Disclosure Report of HSH Nordbank according to § 26a KWG
Reporting date: 31 December 2008

HSH NORDBANK

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LIST OF ABBREVIATIONS

ABCP	Asset-backed commercial paper
ABS	Asset-backed securities
ABSE	Ancillary banking services enterprises (Section 1(3c) German Banking Act)
AIRBA	Advanced Internal Ratings Based Approach
AktG	Aktiengesetz (German Stock Corporation Act)
ALCO	Asset Liability Committee
AMA	Advanced Measurement Approach
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)
Basel II	Basel Framework Agreement
BU	Business unit
CCF	Credit conversion factor
CDS	Credit default swaps
CFO	Chief Financial Officier
CI	Credit institution (Section 1(1) German Banking Act)
CIP	Credit Investment Portfoilio
CLD	Credit loss database
CLLP	Country loan loss provisions
CLN	Credit linked notes
CMST	Capital Markets Structuring & Trading
CRO	Chief Risk Officer
CRA	Credit risk analyzer
DakOR	Operational risk data consortium
DCF	Discounted cash flow
DQM	Data quality management
DRS	Deutsche Rechnungslegungs Standards (German Accounting Standards)
DSGV	Deutscher Sparkassen- und Giroverband (German Association of Savings Banks and Giro Banks)
DV-System	Data processing system
EAD, EaD	Exposure at default (gross loan volume at the date of default)
EL	Expected loss
ECB	European Central Bank
FCR	Foreign currency rating
FE	Financial enterprise (Section1(3) German Banking Act)
Fitch	Fitch Ratings
FSI	Financial services institution (Section 1(1a) German Banking Act)
GLLP	General loan loss provisions
GmbHG	GmbH-Gesetz (German Limited Liability Companies Act)
HGB	Handelsgesetzbuch (German Commercial Code)
IAA	Internal Assessment Approach
ICAAP	Internal Capital Adequacy Assessment Process
IdW	Institut der Wirtschaftsprüfer (Institute of Certified Public Accountants)
IFRS	International Financial Reporting Standard
IRB	Internal Rating Based
IRBA	Internal Rating Based Approach
ISDA	International Swaps and Derivatives Association
KPI	Key performance indicators
CRM	Credit Risk Management
CRSA	Credit Risk Standardised Approach

KWG	Gesetz über das Kreditwesen / Kreditwesengesetz (German Banking Act)
LBO	Leveraged buyout
LCR	Local currency rating
LGD	Loss given default
LLC	Limited liability company
LP	Limited partnership
Ltd	Limited
LvaR	Liquidity Value-at-Risk
LWB	Country value adjustment
M	Maturity
MaRisk	Minimum Requirements for Risk Management
Moody's	Moody's Investors Service
NPNM	New products – new markets
OECD	Organisation of Economic Cooperation and Development
OR	Operational risk
P&L	Profit & Loss
PD	Probability of default
PWB	Lump sum value adjustments (including lump sum provisions)
PQC	Process quality controlling
RaRoC	Risk adjusted return on capital
RBA	Rating Based Approach
RCP	Risk coverage potential
RSU	RSU Rating Service Unit GmbH & Co. KG
RW	Risk weight
RWA	Risk-weighted assets
SFA	Supervisory Formula Approach
SLLP	Specific loan loss provisions
SoFFin	Sonderfonds Finanzmarktstabilisierung (German Financial Market Stabilisation Fund)
SolvV	Solvabilitätsverordnung (German Solvency Regulation of 14 December, 2006, as amended on 14 December, 2007)
S & P	Standard & Poor's
SPC	Special purpose company
S Rating	Sparkassen Rating und Risikosysteme GmbH
t	time (index)
TWR	Träger wirtschaftlichen Risikos (Bearer of economic risk)
VaR	Value-at-Risk
VÖB	Bundesverband öffentlicher Banken Deutschlands (German Association of Public Sector Banks)
WpHG	Wertpapierhandelsgesetz (German Securities Trading Act)

1 INTRODUCTION

Since 1975 the Basel Committee on Banking Supervision has been establishing international rules to be applied for harmonising the capital adequacy of banks. Based on the "Basel Accord" (Basel I) of 1988 the objective of Basel II is to relate the capital requirements much more to the risk incurred and to take into account new developments in the financial markets. Basel II was transposed into EU law by the Directive 2006/48/EC (Banking Directive) and Directive 2006/49/EC (Capital Adequacy Directive). It was transposed into German law through amendments made to the German Banking Act ("Kreditwesengesetz" or "KWG") and the implementation of the new German Regulation on Solvency ("Solvabilitätsverordnung" or "SolvV")[1]. This came into force on 1 January 2007 and completely replaced the regulations regarding the previous Principle 1 following a one year transitional period on 1 January 2008.

The disclosure requirements of SolvV and/or the third pillar of the Basel Framework Agreement supplement the minimum capital requirements (Pillar 1) and the regulatory monitoring process (Pillar 2). The objective is to strengthen the market discipline of the credit institutions. This shall be achieved through a series of new disclosure requirements that enable market participants to assess core information on the scope of application, equity capital, risk positions, the risk management process and procedures and, derived from this, the appropriateness of the capital adequacy of the institution. In principle, disclosures are made at Group level. Section 26a of the German Banking Act in conjunction with Part 5 of the SolvV constitutes the statutory basis of disclosure at the national level in Germany.

In November 2007 HSH Nordbank was the first federal state bank (Landesbank) and at the same time one of the first European credit institutions to receive permission to apply the Advanced IRB Approach. The disclosure requirements under Basel II are now met for the first time in this report for the financial year ending December 31, 2008.

The disclosure report prepared in accordance with § 320 (1) SolvV will be published under "Investor Relations" on the HSH Nordbank's website at www.hsh-nordbank.de. The date and communication medium of the publication will be communicated to the supervisory authorities and will be announced electronically in the Federal Gazette.

[1] Regulation on the appropriate capital adequacy for institutions, groups of institutions and finance holding groups (Solvency Regulation - SolvV), as of 21 December 2007, Sections 319 to 337.

2 SCOPE OF APPLICATION

HSH Nordbank AG is the parent institution of the HSH Nordbank group of institutions (subsequently HSH Nordbank) within the meaning of Section 1 (7a) KWG. Those entities belonging to the Group, which form part of the regulatory consolidation group pursuant to Section 10a (1) and (2) KWG are to be reflected in the disclosures. The consolidation group recognised for financial accounting/reporting purposes under International Financial Reporting Standards (IFRS) as described in the annual report of the HSH Nordbank Group for the financial year ending December 31, 2008 differs from the regulatory principles of consolidation.

In Table 44 (see appendix, chapter 10) the consolidation principle pursuant to Section 323 (1) no. 2 SolvV as well as the difference between the regulatory and IFRS consolidations are described. All entities to be consolidated and their allocation to the regulatory and/or financial accounting consolidation group are listed. The entities are allocated to entity types for the purposes of the regulatory consolidation on the basis of the definitions set out in Section 1 KWG. The entities listed in Table 44 under the accounting consolidation basis are fully consolidated as at the reporting date, proportional or at-equity consolidation is not relevant for HSH Nordbank.

Those subsidiaries deducted from the equity capital of the HSH Nordbank Group are also shown in the table. The Bürgschaftsbank Schleswig-Holstein GmbH is the only subsidiary defined as a financial institution in accordance with § 1 (1) KWG. With reference to § 320 (1) SolvV the Bürgschaftsbank is classified as immaterial. Therefore, HSH Nordbank abstains from calculating the capital deficit that otherwise would have to be disclosed pursuant to § 325 SolvV. A capital deficit is defined as the amount by which the current equity capital is lower than the regulatory capital required.

Next to the parent institution, HSH Nordbank AG, the regulatory consolidation group includes 137 entities. The financial accounting consolidation group comprises 57 entities. 28 entities and/or portfolios are included in the financial accounting consolidation report but not in the regulatory consolidation group due to their business activities. These are taken into account as risk-weighted positions for regulatory purposes. 108 entities, included in the basis of consolidation for regulatory purposes, are not taken into account in the financial accounting consolidation for reasons of immateriality.

HSH Nordbank applies Section 31 (3) KWG to the entities listed below and does not include these in the consolidation under the exemption pursuant to Section 10a (6) to (12), Section 12a (1) sentence 1 and Section 13b (3) and (4) KWG:

- HSH N Real I GmbH, Kiel
- Verwaltungs- und Treuhandgesellschaft von 1963 mbH, Kiel
- HSH Invest S.A., Luxembourg
- Kieler Förde-Verwaltungsgesellschaft mbH, Kiel
- HSH Baltic Sea GmbH, Kiel
- HSH N Real II GmbH, Kiel
- HSH Immobilien Management GmbH, Kiel
- Yara Sourcing Oy, Helsinki
- RELAT Beteiligungs GmbH & Co. Vermietungs-KG, Munich
- DANUS Grundbesitzverwaltung GmbH (ASG), Munich.

In principle the basis underlying all qualitative and quantitative information to be disclosed is the regulatory group of institutions pursuant to Section 10a KWG. Separate reference is made at the respective places in the report regarding any exceptions to this. The German Commercial Code (“Handelsgesetzbuch” or “HGB”) is applied to determine the regulatory capital adequacy of HSH Nordbank and consequently also to the disclosures.

In accordance with § 320 (1) SolvV all information disclosed within this report are subject to the principle of materiality. Information which is legally protected and/or confidential and the disclosure thereof could harm HSH Nordbank’s competitive position are not part of the disclosure report.

Provided that data from the accounting systems are presented in the Disclosure Report, in particular with regard to the risk provisions (Section 327 SolvV), HSH Nordbank has decided regarding the internal bank definition of group entities to be consolidated to disclose material subsidiaries in addition to HSH Nordbank AG for the purposes of presentation in the Disclosure Report. These are HSH Nordbank Securities S.A., HSH Nordbank Private Banking S.A. and HSH Real Estate AG.

2.1 RESTRICTIONS ON OR OBSTACLES TO THE TRANSFER OF FINANCIAL RESOURCES OR LIABLE CAPITAL WITHIN THE GROUP

With regard to the regulatory capital adequacy of subsidiaries, in which there are other shareholders in addition to the HSH Nordbank Group, a change in capital and/or own funds requires the approval of the co-shareholders and their respective committees.

In the case of subsidiaries, which are also credit institutions, changes in capital must be approved, where necessary, by the appropriate banking supervisory authorities. This applies, for example, to subsidiaries in the USA, in which the HSH Nordbank Group has an equity holding of more than 5% and for which the regulations of the US banking supervisory authorities must be complied with. Statutory restrictions such as, for example, the capital maintenance regulations as defined in the Limited Liability Companies Act (GmbHG) and the German Stock Corporation Act (AktG) are to be adhered to by domestic subsidiaries, on the basis of which a free capial reserve can only be repaid with difficulty in the course of the fiscal year.

With the exception of the above-mentioned restrictions as well as the statutory and regulatory requirements there are no other restrictions based on contractual agreements within the HSH Nordbank Group that have to be taken into account.

2.2 EXERCISE OF THE WAIVER RULE

Pursuant to Section 6 SolvV as well as Section 10 (1e) KWG all domestic institutions must provide evidence of the adequacy of their regulatory capital to the German Bundesbank by means of reporting forms. An individual report needs not be submitted in the case of a subordinated entity of the Group, provided that the conditions referred to in Section 2a of the KWG are met (so called waiver rule).

As at 31 December 2008 there are no other domestic institutions within the regulatory consolidation group of the HSH Nordbank Group, apart from HSH Nordbank AG, that meet the conditions pursuant to Section 2a of the KWG. The option referred to above is not currently being exercised.

3 CAPITAL STRUCTURE AND CAPITAL REQUIREMENTS

3.1 STRUCTURE OF REGULATORY CAPITAL

The structure of own funds is presented below in accordance with Section 10, 10a KWG. The consolidated regulatory capital for the institutional Group is determined on the basis of the aggregation procedure pursuant to Section 10a (6) KWG. The regulatory capital comprises core capital (Tier 1), supplementary capital (Tier 2) and Tier 3 capital. The elements of core capital (Tier 1) within the meaning of Section 10 (2a) KWG are listed in detail in Table 1 in accordance with Section 324 (2) SolvV. The supplementary capital (Tier 2) of HSH Nordbank consists primarily of contingency reserves in accordance with § 340f HGB, liabilities under profit participation rights and long-term subordinated liabilities. Tier 3 funds comprise subordinated liabilities that cannot be classified as supplementary capital for regulatory purposes because § 10 (2) sentence 4 KWG stipulates a capping.

