES

## Deutsche Genossenschafts-Hypothekenbank AG

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**10117 Berlin, Germany**
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## Real Estate Centres for commercial investors

**DG HYP**
**Berlin Real Estate Centre**
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**DG HYP**
**Dusseldorf Real Estate Centre**
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**DG HYP**
**Frankfurt Real Estate Centre**
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**DG HYP**
**Hamburg Real Estate Centre**
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**DG HYP**
**Munich Real Estate Centre**
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**DG HYP**
**Stuttgart Real Estate Centre**
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## Representative offices

**DG HYP**
**London Representative Office**
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**DG HYP**
**New York Representative Office**
Jean Barden
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