Regulatory capital item	Amount
Subscribed capital	1,817
Reserves (capital reserve and other allocable reserves)	3,939
Interim profit (or interim loss)	-
Assets contributed by silent partners	2,385
Special reserves for general banking risks in accordance with Section 340 g of the HGB	1,052
(-) Other country-specific core capital components less other positions to be deducted under Section 10 (2a) sentence 2 of the KWG	-33
Total core capital in accordance with Section 10 (2a) of the KWG	**9,160**
Total amount of supplementary capital in accordance with Section 10 (2b) of the KWG and of Tier 3 funds in accordance with Section 10 (2c) of the KWG	5,379
Total amount of the positions to be deducted in accordance with Section 10 (6) and (6a) of the KWG of which value adjustment shortfalls and expected losses in accordance with Section 10 (6a) nos. 1 and 2	-1,616 -1,242
Total amount of modified available capital in accordance with Section 10 (1d) sentence 1 of the KWG and of allocable Tier 3 funds in accordance with Section 10 (2c0 of the KWG	**12,923**

Table 1: Structure of regulatory capital in € m

3.2 TERMS AND CONDITIONS OF REGULATORY CAPITAL INSTRUMENTS

As at the reporting date the regulatory capital instruments of the HSH Nordbank Group mainly comprise the following:

- The subscribed capital amounts to Euro 1,817 million. The entities to be consolidated in the regulatory consolidation group have different types of share capital depending on the legal form.
- The reserves of Euro 3,989 million consist of capital reserves (Euro 3,167 million) and other allocable reserves (Euro 772 million). Silent participations were allocated in the amount of Euro 2,385 million.
- The supplementary capital amounts to Euro 4,787 million and comprises reserves allocated in accordance with Section 340 f of the HGB, liabilities under profit participation rights and long-term subordinated liabilities. The claims of the holders of the profit participation rights for repayment of the profit participation capital are subordinate to other claims. Profit participation capital in the total amount of Euro 139 million, not including the profit participation certificates not allocable under regulatory requirements, is allocated to supplementary capital.
- Subordinated liabilities were issued in the form of loan notes, registered or bearer bonds and are denominated in Euro, US Dollar and Japanese Yen. The original maturities range from five to 40 years. The interest rates payable are between 1.6% and 6.5% p.a. In total there are subordinated liabilities in the amount of Euro 5,172 million, of which Euro 4,580 million was included in supplementary capital as at the reporting date.
- Tier 3 funds in the amount of Euro 592 million consist solely of subordinated liabilities that were not taken into account for regulatory purposes.

An annual distribution is payable on assets contributed by silent partners, which, according to the structure of the agreement, is dependent either on the annual net income for the year or the distributable profit. No distributions were made on the silent participations in the reporting year due to the net loss reported for the year and an insufficient distributable profit. Silent participations held by shareholders of the Bank participate to the amount of Euro 351 million in the net loss for the year. For the most part the silent participations are for an indefinite period and cannot be cancelled by the investors. HSH Nordbank has the right to cancel on a regular basis after the expiry of an agreed minimum period of time that is subject to the approval of the German Federal Financial Supervisory Authority (“Bundesanstalt für Finanzdienstleistungsaufsicht or “BaFin“).

Detailed information on the terms and conditions on the allocable components of equity capital are set out in Table 2.

Own funds instrument	Allocable total amount in € million	Residual maturity < 5 years in € m	Residual maturity > 5 years in € m	∅ Residual maturity in years	∅ Interest rate in %
Core capital					
Ordinary shares of HSH Nordbank AG	**881**	**-**	**-**	**-**	**-**
Allocable share capital of other entities included in the regulatory consolidation group	**936**	**-**	**-**	**-**	**-**
Silent participation, variable interest rate, fixed maturity	**-**	**-**	**-**	**-**	**-**
Silent participation, variable interest rate, indefinite maturity	**976**	**-**	**-**	**-**	**-**
Silent participation, fixed interest rate, indefinite maturity	**1,266**	**-**	**-**	**-**	**7.8**
Silent participation, fixed interest rate, fixed maturity	**143**	**118**	**25**	**6**	**6.8**
Silent participations (summary account of smaller participations)	**-**	**-**	**-**	**-**	**-**
Supplementary capital					
Preference shares	**-**	**-**	**-**	**-**	**-**
Profit participation certificates	**139**	**139**	**-**	**2**	**7.0**
Subordinated liabilities (before utilisation of § 10 Abs. sentence 2 of the German Banking Act (KWG)).	**5,172**	**302**	**4,870**	**10**	**4.3**

Table 2: Terms and conditions of own funds instruments

3.3 REGULATORY CAPITAL REQUIREMENTS

Since the beginning of 2008 HSH Nordbank has determined the amount of regulatory capital backing required for counterparty default, market and operational risks on the basis of SolvV. Following the approval from the supervisory authority the counterparty default risk positions are determined using the Advanced IRB Approach. The Bank is consequently applying the same parameters already being used internally in risk management and counterparty default risk management for regulatory reporting and is utilising the associated capital relief. The amounts allocated to market risk positions are determined in accordance with the Standardised Approach. Operational risk is taken into account under the Standardised Approach. The procedures used to calculate the regulatory capital requirement are listed for each of the counterparty default risks.

The total own funds requirement of Euro 8,942 million is the sum of the amounts allocated to counterparty default, market and operational risks (see Table 3 pursuant to Section 325 (2) SolvV). Positions deducted from equity capital are not taken into account here as a capital requirement. Pursuant to the Bundesbank circular B 40-5 / B 410-1 65.2.229.13 the data disclosed under Section 325 SolvV is geared towards the information in the reporting forms.

Counterparty default risk	Regulatory capital requirement
CSRA	
Central governments	**5**
Regional governments and local municipalities	**0**
Other public institutions	**0**
Multilateral development banks	**0**
International organisations	**0**
Institutions	**68**
Covered bonds issued by credit institutions	**5**

Counterparty default risk	Regulatory capital requirement
Companies	1,513
Retail banking	44
Positions secured by real estate	51
Investment certificates	112
Other positions	27
Past due positions	70
Advanced IRB Approach	
Central governments	46
Institutions	386
Retail banking	-
Companies	4,939
Other non-credit related assets	13
Securitisations	
Securitisations under the CSRA	156
Securitisations under the Advanced IRB Approach	110
Risks arising on equity holdings	
Equity holdings based on the continued use of the old methodology/grandfathering	114
Equity holdings excluded from the IRBA on a permanent basis or for a limited period	0
Equity holdings in accordance with market approaches (IRBA)	134
Simple risk weight approach	97
Listed equity holdings	23
Not listed, but belonging to a sufficiently diversified portfolio	24
Other equity holdings	50
Model-based method	0
Equity holdings in accordance with the PD-LGD approach	37
Market risk in the trading book	
Market risk in accordance with the	
Standardised Approach	857
Settlement risk	
Settlement risk	0
Operational risk	
Operational risk in accordance with the	
Standardised Approach	291
Total[1]	8,942

[1] The differences in amounts are due to rounding off of figures

Table 3: Regulatory capital requirements in € m

3.3.1 Credit risk

HSH Nordbank determines internally the risk parameters required to calculate the risk weight using the Advanced IRB Approach (see chapter 5.9.1). However, as part of the temporary and/or permanent partial use, the Standardised Approach to credit risk is applied on a temporary and/or permanent basis to individual portfolios as well as to subsidiaries that are to be consolidated (see chapter 2). For this reason the information on the regulatory capital requirement for credit risk is broken down between the Advanced IRB Approach and the Standardised Approach to credit risk as well as into receivable classes in accordance with the approaches applied.

Due to the special treatment applied to equity holdings and securitisations the regulatory capital requirement for these portfolios are separately disclosed. In the case of equity holdings there is an option available to determine the regulatory capital backing using the PD-LGD approach, the simple risk weight method or a model-based methodology. Furthermore the equity holdings already held prior to 1 January 2008 and are consequently “grandfathered” (portfolio protection) pursuant to Section 338 (4) SolvV can be excluded from the Advanced IRB Approach until Dezember 31, 2017 and treated in accordance with the rules applicable to the Standardised Approach to credit risk. These are also separately disclosed. The total regulatory capital required for counterparty default risk amounts to Euro 7,794 million.

3.3.2 Market risk

HSH Nordbank is currently applying the Standardised Approach for the purposes of determining the regulatory capital requirement for market risk pursuant to Section 294 et seqq. SolvV. The regulatory capital requirement for market risk amounts to Euro 857 million as at the reporting date.

3.3.3 Operational risk

HSH Nordbank applies the Standardised Approach pursuant to Section 272 et seqq. SolvV for the purposes of determining the regulatory capital requirement for operational risk. In total there is a regulatory capital requirement for the Group of € 291 million as at the reporting date.

3.4 ADEQUACY OF REGULATORY CAPITAL

The adequacy of regulatory capital is determined based on the above-mentioned structure of regulatory capital and the risk-weighted assets (RWA). The overall capital requirements are defined pursuant to Section 3 (1) in conjunction with Section 2 (6) SolvV. The overall capital ratio are expressed in RWA terms for default, market and operational risks in relation to the regulatory capital. The allocable regulatory capital to be applied in the calculation is the total of the modified available capital and the Tier 3 funds utilised (Section 2 (6) sentence 3 SolvV). The prescribed minimum overall ratio is 8.0%. The core capital ratio includes the RWA for default, market and operational risks in relation to the core capital (Tier 1) pursuant to § 10 (2a) KWG.

The overall capital ratio of both the HSH Nordbank Group as well as the subsidiaries (see Chapter 2), which are obligated to individually report the overall solvency ratio in their respective national countries of domicile, were always in excess of the prescribed minimum-overall capital ratio.

In addition to the overall numbers for the Group the solvency ratios are disclosed at the individual entity level in Table 4 pursuant to Section 325 (2) No. 5 SolvV for the following entities:

- HSH Nordbank AG, Hamburg / Kiel
- HSH Nordbank Securities S.A., Luxembourg
- HSH Nordbank Private Banking S.A., Luxembourg

Company	Overall ratio in %	Core capital ratio in %
HSH Nordbank Group	11.6	7.5
HSH Nordbank AG	11.9	7.7
HSH Nordbank Securities S.A.	14.4	13.0
HSH Nordbank Private Banking S.A.	16.9	9.6

Table 4: Capital ratios of the HSH Nordbank Group

The HSH Nordbank Group as well as HSH Nordbank AG revert to HGB data for the purposes of determining the overall capital requirements. However, pursuant to the provisions stipulated by the Luxembourg Supervisory Authority (Circulaire CSSF 06/251 – circular issued by the Luxembourg Financial Sector Supervisory Commission), HSH Nordbank Securities S.A. and HSH Private Banking S.A. must prepare their solvency ratios and reports on the basis of International Financial Reporting Standards (IFRS). For this reason the overall (equity funds) and core capital ratios of both these subsidiaries to be shown in the Disclosure Report are also based on IFRS financial data.

4 RISK MANAGEMENT

HSH Nordbank sees active risk management as a fundamental component of its overall bank management. In the year under review, the Bank began to systematically work through the starting points as identified during the financial crisis to further improve its risk processes, such as strengthening the back-office functions.

HSH Nordbank defines risk as unfavourable future developments that may have an adverse impact on the Bank's asset, earnings or liquidity situation. Distinctions are made between default risks, market risks, operational risks, liquidity risks and other risks. A Risk Manual, which is published throughout the Bank, sets out the methods and instruments used in risk management. Furthermore HSH Nordbank has a standardised risk reporting system geared to the risk strategy.

4.1 STRATEGIES AND PROCESSES

As part of the strategy process carried out in 2007 the Management Board set the Bank's business strategy for 2008. One of the results obtained from this process was the determination of the business segments as well as the definition of core, growth and supplementary transactions. It was also determined which activities should not be continued in the future. The strategic objectives of HSH Nordbank for 2010 resulted from this process. Given the background of the crisis in the financial markets the fundamentals of the business strategy were called into question and revised from mid-2008 onwards. The business segments were subdivided into the "core bank", "non-strategic portfolios" and "winddown portfolio" categories. Limitations in the areas of equity capital and refinancing were the primary drivers behind the new positioning.

The risk strategy is determined annually by the Management Board based on the results obtained from the strategy and planning process and is therefore built upon the strategic direction set for HSH Nordbank. It is the starting point for the fundamental, organisational and strategic direction of risk management at HSH Nordbank. Risk management is based on a continuous process. This consists of five stages – risk identification, risk analysis and assessment, risk management, risk monitoring and risk reporting. Economic capital forms the basis of the risk management process. In addition to risk-bearing capacity considerations and the management of concentration risk, the risk-adjusted process for managing the business (profit centre reporting) as well as risk reporting is based as at the reporting date on economic capital, whereby the regulatory capital requirements continue to set the general framework to be applied.

Risk Strategy

The risk strategy includes the planned development of the Bank's business activities, specifically taking into account the risk-bearing capacity, the strategic company objectives and the risk assessments specific to business segments. The risk strategy is formulated and updated annually on the basis of the results obtained from the strategy and planning process for the individual business segments. The Management Board is responsible for approving and making any necessary adjustments to the risk strategy. The Supervisory Board is informed of the risk strategy. In addition to the committees the risk strategy is also distributed to all employees of the Bank, as the strategy constitutes a framework for their actions.

The risk strategy is an important tool of the Bank's risk culture. It is supplemented by the Credit and Risk Manuals that contain detailed descriptions of the process-related and methodological rules. The guiding principle behind the risk strategy is to ensure that the risk-bearing capacity is maintained. HSH Nordbank has specifically integrated the safeguarding of the risk-bearing capacity into its internal risk management process (see below). The components required for the Internal Capital Adequacy Assessment Process (ICAAP) are implemented in a Bank-wide limit system.

Risk-bearing capacity

The risk-bearing capacity consists of two components: the risk coverage potential in the narrower sense (taking into consideration the liquidity maturity transformation risk) as well as the insolvency risk. The insolvency risk is separately calculated and managed by means of liquidity maturity statements (see chapter 8).

To monitor its risk-bearing capacity and to safeguard it in a sustainable way, HSH Nordbank has integrated a capital adequacy process into its risk management. The management of risk-bearing capacity is closely related to equity capital and value added management. The economic capital required to protect against unexpected losses (overall risk) is regularly compared with the available risk coverage potential (risk-bearing capacity in the narrower sense). This comparison takes place within an integrated limit system which forms the basis for economic risk limitation across the Group. In addition to ensuring economic management and limitation, the regulatory requirements relating to equity capital backing are also met.

Risk coverage potential is derived on the basis of the net asset value approach. In addition to equity capital (including changes in the net asset value), the net asset value approach also includes unrealised gains and losses on securities, equity holdings and lending activities, and negative effects on the income statement. A global limit for the overall risk is derived from the planned risk coverage potential for the year; individual limits for default, market, operational and liquidity risks are then determined on this basis. As not all of the risk coverage potential is allocated to the fundamental risk types, a buffer remains that is used to cover other risks.

The overall risk takes into account the default risk, market risk, operational risk and liquidity risk. The different types of risk are aggregated using a consistent method on the basis of a Value-at-Risk approach to determine the overall economic risk. The overall risk represents the level of aggregated unexpected losses within a period of one year that, with a probability of 99.9 % in normal market conditions, is not expected to be exceeded. During the aggregation of the various risk types to determine the overall risk, no risk-reducing correlations are applied.An analysis of the risk bearing capacity and the resulting risk limits is carried out quarterly as well as within the framework of the Bank's yearly planning process.

Risk monitoring for individual risk types is performed mainly in the relevant limit systems through an ongoing review of the limit utilisation. A limit excess for the risk type arising on the calculation of the risk-bearing capacity results in an ad-hoc recommendation for action being made within the reporting frequency to the Asset Liability Committee (ALCO) as well as to the Management Board. Default risk is monitored – in accordance with the Global Head principle (see below) – within operating limits at the level of the individual business areas. A loss limit is allocated to the portfolio level for the purposes of monitoring market risk. Allocation to limits is based on the daily measurement of the Value-at-Risk (VaR). As a reaction to the liquidity shortage in the markets HSH Nordbank developed a VaR approach for the first time as early as the end of 2007 to quantify the liquidity maturity transformation risk and implemented it on 1 January 2008. This long-term/structural liquidity risk represents the risk of an increase in refinancing costs from open liquidity items. The risk of the inability to pay, which represents during the current crisis in the financial markets the more important aspect of liquidity risk for the Bank compared to the maturity transformation risk, is not supported by the risk coverage potential, as it is not possible to quantify it as a loss amount. Information, amongst other things, regarding the management of the risk of the inability to pay is contained in chapter 8 "Liquidity risk". Since the beginning of 2008 operational risk has been determined in accordance with the Standardised Approach as defined in the SolvV.

In order to be able to better estimate the effects of potential crises on the overall risk situation of HSH Nordbank above and beyond considering the risk coverage potential utilisation at the balance sheet date, the Bank introduced regular stress tests in 2008, which simulate the increase in economic capital required in special default, market and liquidity risk scenarios. In addition a corresponding reduction in the risk coverage potential and in the global limit derived from this potential is also imputed. At the reporting date, the overall Group risk as determined under these stress conditions exceeded the reduced global limit. The risk coverage potential buffer was entirely used up.

The Bank's risk coverage potential dwindled considerably at the end of 2008, in particular due to the write-downs of the credit investment portfolio, additional burdens triggered by the financial crisis (e.g. Lehman and Iceland) and increased risk provisioning in the lending business in comparison to 2007. There was virtually no more risk-bearing capacity at the end of 2008 due to the accumulated annual deficit. Although the banking group's equity funds ratio of 11.6 % was still considerably higher than the regulatory minimum of 8 %, there was a real risk that this loss situation would result in the regulatory minimum not being met. Moreover, the utilisation of the guarantee already approved by the SoFFin is tied to, among other things, the requirement that the Bank guarantees a minimum Tier 1 capital ratio of 7 % (including market risk items). Taking the capitalisation measures and restructuring measures approved of by the shareholders into account, the supervisory authority chose not to consider the losses accumulated in the year under review. For these reasons, and taking into account the assessment of the Bank's future development, the Bank entered into talks on equity-related measures with its shareholders in the fourth quarter of 2008. The planned capital increase of EUR 3 billion will be considered in full within the Bank's 2009 risk coverage potential. In addition, the financial guarantee of EUR 10 billion planned within this context will significantly bolster the Bank's regulatory capital ratio and will restore it's risk-bearing capacity.

Risk-adjusted business management

For the purposes of managing its business HSH Nordbank uses an internal key ratio system through which the profitability of the business segments is to be monitored. At HSH Nordbank the value added (also referred to as excess profit) is used as the central key ratio for the value-based measurement of profitability of the business segments as well as of individual transactions and products.

The value added is determined by means of a multi-level contribution margin calculation. In this calculation the liquidity, risk, processing and capital costs are deducted from the gross income generated. The critical success factors regarding the value added are managed by means of additional key performance indicators (KPI), amongst which are, for example, the new business margin and the cross-selling ratio in the business segments.

The income reported in the contribution margin calculation conforms for the most part to the disclosure and recognition requirements of the IFRS regulations. As a result the internal measurement of profitability is geared to the requirements of the capital markets.

4.2 STRUCTURE AND ORGANISATION

There are clear rules in the Bank concerning responsibilities within the framework of the risk management process. The overall responsibility for risk management in the Bank lies with the Management Board. This also includes the methods and procedures to be applied for measuring, managing and monitoring risk. The Management Board annually sets the risk strategy of the Bank (see above) as part of its overall responsibilities.

The risk and financial responsibilities of the Chief Risk Officer (CRO) and the Chief Financial Officer (CFO) were combined again in the reporting year under a single member of the Management Board. As a member of the Management Board, the CRO is responsible for risk controlling, including risk monitoring and back-office functions in the Bank's lending business. Accordingly, he is responsible for the business units (BUs) Group Risk Management and Credit Risk Management. The CRO makes decisions independently of the Management Board members responsible for front-office and trading units. This ensures the functional separation of front-office and trading activities, on the one hand, and risk controlling, settlement and control and back-office activities, on the other, at all organisational levels of the Bank, as stipulated by the relevant regulatory requirements. The CRO regularly reports to the Management Board and the Supervisory Board's Risk Committee on the Group's risk situation.

Active risk management is carried out in particular in the front-office and trading units whose business activities mean that they are directly responsible for risks and results. Management of business segments on a worldwide standardised basis is achieved through the application of a decentralised Global Head principle. Based on this the Global Heads – mainly Heads of BUs – are responsible worldwide for the active management of the business segments assigned to them and/or administration and services. The Global Head principle applies to the same extent to risk controlling, so that the future enhancement of the risk controlling process is ensured on a coordinated group wide basis.

The Asset Liability Committee is responsible not only for managing the Bank's overall strategic positions, but also for managing its risk-bearing capacity during the course of the year and for equity-related measures. It is made up of the CFO / CRO, the Board Member responsible for the Capital Markets segment, the head of Group Treasury, the heads of the Finance and Group Risk Management divisions and the head of a front-office unit granting the loan.

The methods and instruments for measuring, managing and monitoring risk are developed by Risk Controlling within the Group Risk Management unit. It ensures that the main risks to which the Group is exposed remain transparent and manageable. In September 2008, the Bank resolved to wind down its credit investment portfolio as market conditions permit and in such a way as to minimise the ensuing losses. Since October 2008, the Group Risk Management division has been centrally responsible for overseeing the winddown.

Other components of the monitoring system, that is independent of trading, are BUs Transaction Services, Credit Risk Management and Internal Audit. Settlement of and control over trading transactions are the responsibility of BU Transaction Services. Credit Risk Management covers all the independent back-office credit risk functions. These include preparing a second risk assessment, examining and determining the rating, calculating the value of collateral and defining the processes and rules for the Bank's lending activities. Internal Audit is an instrument established by the Management Board and is required to report directly to that body. It performs risk-oriented, process-independent audits of the effectiveness and suitability of risk management. Internal Audit plays a supporting role in key projects, whilst maintaining its independence and avoiding any conflicts of interest. BU Legal and Group Compliance is an independent unit which monitors the Bank's legal and compliance risks.

The Bank has stipulated rules according to which any transactions involving new products or new markets must be subject to a formal auditing process, with a view to ensuring that any such products can be mapped in the relevant systems and that they are in line with the relevant processes. Transactions of this nature may only be concluded with the approval of the Management Board.

As part of Group-wide risk management, each of the relevant subsidiaries is taken into account when managing and controlling individual types of risk.

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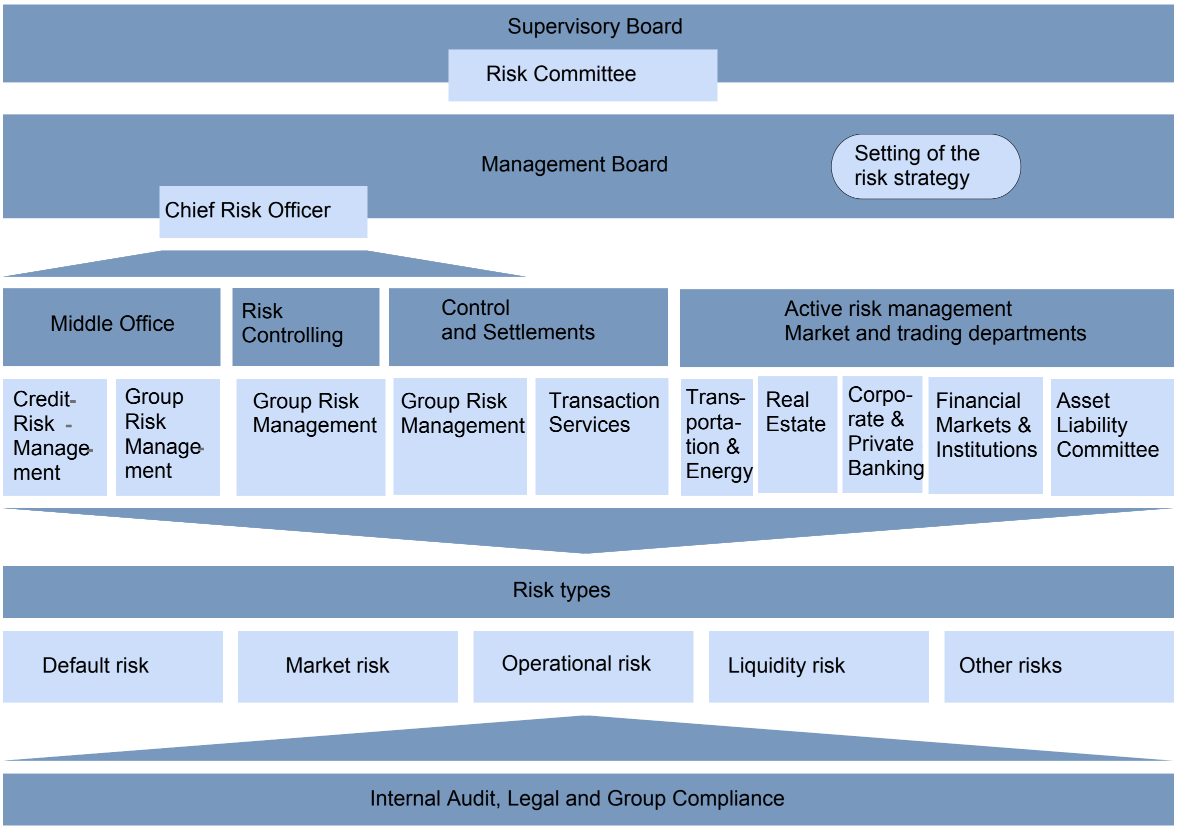

Figure 1: Organisational structure of risk management at HSH Nordbank

The Bank began to significantly advance its risk management at the end of 2007. The first step it took was to establish BU Group Risk Management in October 2007, which has assumed responsibility for managing HSH Nordbank's restructuring and workout exposures independently of the market segments. Since October 2008, this has also included credit investment business (Credit-Investment-Portfoilio). The effects of the crisis on the Bank were to some extent attenuated in the year under review through the Bank limiting its market activities for the duration of 2008. HSH Nordbank's systems, processes and organisation were defined anew, in particular for risk management in the area of capital markets. There are plans to implement the corresponding changes in 2009. In addition, since October 2008, the Credit Risk Management division has been further developing the Bank's loan approval process. The objective is to strengthen the back-office activities, which should maintain a balance between risk and targeted revenue in cyclical transactions in particular. All in all, these measures will play a major part in further developing the Bank's risk culture.

As a committee of the Supervisory Board, the Risk Committee exercises a control function with regard to all actions taken by risk management. In the year under review the Risk Committee met seven times and was also provided with information on the risk position of the Group on a quarterly basis by means of a risk report.

HSH Nordbank's strategic realignment

In the light of the significant burdens created by the global financial crisis, HSH Nordbank has initiated a far-reaching strategic realignment in order to maintain the Bank as a going concern. The aim is to strategically focus on sustainably strong business areas in the home region of Hamburg / Schleswig-Holstein and on attractive international sectors. The strategic realignment also entails a significant cost reduction for the HSH Nordbank Group. In addition to the curtailment of operating expenses, staff reductions are on the agenda as well. The structural amendments that this constitutes are being made in four main areas:

- Creation of a core bank with sustainable business areas. In summary, the activities of the core bank are structured as follows: A regional focus will be placed on corporate and real estate clients, private banking and savings banks. A sectoral focus will be placed on the following business segments: shipping, transport:

in particular aviation and transportation infrastructure, renewable energy as well as capital market activities which include auxiliary capital market business, in particular for the core areas and for institutional clients.

- Hiving off non-strategic portfolios and portfolios to be wound down. As part of its strategic realignment, HSH Nordbank has consequently identified non-strategic lines of business. These include its commodity finance activities with foreign clients, its corporate clients business in Asia and Scandinavia, its refinancing of leasing companies, its capital market activities not directly relating to clients, and the portfolios that entail too much risk potential for the smaller core bank (e.g. credit investment portfolio, leveraged finance business, real estate in the USA). These are all to be separated from the Bank's core areas. In addition to gradually winding down portfolios by loan redemptions and significantly downsizing new business, the Bank is also exploring the options of selling or transferring portfolios.
- Targeted risk shielding and adequate capitalisation: The shareholders Hamburg and Schleswig-Holstein have spoken in favour of increasing the share capital of HSH Nordbank AG by EUR 3 billion and shielding the Bank against risks, to give the core bank firm foundations and to meet capital requirements – especially those of the Special Fund Financial Market Stabilization (SoFFin). The Bank's major assets (reference portfolio) are expected to be shielded by the capital increase and by a secured financial guarantee of EUR 10 billion through a public-law institution to be established specifically for the purpose.
- Implementation of a comprehensive restructuring plan: Based on the key elements of its new business concept, HSH Nordbank devised a restructuring plan in the first quarter to take the necessary steps towards implementing the measures in the various Bank divisions. The Bank's realignment goes hand in hand with measures to improve its primary banking functions and steering and risk management processes.

4.3 BASIC PRINCIPLES REGARDING THE HEDGING OR REDUCTION OF RISK

At HSH Nordbank the assumption of risk is subject to the superordinate principle of risk-bearing capacity (see above). The hedging or reduction of risk as well as the continuous monitoring of measures taken to hedge or reduce risk are managed at the individual risk type level. Details on the measures taken for each relevant risk type are set out in the following chapters.

4.4 RISK REPORTING

The manner and scope of risk reporting is geared to the risk strategy and follows a uniform concept that is applied to all reports. This overall concept creates the conditions whereby the reporting is aimed at the recipient. It is thereby ensured that resources are utilised optimally, and inefficiencies and any overlapping in reporting as well as management errors caused by inconsistent data are avoided.

Reports are produced at different intervals. Reports produced monthly enable information relevant to the management process to be forwarded promptly to the recipients. Reports produced quarterly and annually support the management, planning processes and the strategy. BUs Group Risk Management and Finance are responsible for the content and dissemination of the reports on the overall risk and the individual risk types as well.

In Table 5 reports on the overall risk taking into account the relevant subsidiaries pursuant to the requirements of MaRisk, ICAAP and SolvV are listed. The recipients of the Group-wide risk reports are as a rule the Management Board, the Risk Committee and ALCO as well as to a restricted extent the Heads of the BUs and the Supervisory Board. The reports are supplemented by specialised, internal reports.

The risk report constitutes the core element of risk reporting to the Management Board and the Risk Committee. It is prepared quarterly and shows the overall risk position of HSH Nordbank together with detailed information on the default, market, operational and liquidity risk types. Furthermore it contains as part of the MaRisk compliant reporting, amongst other things, statements on the development of the loan portfolio, the available risk coverage potential as well as the degree of utilisation, the scope and development of new business as well as the movement in the risk provisions.

In addition to the Group-wide risk reporting there are reporting tools based on the risk type, which are described in the following chapters.

Report	Recipient	Interval	Content	Objective
Risk Strategy	Management Board, Supervisory Board/ Risk Committee overall bank	Annually	Overall bank perspective of all types	Description of the organisational and strategic direction of risk management; presentation of the planned development of all material business activities from a risk strategy perspective and taking into account the risk-bearing capacity in particular.
Risk Report in the Annual Report	The public, (potential) investors rating agencies	Annually	Risk management system; risk-bearing capacity; methods, processes, key ratios for the material risk types	Presentation of the risk situation of the Bank and the adequacy of its management; gradual, quantitative expansion as part of the enhancement of the Risk Report for the Risk Committee; compliance with the requirements under DRS, IFRS and HGB.
Risk Report	Management Board, Supervisory Board/ Committee	Quarterly	View of the overall bank Default risk Market risk Operational risk Liquidity risk Across the board topics	Core element of the reporting of risk to the Management Board and the Risk Committee; reporting medium for adhering to the risk strategy, also contains analyses of individual risks in addition to portfolio analyses; consolidated presentation of contents relevant for the management process which are derived from the internal and external reporting objectives (e.g. utilisation of the global limit and the Principle I ratio); ongoing enhancement of the internal management process in line with the requirements of the capital markets
Risk Report in the Interim report	The public, (potential) investors rating agencies	Quarterly	The risk situation of the Bank	Presentation of the material changes to the risk position of the Bank and the adequacy of its management compared to the last report
Management Report for ALCO	ALCO	Monthly	Liquidity position of the Bank, Management of capital and risk-bearing capacity, P&L situation	Information on the management of capital and risk-bearing capacity
Profit centre accounting	BUs' customer units, BU Heads, decentralised controllers	Monthly	Important management information	Management of the BUs

Table 5: Reports on the overall risk

5 DEFAULT RISK

In view of HSH Nordbank's strong orientation towards the lending business, entering into, managing and limiting default risks represents one of the Bank's key tasks. The default risk is broken down into credit, country, equity holding and settlement risks. In addition to traditional credit risk, credit risk also includes counterparty and issuer risk. Settlement risk consists of advance payment risk and processing risk. All the elements of default risk referred to are taken into account within the context of the management of equity capital. Additional management measures are in place for concentration risks (in particular at the borrower / country level) and equity holding risks.

The structure and the methods for managing default risks are constantly optimised to reflect changes in market conditions and new regulatory requirements.

5.1 ORGANISATION OF DEFAULT RISK MANAGEMENT

The organisational structure of HSH Nordbank means that, for the lending business, it is possible to separate front-office from back-office and risk controlling functions at all levels up to the Management Board.

- Active risk management is carried out in particular in the front-office and trading units whose business activities mean they are directly responsible for risks and results.
- In order to ensure a common credit policy and quality of risk assessment in the lending business, the tasks of the independent non-market units are concentrated under the BU Credit Risk Management. This includes organisation of the second risk assessment, rating review and setting, determination and review of collateral values, design of processes and regulations for the Bank's lending business as well as quality assurance of the loans intended as cover stock in accordance with the German Pfandbrief Act and special responsibilities of trustees.
- The model chosen by HSH Nordbank for the separation of functions in the loan approval process reflects its strategic orientation as a client-driven bank focusing on special-purpose finance business. Any loan approval requires a high-quality risk analysis as part of the front-office unit assessment as well as a second risk assessment on the part of the back-office unit. The back-office unit is therefore responsible for performing independent, uniform quality assurance for risk assessment within the Bank's loan approval process. In the event of any discrepancy between the front-office and back-office assessments, a decision is reached by means of an escalation process.
- HSH Nordbank makes use of the option to dispense with back-office risk assessment for all lending business classified as non-risk-relevant that involves certain transaction types and for loans below certain amounts, as set out by the opening clause in the Minimum Requirements for Risk Management (MaRisk). Like the competency levels for assessment and loan approval, the definition of non-risk-relevant lending is in accordance with the "economic capital required" parameter.
- Operations in the lending area are based on the rules and internal guidelines set out in the HSH Nordbank Credit Manual, particularly the lending, competence, risk assessment, rating, collateral and LGD guidelines and the guidelines on the monitoring of exposure, the value calculation guidelines and the guideline on the definition of default[2], which describes the main principles of the Bank's lending and credit monitoring activities. Under these principles, credit risks recorded in accordance with the extended definition as set out in Section 19 (1) of the German Banking Act (KWG) are viewed and treated individually according to the collateral provided, the type of loan, the rating class and the particular type of credit risk. This is based on the aggregate exposure of the HSH Nordbank Group to the borrower unit in accordance with Section 19 (2) KWG. For this purpose, the relevant borrower is always the economic risk bearer.
- With regard to the distinction between secured and unsecured loans, the types of collateral considered

[2] An overview of the different guidelines is provided in Table 45 (see appendix, chapter 10.2).

acceptable by the Bank are set out in the Bank's collateral and LGD guidelines. Compliance with the requirements of the German Solvency Regulation (e.g. identifiable market value, ability to realise collateral value, no correlation with secured loan, legal enforceability, matching of maturities) is taken into account. The list of recognised forms of collateral may be expanded by means of a review by a market-independent team of specialists from the BUs Credit Risk Management, Group Risk Management and Legal and Group Compliance.

- Management of individual credit risks is supplemented in particular by rules governing the monitoring of exposure and the early detection of risks.
- Group Risk Management is responsible for the independent monitoring of risks at the portfolio level, independent reporting, managing problem loans and country risks, the processing and management of cases of restructuring and liquidation, and risk provisioning.
- To ensure Group-wide controlling of default risks, the relevant subsidiaries HSH Nordbank Securities S.A., HSH Real Estate AG and HSH Nordbank Private Banking S.A. are included in risk reporting.

5.2 MANAGEMENT OF DEFAULT RISK

Default risks account for the largest part of the risk potential of HSH Nordbank. The Bank has developed an advanced range of instruments to enable it to analyse, evaluate and actively manage these risks. Further information on risk assessment methods can be found in chapter 5.9.3.

Rating process/LGD

During the initial development of various internal rating modules and during their further development and ongoing validation, HSH Nordbank collaborates closely with other banks. This takes place via RSU Rating Service Unit GmbH & Co. KG within the association of federal state banks and also in collaboration with Sparkassen Rating und Risikosysteme GmbH (SR), a subsidiary of the German Savings Bank Association ("Deutschen Sparkassen- und Giroverband" or "DSGV").

RSU, which was founded in 2003 as a result of a cooperation between federal state banks aimed at developing internal rating procedures, is a subsidiary of the nine participating banks and is responsible for the creation, uniform management and development of rating systems complying with banking regulatory quality requirements and for the operation of the rating modules in a uniform IT environment. In its activities, RSU is provided with methodological and technical support by specialists from the participating banks. In addition to the rating modules managed by RSU, HSH Nordbank also makes use of rating methods which are provided, managed and developed by SR.

The Bank uses an identical rating master scale for all modules (Table 31, page 39) which not only allows comparison of differing portfolio segments but also mapping with external ratings. The internal guidelines are adapted continuously to new methodological developments and validations; the mapping is verified accordingly.

Credit Conversion Factors (CCF) are empirically observed and applied to determine the contingent liabilities and commitments anticipated in the event of a default. The loan amount outstanding weighted with a CCF is called Exposure at Default (EaD). To forecast the Loss Given Default, HSH Nordbank has developed a differentiated LGD method for lending and trading transactions for all business segments. Item-specific collateral recovery rates and borrowerspecific recovery rates are estimated on the basis of historical loss information. The default amount is calculated on the basis of the EaD using the LGD. The LGD and CCF procedures were assessed and further developed as part of the annual validation process in the year under review.

The Bank pursues an approach of ensuring that the methods newly developed and refined with Basel II in mind are not only applied to determine the regulatory capital required, but are also incorporated in full at an early stage into the internal management system. This means that all of the parameters relating to Basel II form the basis for the integrated approach to overall bank management and risk management at HSH Nordbank. For example, the results of the rating and LGD estimates are used in pricing calculations and in determining competencies. They are also factored into the Bank's integrated risk limitation system and its planning and strategy processes.

Stress tests

HSH Nordbank regularly carries out stress tests to determine the economic capital required for default risks. The risk parameters that are relevant to the calculation of the economic capital required are varied, e.g. the expected probabilities of default and default rates are altered. It can then be ascertained whether the risk limit budgeted for the default risks is complied with, by considering the relevant stress scenarios. These stress tests also serve to meet the regulatory requirements of the German Solvency Regulation.

Early warning system

HSH Nordbank operates an early warning system on a daily basis to identify credit rating risks for publicly listed companies. Firstly, quantitative indicators (e.g. share prices, sales volume, volatility, etc.) are applied to identify potential problematic entities. Then an initial analysis is performed for risk relevance according to quantitative and qualitative aspects. A defined monitoring and decision process is implemented ad hoc for all cases classified as being at risk. This is done within a very narrow time frame with clearly defined competences for market and non-market units.

The development of a comparable process to monitor CDS spreads is well underway and has returned stable results in trial operation. This will increase the significance and coverage of the Bank's monitoring portfolio.

Monitoring information on equity capital and borrowed capital through share prices and CDS spreads is the first pillar of the monitoring portfolio at HSH. HSH has recognised the significance of early warning and monitoring and intends to expand this process considerably. The objective is to monitor on the basis of both internal and external information in order to be able to capture borrowers outside the capital market in particular.

Concentration risk

Concentration risks must be effectively limited for both regulatory and economic reasons. To manage and monitor concentration risk effectively at the borrower and country level, corresponding upper limits for economic capital have been set. These upper limits were determined on the basis of the risk coverage potential using a credit portfolio model which considers the portfolio granularity. At least once a year, the upper limits are examined on the basis of the Bank's risk-bearing capacity and approved by the Management Board in accordance with the risk strategy. Sector and rating class-specific concentration risks are monitored within an integrated limit system. This allows for early identification of unwelcome developments and the implementation of corresponding countermeasures.

With regard to the limiting of concentration risks at the borrower level, the decision on any new lending business which would result in the upper limit being exceeded lies with the Management Board. The Management Board and the Risk Committee were informed about all cases where upper limits had been exceeded in new and existing business, as well as about any measures introduced, as part of the quarterly risk report.

A further limitation of the concentration risks is effected at the regulatory borrower entity level (in accordance with Section 19 (2) KWG) as part of the internal large risk management. The process used for managing large risks ensures compliance with the regulatory limits for large loans at both the bank and banking group level, and allows the Bank to detect potentially excessively large loans at an early stage and take suitable precautionary measures before they actually arise. Conventional lending and trading activities are also subject to limitations.

Country risk

HSH Nordbank considers country risk to mean the risk of agreed payments either not being made at all or only made in part or with a delay on account of state restrictions on cross-border payments (transfer risk). The risk is not related to the debtor's rating.

The limitation of country risk represents an additional management dimension within the context of managing concentration risks. The risks of foreign lending transactions are managed using economic capital. Fundamental risk drivers taken into account in the measurement of the country risk include the rating and LGD of the country where an economic risk applies. The country ratings and country LGDs are based on a method that was developed as part of the joint project by the regional banks / RSU. Furthermore, portfolio granularity aspects are taken into account in order to correctly represent cluster effects.

The concentration risks for all countries at the Group level are limited by the country upper limits for economic capital derived from the risk-bearing capacity. In addition, for countries in which the Bank has its core business areas, limits are also defined by the Management Board at the global head level, taking strategic importance into account. The utilisation of limits is monitored centrally on an ongoing basis by the division responsible for country risk management.

In view of the worsening of the financial market crisis, country risk management identified high-risk countries that are expected to be particularly hard hit by the negative macroeconomic effects of the crisis. Strict limitations have been implemented for these high-risk countries and these are subject to ongoing examination. The country risk concept of this limitation comprises all country risks, and is therefore more extensive than the consideration of the transfer risk described.

Securitisation

The securitisation of loan portfolios is a fundamental instrument of HSH Nordbank's risk management. There was very limited scope for effecting such transactions for the whole of 2008, since the securitisation markets were as good as illiquid. The principal aim of transactions carried out by the Bank since 2004 was risk transfer. This was achieved by means of synthetic securitisation through entering into Credit Default Swaps (CDS) and issuing and placing Credit-Linked Notes (CLN). The Bank's securitisation portfolio is explained in detail in chapter 5.7.

Equity holding risk

Equity holding risk is understood to mean the danger of a financial loss due to value impairments on equity holdings. Under regulatory requirements, equity holdings must either be consolidated, deducted from equity capital or backed with equity as an asset in the equity holdings class. In this context, regulatory law regards equity holding risk as a subcategory of default risk.

Equity holding controlling therefore focuses on the continuous monitoring and management of risks arising from equity investments, as well as the ongoing review of profitability in terms of the return on investment and RAROC in particular. The new regulatory requirements (SolvV) are applied for this purpose. In the course of the KPI-based analysis of profitability, a uniform calculation of the return from individual equity investments is used as an early warning indicator.

Investment guidelines are applied in order to ensure that quantitative targets are already in place when a participation is acquired, and that compliance with these targets is monitored continuously. In addition, the strategies of the companies in which equity interests are held are examined to ensure that they are consistent with the Bank's own strategic objectives. Furthermore, due diligence reviews are conducted as part of an examination of the equity interest to analyse the opportunities and risks intensively.

Regular reporting on the development of business and the economic position of the companies is carried out at varying intervals and intensities, according to the importance of this information for the Bank. In addition, partnership agreements are formulated in such a way as to ensure that the Bank can assert as much management influence as possible over its equity holdings. The Bank also takes steps to ensure that it is represented in the supervisory bodies of particularly important companies. The Bank's participation portfolio is explained in detail in chapter 5.8.

Underlying conditions: Financial market crisis and economic downturn

From the fourth quarter 2008 onwards the real economic sector was influenced by the financial markets crisis as well. This effect, which is not directly related to the origins of the subprime crisis, lead to noticeably downgrades in the classic lending business/portfolios of HSH Nordbank. The market environment for syndication worsened as well. In the course of the financial market crisis, the expected losses in 2008 were taken into account through value adjustments or impairments to profit or equity. As a gauge of unexpected losses, the economic capital required increased as a result of the rating downgrades in the shipping, industry and credit investment portfolios (see also chapter 5.9.9).

HSH Nordbank do not believe that the end of the increase in corporate spreads is near. This is first and foremost influenced by the unclear economic development in the medium term, the increasing probability of state defaults and the soaring default rates in the corporate sector. While the banks have thus far mainly experienced writedowns due to depreciation on the back of the economic crisis, they will probably now increasingly suffer from loan losses triggered by the economic slump.

The Bank's loan approval process was thoroughly analysed as part of the measures implemented by the Bank as a result of the financial market crisis. To strengthen its back-office activities, the Management Board decided that the most important procedural and organisational measures to further develop this process would be implemented in 2009.

5.3 REPORTS ON DEFAULT RISK

In general, reporting of HSH Nordbank on default risk is integrated in the reports on the overall exposure of the Bank (see chapter 4.4).In addition HSH Nordbank uses different regular reporting tools to report exclusively on counterparty default risks (see Table 6). These reports are supplemented with information on the monitoring and management of country risk (see Table 7).

Report	Recipient	Interval	Content	Objective
Internal validation reports (RSU rating modules, LGD and CCF)	Rating multipliers, Supervisory Authority, Management Board	Quarterly	Default risks	Provision of information for recipients and fulfilment of requirements of the Supervisory Board
Stress test report	CRO	Quarterly	Stress test; short review of the scenarios developed; results at overall bank level; sensitivity tests	Evaluation of risk-bearing capacity and observance of the global limit for individual stress scenarios
Problem Loan Report	Management Board, selected BUs	Case by case	Comprehensive information on the problem loan portfolio	Comprehensive information on the problem loan portfolio
Management Reporting	Management Board, selected BUs	Monthly	Individual indicators (e.g. utilisation of regulatory capital and RWAs)	On-going information for the Management Board on the financial situation and hence also aggregated statements on risk

Table 6: Reports on default risk

Report	Recipient	Interval	Content	Objective
Country Risk Update	Management Board, Market BUs, heads (Version A), Staff BUs and operative level (Version B)	Quarterly	Country Risk Monitor; Country Risk Ticker; HSH Nordbank Foreign Exposure	Current information on specific country risk and cross-border commitment of HSH Nordbank
Country Risk Watchlist	BU CRM (risk assessment)	Monthly	Country risks	Condensed practical guidelines for high-risk countries/countries with special limits
Country Global Head Reporting	BU level, market units	Monthly	Utilisation of special countries and GH limits	Information for Market BUs, limit monitoring tool
Country limit list	Infoport	Weekly	Utilisation of country limits	Information for Market BUs, limit monitoring tool

Table 7: Reports on country risk

5.4 COUNTERPARTY DEFAULT RISK: GENERAL DISCLOSURE REQUIREMENTS FOR ALL FINANCIAL INSTITUTIONS

5.4.1 Exposure values of receivables sorted by risk-bearing instruments

In this section the exposure values of the portfolio of the HSH Nordbank Group are presented, divided into the main types of receivables (risk-bearing instruments), main regions, main sectors and contractual residual maturities, in accordance with Section 327 (2) No. 1 to 4 SolvV. The residual maturity of “1 day” includes all transactions due within one day, which also means transactions callable daily with indefinite maturity. Receivables which generally do not have fixed terms to maturity, like investment shares, are included in the last maturity range with a flat residual maturity of 10 years.

The exposure values of the portfolio are calculated after considering CCFs in accordance with § 48 and § 99 SolvV. However, with respect to the regualtions put forward in § 327 (2) sentence 1 SolvV credit risk mitigations techniques are not considered in the calculation. The credit equivalent value is shown for derivative instruments. IRBA and KSA exposure values are combined.

This division does not include investment exposures (equity holdings) and securitisations since these are reported separately. The exposure values on the reporting date do not vary greatly overall from the average values of the reporting year. Therefore the average values are not disclosed.

	Loans	Loan commitments	Other non-derivative off-balance sheet assets	Securities	Derivative instruments
Exposure value (total)	**133,782**	**11,029**	**8,565**	**25,719**	**10,815**

Table 8: Exposure values according to risk-bearing instruments in € m

Main region	Loans	Loan commitments	Other non-derivative off-balance sheet assets	Securities	Derivative instruments
Western Europe	107,981	8,708	6,681	22,273.3	8,197.0
North America	13,004	1,046	1,030	2,371.4	2,080.8
Asia Pacific Region	5,461	738	675	565	174
Latin America	1,425	125	29	187	59
Central and Eastern Europe	3,852	224	83	242	187
Middle East	1,699	142	54	0	117
African countries	346	42	13	0	0
Int. Organisations	0	0	0	75	0
Other	12	5	0	4	0
Total[1]	133,782	11,029	8,565	25,719	10,8159

[1] The differences in amounts are due to rounding off figures.

Table 9: Exposure values according to the main regions in € m

Main sector	Loans	Loan commitments	Other non-derivative off-balance sheet assets	Securities	Derivative instruments
Credit institutions	16,697	685	590	12,711	4,572
Other financial institutions	6,641	749	2,736	3,894	835
Public sector	22,966	903	1,162	7,689	1,391
Private budgets	3,491	57	236	50	31
Properties and flats	28,770	2,045	541	74	1,077
Shipping	27,409	2,931	891	223	1,856
Industry	14,808	2,319	1,648	263	531
Trade and transport	12,794	1,165	761	511	522
Other	205	174	0	303	1
Total[1]	133,782	11,029	8,565	25,719	10,815

[1] The differences in amounts are due to rounding off of figures.

Table 10: Exposure values according to main sectors in € m

Contractual residual term	Loans	Loan commitments	Other non-derivative off-balance-sheet assets	Securities	Derivative instruments
Up to one day	5,086	432	93	369	11
1 day to 3 months	10,580	890	662	2,184	214
3 up to and including 6 months	3,152	196	196	419	49
6 months up to and incl. 1 year	6,677	975	390	650	148
1 year up to and incl. 5 years	41,025	4,685	2,593	11,316	2,161
Longer than 5 years	67,261	3,851	4,631	10,779	8,231
Total[1]	133,782	11,029	8,565	25,719	10,815

[1] The differences in amounts are due to rounding off of figures.

Table 11: Exposure values according to contractual residual terms in € m

5.4.2 Procedure for creating loan loss provisions for the purposes of financial reporting

As part of the risk monitoring process of HSH Nordbank risk provision for loan commitments is created in accordance with Group-wide standards through specific loan loss provisions (SLLP) for receivables and allowances for contingent receivables and irrevocable loan commitments to the sum of the potential default. Furthermore, the Bank takes general loan loss provisions

(GLLP) and country-specific loan loss provisions (CLLP) into account.

As part of on-going loan monitoring, the units responsible for the customers identify whether new risk provision or adjustments are required. Furthermore, a statement on the necessity of creating or modifying risk provisions or for constant monitoring of borrowers on the restructuring and liquidation list is compiled with the half-yearly monitoring documents. Notification and recording of the creation or modification of risk provisions is performed immediately on identification of the pertinent events. Determination and recording of risk provision is performed at the transactional, i.e. account, level.

The Bank must assess as at every reporting date whether there is “objective evidence” that a financial asset is impaired. Sustained impairment of the receivable is a precondition for the creation of risk provisions. Objective proof for impairment must be provided. Criteria for impairment are generally considerable financial difficulties of the obligor and indications based on current information that the future capital service cannot be performed and that there is no improvement foreseeable in the economic situation. Opening or applying for bankruptcy, insolvency or composition proceedings are also reasons to examine the recoverability of a financial instrument. Impaired performance or delayed payment in standard transactions of more than 90 days and/or in individual transactions without any fixed thresholds are further indications for an impairment.

Recognisable risks in the lending business are allowed for by creating an SLLP for the corresponding receivable. To calculate the sum of the SLLP the present value of the expected cash flows for the receivable, i.e. the recoverable amount, is compared to the carrying amount of the receivable. Estimated future cash flows are composed of principal and/or interest payments as well as cash inflows from liquidating collateral less costs for obtaining and selling the collateral. If the carrying amount is higher than the recoverable amount, an SLLP is created for the sum of the difference.

Provisions for the lending business are reported in the balance sheet for expected defaults on off-balance sheet transactions. The sum of the allowances is the difference between the expected payment obligations of HSH Nordbank and the incoming payments expected from the obligor without discounting.

In contrast to SLLPs, GLLPs are not created for specific, but for latent credit risk. Latent credit risk means receivables considered recoverable on the balance sheet date already contain risks which are not recognisable until later and which lead to defaulting. General loan loss provisions are created on the loan portfolio which is not entitled to specific loan loss provision. These loans are also written off for their lower reconcilable value based on the principle of prudence. Since allocation to certain receivables is not possible, general loan loss provisions are created. HSH Nordbank is therefore complying with the circular from the Federal Ministry of Finance dated 10 January 1994.

Provisions for country risks are generalised SLLPs. They are measured subject to the political and economic conditions of a country and created based on the overall credit commitment of the Bank in that country. The internal country rating of HSH Nordbank is the basis for the general CLLP. For all countries classified from 6 to 18 according to the rating of HSH Nordbank (see Table 31, page 39) a country-specific general loan loss provision is created. All claims (including those not reported in the balance sheet) against foreign obligors can be included in the basis for assessment, with value of collateral, receivables with maturity terms of less than one year and SLLPs being deducted. Increasing loan loss provisions are applied to the remaining sum according to the risk category. The loan loss provisions start at 5% for rating category 6 and increase by 5% per rating category to 50% for rating category 15. Higher rates are set for rating categories 16 to 18 depending on the risk evaluation for the countries concerned.

Non-recoverable receivables are written off directly in profit or loss.

The adequacy of risk provision is monitored continuously as part of problematic loan processing. The expected risk provision requirements for the current financial year are determined on a quarterly basis and are reported to the Management Board.

5.4.3 Definition of “non-performing” and “defaulting” for financial reporting purposes

According to the German Commercial Code, both current assets and the receivables portfolio of the Bank are to be written off at their lower fair value. The “fair value” of a receivable is determined by assessing the creditworthiness of the obligor, i.e. the ability to comply with the contractual terms for the receivable, together with interest and principal repayments. The loans are then divided into the following categories depending on the creditworthiness of the obligor.

No SLLP or allowances created	Loans without recognisable default risks. As at the reporting date these loans do not show any risk; no SLLPs are created for these credits, only GLLPs.	
	Earmarked loans (higher risk loans). These loans contain higher latent and/or not finally assessable risks and need to be monitored closely. SLLP is not required. GLLP is sufficient.	defaulting
Creation of SLLPs or allowances and/or direct write-off	Non-performing loans On the basis of objective criteria, for these loans (partial) default is expected; hence the creation of an adequate SLLP is required. No (additional) GLLP are created for these loans. Non-recoverable loans Such receivables can no longer be collected. No recoverable collateral available. These loans need to be written-off.	non-performing

Table 12: Division of receivables into *non-performing* and *defaulting*

An obligor is considered to have defaulted:

- if he is more than 90 consecutive calendar days in arrears with a significant part of his overall liability to the Bank from loans granted (90 days in arrears). The delayed payment is considered to be significant if the overall liability exceeds the current limits reported by more than 2.5%;
- if the Bank assumes that there is a high degree of probability that the borrower will not be able to meet his obligations in full, without the need for recourse to such actions as the realisation of collateral (unlikeliness to pay). This basic assumption should be made when certain circumstances occur (e.g. restructuring) which are specified exactly by the Credit Manual.

5.4.4 Development of risk provision in the lending business

Table 13 lists the overall portfolio as well as the changes in risk provision types in the reporting year in accordance with HGB accounting regulations. Additions, changes due to exchange rate fluctuations as well as other changes to impairments were disclosed separately.

Loan loss provision	SLLP	Allowances	GLLP	CLLP
Portfolio at the beginning of the reporting year	1,121	140	201	33
Addition	2,116	437	3	136
Reversal	438	117	6	5
Utlisation	243	19	-	-
Changes due to exchange rate fluctuations and other changes	4	3	-	-
Portfolio at the closing date[1]	**2,560**	**444**	**198**	**163**

[1] The differences in amounts are due to rounding off of figures.

Table 13: Development of loan loss provisions in € m

5.4.5 Non-performing and defaulting receivables in the lending business according to main sectors and main regions

Subsequently the non-performing and defaulting receivables are listed according to the main regions and main sectors consistent with § 327 (2) sentence 5 SolvV. Table 14 and Table 15 show values taken from HGB data.

Main sector	non-performing[1]	Portfolio				Net additions/reversals of				DW[2]	Receipts[3]	in default[4]
		SLLP	GLLP	CLLP	Allow.	SLLP	GLLP	CLLP	Allow.			
Credit institutions	665	316			0	315			0			19
Other financial institutions	1.210	726			39	742			-37			158
Public sector	506	294			18	179			11			267
Households	184	91			10	11			10			94
Properties and flats	2.000	554			93	153			74			846
Shipping	101	61			257	40			258			42
Industry	742	303			22	136			2			257
Trade and transport	447	212			3	101			3			199
Other	2	1			1	1			0			1
Total[5]	5.857	2.560	198	163	444	1.678	-3	131	320	11	11	1.885

[1] Non-performing loans (with need for loan loss provisions)

[2] Direct write-offs

[3] Recoveries on receivables written off

[4] Defaulting loans (without need for loan loss provisions)

[5] The differences in amounts are due to rounding off of figures.

Table 14: Non-performing or defaulting receivables acc. to main sectors in € m

Major region	non-performing[1]	SLLP portfolio	GLLP portfolio	CLLP portfolio	Allowances portfolio	in default[2]
Western Europe	4.452	2.153		40	416	1.522
North America	1.076	223		-	27	205
Asia Pacific Region	184	98		58	1	2
Latin America	22	13		14	0	89
Central and Eastern Euro	84	37		35	0	62
Middle East	40	36		1	0	0
African countries	-	-		16	-	5
Int. Organisations	-	-		-	-	-
Other	0	0		-	0	0
Total[3]	5.857	2.560	198	163	444	1.885

[1] Non-performing loans (with need for loan loss provisions)

[2] Defaulting loans (without need for loan loss provisions)

[3] The differences in amounts are due to rounding off of figures.

Table 15: Non-performing or defaulting receivables acc. to main regions in € m

5.5 COUNTERPARTY DEFAULT RISK: CRSA AND/OR IRBA RECEIVABLE CLASSES

5.5.1 Names of nominated rating agencies

In CRSA the required risk weighting for calculation of regulatory capital backing is stipulated by the supervisory authority. The scope of risk weighting depends on the type of receivable, its external rating and any collateral. If external ratings are being used HSH Nordbank takes only those into account which are issued by agencies approved by the supervisory board (Section 44 SolvV). Different rating or export insurance agencies can be appointed for each category of receivable. The CRSA or IRBA receivables category for securitisations allows rating agencies to be appointed at the transaction level; for all other CRSA exposures they are appointed per receivables category related to credit assessment.

If an external rating from a recognised rating agency is used this external rating must be converted to a rating on the rating master scale. A check should be made for each of the recognised rating agencies if an external rating is available. If more than one external rating is found, the lower rating shall be taken as the decisive rating and transferred to the rating master scale. The issuer rating should always be used except for ABS transactions where the external rating for the transaction is used.

HSH Nordbank has appointed the following rating agencies.

Receivables category	Receivables class	Rating agency
States	Central governments Regional governments Other public sector entities Institutions Covered bonds issued by banks	Fitch Moody's S & P
Banks	Multi-lateral development banks	External ratings not used
Companies	Companies	External ratings not used
Investment shares	Investment shares	External ratings not used
Securitisation	IRBA exposures in acc. with Art. 85 Par. 6, 1 No. 1 Ge Solvency Regulation CRSA securitisation exposures IRBA securitisation exposures	Fitch Moody's S & P

Table 16: Rating agencies per receivables category

5.5.2 Transfer of ratings from issues to receivables

Issuer ratings are necessary to determine the CRSA and IRBA risk weighting for securitisations as well as the amounts of eligible collateral for CRSA exposures. In addition, issuer ratings may have to be provided for the receivables class Investment Certificates. Issuer ratings are also needed for securities and structured products in the trading book in order to treat them as securities with high investment quality in accordance with Section 303 (1) SolvV for CRSA exposures as well to be able to identify securities of the trading book not eligible when determining the partial capital charge for specific risk in accordance with Section 303 (1) SolvV.

Regarding the emission ratings for the receivables class Securitisations HSH Nordbank has nominated the rating agencies Fitch, Moody's and S & P. The emission ratings for this receivables class are maintained in the internal IT systems.

HSH Nordbank does not use the creditworthiness assessment via comparable exposures and obligor creditworthiness due to the minor relevance of the low exposure.

5.5.3 CRSA and IRBA exposure values when applying regulatory risk weighting

In order to determine the equity capital requirements, both the CRSA and the Advanced IRB Approach require so-called risk-weighted exposure values (product of risk weighting and exposure value) to be created. For CRSA the risk weighting is set globally by the supervisory authority according to the receivables category and the external rating. Table 17 shows the CRSA exposure values before and after credit risk reduction measures in accordance with Section 328 (2) SolvV. Substitution effects mean that exposure values with risk weightings that were originally higher are replaced with those with a lower risk weighting. In contrast, the Advanced IRB Approach always calculates the risk weightings using parameters assessed internally. The IRBA receivables classes Special Financing and Participations are exceptions. In these cases it is possible to determine risk weighting using the “simple risk weighting”. Risk weighting is set by the supervisory authorities depending on fixed criteria. However, within the HSH Nordbank Group the simple risk weighting approach is only used partially for participations at present. Depending on whether the participation exposure is quoted on the stock exchange, not quoted but diversified sufficiently or is another participation exposure, it is assigned a risk weighting of 290%, 190% and/or 370%. These exposure values are also listed in Table 17 in accordance with Section 329 (2) SolvV. The classification does not include securitisations since they are separately disclosed.

Risk weighting in %	CRSA before credit risk reduction	CRSA after credit risk reduction	Advanced IRBA approach
			Total sum of exposures values
0	1,514	1,516	-
10	607	607	-
20	3,273	3,017	-
35	-	971	-
50	184	792	-
70	-	-	
75	1,686	728	-
90	-	-	-
100	22,411	21,045	-
115	-	-	-
150	630	482	-
190	-	-	165
200	-	-	-
250	-	-	-
290	-	-	98
350	-	-	-
370	-	-	170
1250	-	-	-
Capital deduction	-	-	-
Other risk weights	1,803	1,803	-
Total[1]	32,108	30,960	433

[1] The differences in amounts are due to rounding off of figures.

Table 17: CRSA / IRBA exposure values acc. to regulatory risk weighting in € m

5.6 DERIVATIVE COUNTERPARTY DEFAULT RISKS

Derivative financial instruments have been implemented to a considerable extent and their utilisation will be expanded further to ensure efficient risk protection, to exploit market opportunities and to cover specific financing needs of customers.

The nominal volume of derivative transactions totalled EUR 744.3 billions on the reporting date. HSH Nordbank Group operates its derivative business exclusively with counterparties with impeccable creditworthiness. Hence over 81.4 % of the total nominal volume is accounted for by credit institutions registered in an OECD country.

5.6.1 Internal capital allocation and assignment of upper limits for credits to counterparties

The usual credit approval procedures must be complied with when creating derivative counterparty default risk exposures. The risk classification, limitation and monitoring processes of the classic lending business apply accordingly (see Chapter 4.1 and the section on concentration risks in Chapter 5.2). The eligible sums for derivative counterparty default risk exposures are included in the Bank-wide economic management, capital allocation and limitation together with the other exposures subject to credit risk.

5.6.2 Procedure for receiving collateral

Derivative transactions for securing interest rate, foreign exchange and other similar risks are generally concluded with single counterparties and governed by existing master agreements. A differentiation should be made between the German Master Agreement for Financial Transactions and the international Master Agreement of the International Swaps and Derivatives Association (ISDA).

A collateral agreement exists for each of these master agreements; in the case of the German Master Agreement this is the Collateral Annex and for the ISDA Master Agreement it is the ISDA Credit Support Annex. The conditions described below apply identically to both master agreements and the corresponding collateral agreements.

The collateral agreements contain explanations on the minimum conditions for recognising collateral according to the agreement. In such a collateral annex only collateral recognised by the supervisory authority is permitted; this is generally cash collateral or securities with very good creditworthiness which have been received or placed via a (normally) daily margining within the scope of the collateral agreements.

The master agreements on derivative transactions and the collateral agreements are stored in a central system. Article 7-9 of the German Master Agreement (and the ISDA Master Agreement) contains a provision on liquidation netting approved by the supervisory authority. When a transaction is concluded according to a master agreement for the customer, the netting potential of the transaction is determined. In addition the eligibility of individual transactions according to the collateral agreement is verified.

Possible collateral increments under a collateral agreement are determined on a daily basis. Transactions not permitted under a collateral agreement (generally loan derivatives) and hence for which no collateral is provided under the agreement are generally collateralised individually where possible. The exclusion of a transaction from a collateral agreement does not mean automatically that a transaction is not nettable under an existing master agreement. It can also be the case that a transaction which has been classified as not eligible for netting is still permitted under a collateral agreement and collateral for the transaction can be provided under the collateral agreement.

Cash collateral is financial collateral which can collateralise a transaction as permitted collateral under a collateral agreement or which can be used as individual collateral.

5.6.3 Evaluation of derivates and creation of loan loss provisions

Counterparty risk is calculated using the regulatory market evaluation method. The evaluation basis for derivate counterparty default risks is determined using the marked-to-market replacement cost in accordance with Section 19 of the German Solvency Regulation for current potential increases and in accordance with Section 20 of the German Solvency Regulation for future expected increases in the current potential replacement cost. The replacement cost is based either on the market price (marked-to-market) or on a market value projected from a model. The subsequent measurement occurs at fair value.

Derivate financial instruments are reported and evaluated according to general commercial regulations. The conclusion of internal transactions must comply with standard fixed conditions. In particular the terms must conform with market conditions. Purchased and/or written options are reported to the amount of the option premium paid and/or received under Other assets or Other liabilities. The lowest value or imparity principle is also reflected by write-downs or creation of allowances. If a margin system is used for innovative financial instruments, the margin payments are reported as assets or receivables. The imparity principle is also reflected by creation of allowances. Further information on the approach to and evaluation of derivates can be found in the Annual Report for 2008 (see section “Reporting and evaluation methods") and the Financial Report for 2008 (see section “General information and explanations”).

5.6.4 Dealing with correlations of market and counterparty risk

The management of derivative counterparty default risks includes determining both market and counterparty risks and providing capital backing. A reduction due to correlations of both these types of risks is not applied at present.

5.6.5 Effect of the collateral amount which the Bank must provide when the rating is downgraded

HSH Nordbank has concluded master agreements with its counterparties which have been negotiated individually. The Credit Support Annex to the ISDA Master Agreement in particular contains individual clauses which may required HSH Nordbank to provide additional collateral or initial collateral if an external rating of the HSH Nordbank is downgraded. The effect of a rating downgrade on the sum of the collateral to be provided does not impact the risk bearing capacity of HSH Nordbank.

5.6.6 Positive net replacement costs before and after application of credit risk reduction

Table 18 shows to what extent HSH Nordbank Group is committed in different counterparty types as defined by Section 326 (2) No. 1 SolvV and to what extent derivative netting agreements and collateral netting is used. The counterparty default risk according to the approach used (regulatory market assessment approach) is given in Table 19 in accordance with Section 326 (2) No. 2 SolvV.

	Positive replacement value *before* netting and collateral	Netting options	Nettable collateral	Positive replacement value *after* Netting and collateral
Interest-related contracts	16,857			
Currency-related contracts	4,752			
Securities/index-related contracts	287			
Loan derivatives	231			
Other contracts	266			
Total[1]	247			
	22,641	14,503	435	7,702

[1] The differences in amounts are due to rounding off of figures

Table 18: Positive replacement costs in € m

	Market assessment method
Counterparty default risk item	10,829

Table 19: Counterparty default risk after applying method in € m

5.6.7 Loan derivatives

The loan derivates purchased for collateralising the loan portfolio of HSH Nordbank Group have been listed in accordance with Art. 326 Par. 2 No. 3 in Table 20 loan derivatives as part of securitisations are described in the next section.

	Nominal value of collateral
Loan derivatives (secured party))	564

Table 20: Nominal value of loan derivatives eligible for collateral in € m

HSH Nordbank Group acts as collateral assignee and collateral assignor for loan derivatives (see Table 21 in accordance with Section 326 (2) No. 4). There are no brokerage transactions as at the reporting date.

	Use for own credit portfolio protection buyer	Use for own credit portfolio protection seller	Broker activity
Credit Default Swaps	4,242	4,191	-
Credit Linked Notes	-	-	-
Total Return Swaps	-	-	-
Credit Options	-	-	-
Other contracts	-	-	-
Total	4,242	4,191	-

Table 21: Nominal values of loan derivatives in € m

5.7 SECURITISATION

5.7.1 Aims, functions and scope of securitisation activities

The securitisation of loan portfolios is an essential instrument of risk management at HSH Nordbank. In view of practically illiquid securitisation markets, the scope for such transactions was severely limited throughout 2008. The prime motive for the Bank's own transactions since 2004 has been risk transfer. This was done via synthetic securitisation through credit default swaps (CDS) and issuing and placing of credit linked notes (CLN). The underlying receivables for these securitisations are real estate loans for commercial property in the USA (Pure Mortgages 2004), private real estate loans (Förde 2000-1) and ship loans (Ocean Star 2004 and Ocean Star 2005). The risk relief achieved with these transactions support management of the risk concentrations in the loan portfolio with regard to single counterparties and sectors. However, as a result of the financial crisis almost all synthetic securitisation transactions were dissolved during 2008. As at the reporting date the synthetic securitisation transaction Circle 2002 still existed where ABS, in which HSH had invested, were securitised. Furthermore, HSH

Nordbank Group held a share in True Sale International GmbH since mid-2004, along with twelve other banks. The common goal is to promote the strategic importance of securitisations as well as the creation of general legal conditions, in particular for true sale securitisations, in Germany. In 2006 HSHS Nordbank Group placed a true sale securitisation transaction (Prime 2006-1) as lead manager and bookrunner for the first time jointly with another federal state bank (*Landesbank*). The portfolio consists of profit participation rights of medium-sized companies registered in Germany who are participating in the SmartMezzanine programme of HSH Nordbank AG and other banks.

HSH Nordbank has concluded five further transactions of a securitisation programme via its Copenhagen branch (Scandinotes I to V) (of which the transaction Scandinotes I expired in 2008). Subordinated loans of Scandinavian banks were sold to single purpose vehicles, refinanced through the issue of corresponding securities and sold on in part to external investors.

In total the exposure of securitised receivables with HSH Nordbank Group amounted to EUR 2.5 billion as at the reporting date.

In addition HSH Nordbank is investing in tranches of other securitisation transactions (e.g. in ABS, RMBS, CMBS, CDOs). However, this portfolio was reduced successively during 2008, leaving an exposure of EUR 11.4 billion as at the reporting date. Originally these investments were made to further diversify the overall portfolio via the bank's subsidiary HSH Nordbank Securities S. A. in Luxembourg.

5.7.2 Determination of risk-weighted exposure for securitisation transaction to be considered

HSH Nordbank Group always determines its equity requirements using the advanced IRB approach. However, in relation to securitisation transactions the approach to be used depends on the portfolios involved..

Securitisation activity	Kind of securitisation	Approach	Procedure to determine the risk-weighted exposure
Carrera (ABCP programme)	Traditional securitisation	IRBA	Risk weight in line with external rating
Circle 2002	Synthetic securitisation	IRBA	Pool backing
Poseidon (ABCP programme)	Traditional securitisation	IRBA	Formula approach under supervisory law acc. to Sect. 258 SolvV
Prime 2006-1	Traditional securitisation	CRSA	Risk weight in line with external rating
Scandinotes II	Traditional securitisation	IRBA	Risk weight in line with external rating
Scandinotes III	Traditional securitisation	IRBA	Risk weight in line with external rating
Scandinotes IV	Traditional securitisation	IRBA	Risk weight in line with external rating
Scandinotes V	Traditional securitisation	IRBA	Risk weight in line with external rating

Table 22: Determination of risk-weighted exposure for securitisation transactions

An internal assessment approach (IAA) in accordance with Section 259 of the German Solvency Regulation for the determination of risk weighting for exposures from ABCP programmes is not applied by HSH Nordbank at present.

5.7.3 Accounting policies for securitisations

In the event HSH Nordbank Group buys securitisation exposures, the same accounting policies as for securities apply. They are reported in the balance sheet under "Debentures and other fixed-income securities".

Receivables of HSH Nordbank Group that are securitised synthetically are reported in the same way as non-securitised receivables as stipulated by the provisions of the German Commercial Code. Since the risk for these receivables no longer lies with HSH Nordbank Group, they are not included in the risk provision process, nor are they written off in the case of default. Receivables which are securitised as part of a true sale securitisation are derecognised in the balance sheet. Receivables which are contained in securitisation tranches but where the risks have been retained are treated and reported as a non-securitised liability.

Since HSH Nordbank issues an individual financial statement in accordance with the German Commercial Code and a group financial statement according to IFRS regulations Table 23 explains both reporting approaches.

Securitisation transaction	True sale Yes/No	Approach	IFRS Disposal Yes/No	IFRS Consolidation Yes/No	HGB Disposal Yes/No
Prime 2006-1	Yes	CRSA	Yes	No	Yes
Carrera	Yes	IRBA	-	Yes	-
Circle 2002	No	IRBA	No	No	-
Poseidon	Yes	IRBA	-	Yes	-
Scandinotes II bis V	Yes	IRBA	Yes	No	Yes

Table 23: Accounting policies for receivables securitised as originators

5.7.4 Rating agencies used for securitisations

The securitisations issued by HSH Nordbank Group were rated externally in each case. The rating agencies used and the type of the receivables behind the securitisation portfolio are given in Table 24 in accordance with Section 334 (1) No. 6 of the German Solvency Regulation. The names of the appointed rating agencies for investments in securitised assets are shown in Table 16, page 28.

Securitisation transaction	Type of securitisation	Type of receivable	Rating agency
Carrera (ABCP-Programm)	Traditional securitisation	ABS	Moody's, S & P
Circle 2002	Synthetic securitisation	ABS	Fitch, Moody's
Poseidon (ABCP-Programm)	Traditional securitisation	ABS, leasing claims	Moody's, S & P
Prime 2006-1	Traditional securitisation	Profit participation rights	Fitch, Moody's, S & P
Scandinotes II	Traditional securitisation	Claims towards Danish regional banks	Moody's
Scandinotes III	Traditional securitisation	Claims towards Scandinavian regional banks	Moody's
Scandinotes IV	Traditional securitisation	Claims towards Danish regional banks	Moody's
Scandinotes V	Traditional securitisation	Claims towards Danish regional banks	Moody's

Table 24: Securitisation transactions initiated by HSH Nordbank

5.7.5 Exposure values of securities receivables

Table 25 gives the exposure value of the securitised receivables of HSH Nordbank Group as at the reporting date in accordance Section 334 (2) No. 1 of the German Solvency Regulation, divided according to securitisation classification (traditional or synthetic) and according to the type of the securitised receivables. The portfolio of traditional securitisations for the item Other consists primarily of leasing receivables and receivables from Scandinavian regional banks.

Securitisation portfolio	Exposure value
Traditional securitisations	2,315
Real estate	-
Ships	-
Retail banking	-
ABS	**1,064**
Other	**1,251**
Synthetic securitisations	140
Real estate	-
Ships	-
Retail banking	-
ABS	**140**
Other	-
Total	2,455

Table 25: Exposure values of securitised receivables in € m

5.7.6 Non-performing/overdue securitised receivables and losses incurred

In the year under review no losses were incurred for securitisation exposures where HSH Nordbank acted as originator.

5.7.7 Exposure values of retained or purchased securitisation exposures

Table 26 lists the securitisation exposures held by the Bank in accordance with Section 334 (2) No. 3 of the German Solvency Regulation. These comprise retained tranches from the Bank's own securitisation transactions (e.g. with the aim of improving credit), liquidity facilities provided by the Bank for securitisation transactions and investments in third-party securitisation transactions.

Securitisation items	CRSA exposure value	IRBA exposure value
Balance-sheet items		
Credit enhancements[1]	5	158
Participations in ABS transactions	6,670	5,503
Other balance-sheet items	3	8
Sub-total	6,678	5,669
Off-balance sheet items		
Liquidity facilities	132	193
Derivates	-	-
Other off-balance sheet items	-	15
Sub-total	132	208
Total[2]	6,811	5,877

[1] Measures to improve credit quality

[2] The differences in amounts are due to rounding off of figures.

Table 26: Exposure values of retained or purchased securitisation exposures in € m

5.7.8 Risk weight ranges and exposure values of securitisation

Table 27 allocates the individual securitisation items of the Bank (taken from Table 26) to risk weight ranges in accordance with Section 334 (2) No. 4 SolvV.

	Securitised items held back / purchased			
Risk weight range	CRSA exposure value	IRBA exposure value	CRSA capital requirement	IRBA capital requirement
0% to 10%	-	4,223	-	26
10% up to and including 20%	5,899	669	94	5
20% up to and including 50%	230	431	9	9
50% up to and including 100%	283	82	23	6
100% up to and including 350%	223	243	25	51
350% up to and including 650%	-	5	-	2
650% to 1250% excluded	-	-	-	-
1250% or capital deduction	176	224	5	11
Total	6,811	5,877	156	110

Table 27: Exposure values and capital requirements for retained or purchased securitisation items acc. to risk weight ranges in € m

5.7.9 Securitisation activities in the reporting year

In the year under review HSH Nordbank arranged any new securitisation transactions.

5.8 LONG-TERM PARTICIPATION PORTFOLIO

The regulatory authorities state that participations must be consolidated, deducted from equity or backed with equity capital in the asset class Participations. In this context regulatory law considers participation risk to be a sub-class of the counterparty default risk. The participations from the banking book are explained below.

The participation portfolio of the HSH Nordbank Group is divided essentially into five sub-portfolios. Each sub-portfolio has a different objective.

a) Strategic participations

Strategic participations are all those which have a strategic importance for the Group and/or promote the economic interests of the region.

b) Participations to support business segments

Participations to support business segments are oriented towards expanding existing customer relationships or creating new ones.

c) Investment-related participations

Investment-related participations comprise private equity commitments for profit and diversification of risks.

d) Other participations

In contrast to the regulations of the German Commercial Code all items that contain a subordinated residual claim to the assets or income of the issuer are classified as participation under supervisory law. Participations which are considered as a participation under supervisory aspects (in accordance with SolvV) but mostly are allocated to the item “Shares and other non-fixed-income securities” (in accordance with the German Commercial Code) do not therefore belong to the divisions of strategic, business field-related or investment-oriented participations and instead are treated as other participations.

e) Funds and listed certificates

Special assets of domestic or foreign capital investment companies and listed certificates, must be reported under the item “Bonds and other fixed interest securities” according to the German Commercial Code, can also contain participations in the sense of the German Solvency Regulation from the point of view of the supervisory authorities. Insofar as they can be assigned to the banking book these exposures are allocated to the separate sub-portfolio Funds and Listed Certificates.

5.8.1 Accounting principles for participations

An important instrument for monitoring and managing participation risk for strategic, business field-related and investment-oriented participations is regular company assessment. The processes have been designed to ensure that the recoverability of all HSH Nordbank’s direct participations of is assessed at least once a year. Significant participations are subject to a detailed assessment using the relevant standards of the Institute of Public Auditors in Germany (“Institut der Wirtschaftsprüfer” or “IdW”). The assessment of fund holdings and similar constructs is performed using a net asset value approach which also assesses the current year reports and financial statement of the investment companies. All other participations undergo a risk-oriented assessment.

Participations which are allocated to the sub-portfolios “Other Participations” and “Funds and Listed Certificates” also represent a long-term commitment due to their allocation to the Bank’s investment portfolio. Hence these partial portfolios are also assessed on the moderate lower of cost or market principle and the corresponding exposures are reported with their historical costs. This means that reporting of P&L volatilities, which would not be economically justified due to the short-term nature of the underlying fluctuations in value, is avoided. If long-term reductions in value are foreseeable – generally related to creditworthiness – write-downs are made to the lower share price, market price or fair value.

5.8.2 Overview of participations in the banking book

The participation portfolio of the banking book of HSH Nordbank Group is shown in Table 28.

Participation portfolio	Carrying amount	Fair value	Stock market value
Strategic participations	436	436	-
Items traded on the stock exchange	-	-	-
Not listed on the stock exchange but belonging to a sufficiently diversified participation portfolio	436	436	-
Other participation exposures	-	-	-
Business field-related participations	685	625	-
Items traded on the stock exchange	139	80	80
Not listed on the stock exchange but belonging to a sufficiently diversified participation portfolio	545	545	-
Other participation exposures	-	-	-
Investment-related participations	119	119	-
Items traded on the stock exchange	-	-	-

Participation portfolio	Carrying amount	Fair value	Stock market value
Not listed on the stock exchange but belonging to a sufficiently diversified participation portfolio	119	119	-
Other participation exposures	-	-	-
Other participations[1]	657	507	-
Items traded on the stock exchange	170	154	154
Not listed on the stock exchange but belonging to a sufficiently diversified participation portfolio	487	352	-
Other participation exposures	0	0	-
Investment exposures contained in investment funds or listed certificates or exposures treated as participations	205	190	-
Gesamt	2.102	1.877	-

[1] The differences in amounts are due to rounding off of figures.

Table 28: Valuation of participation instruments in € m

5.8.3 Realised profits and losses and latent revaluation profits for participations

Table 29 shows the accumulated profits from divestiture. It also shows the amount of latent revaluation profits (or losses) which represent unrealised profits (or losses) which are not shown in the balance sheet or in the income statement. However, they are not included in Tier 1 or Tier 2 capital.

	Realised profits or losses from sales and workout	Latent revaluation profits/losses	
		overall	of which amounts included in Tier 1 or Tier 2 capital
Participation items	10	-209	-
Participation items contained in investment funds or listed certificates or exposures treated as participations	8	-15	-
Total	18	-224	-

Table 29: Realised / latent profits and losses from participation instruments in € m

5.9 RISK MEASUREMENT FOR IRBA PORTFOLIOS

5.9.1 Procedures permitted by the Federal Financial Supervisory Authority as part of IRBA

HSH Nordbank determines all parameters required to establish risk weightings internally, i.e. probability of Default (PD), loss given default (LGD), exposure at default (EaD), credit conversion factor (CCF) and maturity (M), and hence complies with the requirements of the Advanced IRB Approach of the German Solvency Regulation.

In 2006 and in review assessments in 2007 and 2008 the Federal Financial Supervisory Authority reviewed the rating modules, the estimation procedures for LGDs and CCFs and the corresponding processes. The supervisory authority confirmed the quality and suitability of parameters and processes. This is the result in particular of early and intensive inclusion of these parameters in internal management. As of the first quarter 2009 the equity capital backing for the LBO financing is also determined using the Advanced IRB Approach.

Furthermore, the rating module for aircraft financing is currently under review by the supervisory authority. A detailed description of the rating modules used by HSH Nordbank and approved by the banking authorities can be found in chapter 5.9.3.

The reference point set by the authorities of 50% (entrance threshold), i.e. the minimum degree of cover required for registration for the advanced IRB approach was achieved clearly. The degree of coverage in accordance with Section 67 of the German Solvency Regulation at that time was 70% for the total of risk weighted exposure values and over 80% for exposure values.

The goal is to achieve the regulatory reference point and the withdrawal threshold, i.e. degrees of coverage of at least 80% and 92% for the Advanced IRB Approach, by mid-2010 and/or the end of 2012 at the latest.The current realignment of HSH Nordbank also influences which types of receivables or portfolio segments will remain permanently or temporarily in partial use or will not be included as business fields due to expire when determining the degree of cover. HSH Nordbank will provide detailed information on this after the realignment phase is concluded.

5.9.2 Transition procedures permitted by the Federal Financial Supervisory Authority as part of IRBA

HSH Nordbank Group is using the following transition procedures in accordance with Section 338 and 339 SolvV:

Since HSH Nordbank Group submitted its application for registration for the Advanced IRB Approach at a very early stage, it is able to reference to a period (use test) of two years instead of five years with regard to its LGDs and CCFs estimates.

The Bank does not include participations held before 1 January 2008 in the application of the Advanced IRB Approach; instead it uses the CRSA to determine equity capital requirements (grandfathering).

With regard to investment shares in accordance with Section 294 (6) Sentence 1 to 8 SolvV, HSH Nordbank Group is not applying a pro rata application according to the actual composition of foreign currency until December 31, 2011 if the share of the components of special assets in foreign currency or gold does not exceed 10% of the value of the special assets.

Disclosure as defined in the German Solvency Regulation is only required if at least one risk weighted exposure value is determined according to the CRSA or Advanced IRB Approach. Since this was not the case with HSH Nordbank Group until January 1, 2008, the first disclosure will be reported for December 31, 2008.

5.9.3 Structure of internal rating systems and internal allocation of exposures or obligors to rating classes or risk pools and external credit ratings

In cooperation with nine federal state banks (project of the Landesbanken) rating procedures based on scorecards and simulations were developed at an early stage for the individual portfolio segments. This cooperation between the federal state banks led in 2003 to the founding of the RSU Rating Service Unit GmbH & Co. KG (RSU). Since 2004 it has assumed responsibility for the methodical maintenance and development of the rating systems. The individual federal state banks provide their expertise in the form of competence or support centres. Currently 12 of the rating modules developed by the participating banks are provided by the RSU. In addition, RSU has integrated two rating modules of S Rating und Risikosysteme GmbH, a subsidiary of Deutscher Sparkassen und Giroverband (DSGV), into the central LB-Rating application.

Rating methods

The rating procedures distinguish between scorecard and cash flow approaches. The scorecard approach identifies characteristics and factors that are able to differentiate between good and bad borrowers. Their validity is first verified with a single factor model. Subsequently several characteristics, which each have high significance in a single factor model, are combined to create a multi-factor model. The scores determined using the multi-factor model are translated to default probabilities. A precondition for the application of a scorecard approach is that a sufficient number of relatively homogeneous borrowers is available.

The cash flow approach simulates cash flows of the object in various scenarios. These vary depending on macro-economic and sector-based conditions. An simulation engine is used to create numerous scenarios which differ according to macro-economic conditions before the data enter the corresponding rating modules. A so-called sector-based model uses these scenarios to calculate scenarios for the future development of sector-related factors, such as rents, vacancies or charter rates. The values are then input to the calculation of scenarios for the cash flow of the corresponding asset. Subsequently scenarios are selected where the borrower must be considered to be defaulting. The default probability is calculated as a ratio from the number of scenarios where a default was recorded to the total number of scenarios.

Qualitative factors as well as quantitative factors are used both for the scorecard and for the cash flow approaches. When these factors have been included, it is possible to overwrite these data. The options to overwrite data in order to improve the rating are limited. The options to overwrite data and thus to deteriorate the rating are unlimited. Warning signals and the Group background are then incorporated. Only when all these aspects have been included can this lead to the final rating result, the local currency rating (LCR). The result is an individual PD for each borrower and hence an allocation to an actual credit rating class. In addition to the default risk of the borrower, risks of foreign currency transfer limitations must also be considered when measuring the credit risk.

The rating result is calibrated on a standard rating master scale. This master scale is the DSGV master scale which contains 22 living and 3 default categories. Each rating class on the rating master scale is assigned a 1 year default probability. This standard rating scale allows for immediate comparison of exiting ratings separately from the portfolio segment. The scale also includes mapping of external ratings to the internal categories.

The rating modules and methods used within HSH Nordbank Group for purposes of equity capital reporting as at the reporting date are presented in Table 30. The rating module leveraged finance is also presented with which LBO financing has been rated since the first quarter of 2009 in order to determine equity capital backing within the advanced IRB approach.

Borrower, economic risk bearer, asset or project	Rating module	Rating methods
Companies	Corporates Sparkassen-StandardRating	Scorecard
Real estate	Sparkassen-ImmobiliengeschäftsRating Internationale Immobilienfinanzierungen	Cash flow
Ships	Ship financing	Cash flow
Banks	Banks	Scorecard
Insurance companies	Insurance companies	Scorecard
International regional authorities	International regional authorities	Scorecard
Leasing companies SPC real estate leasing	Leasing	Scorecard with cash flow component
Projects	Project financing	Cash flow
LBO financing	Leveraged finance	Scorecard
Individuals, self-employed, craftsmen, corporate clients	Sparkassen-StandardRating or Sparkassen-ImmobiliengeschäftsRating (depending on the prim origin of capital)	Scorecard or cash flow
States	Country and transfer risk	Scorecard
DSGV guarantee system	DSGV guarantee system	Scorecard with simulation part

Table 30: Rating modules of HSH Nordbank Group approved by the supervisory authorities

The federal state banks participating in the development of rating procedures are divided into competence and support centres and participants. The competence centre bank assumes the lead for the development and maintenance of modules where it can offer special expertise. It is supported by experts from the support banks while the remaining banks act as participants (collaborating indirectly). HSH Nordbank has the main responsibility for the rating modules Ships, Leasing and Leveraged finance and is also co-responsible for the modules International real estate financing and Country and transfer risk. HSH Nordbank collaborated in the development of a rating module for loan financing for funds in 2008 within the RSU group. The module was implemented at HSH Nordbank at the beginning of 2009 for internal management purposes.

Rating classification per the masterscale rating	Moody's	S & P	Fitch
1 (AAA)	-	-	-
1 (AAA)	Aaa, Aa1	AAA, AA+	AAA
1(AA+)	Aa2, Aa3	AA, AA-	AA+, AA
1(AA)	A1	A	AA
1(AA-)	-	-	-
1(A+)	A2	A	A
1(A)	A3	A	A
1(A-)	-	-	-
2	Baa1	BBB+	A
3	Baa2	BBB	BBB+
4	Baa3	-	BBB
5	-	BBB-	-
6	Ba1	BB+	BBB-
7	Ba2	BB	BB+
8	-	-	BB
9	Ba3	BB-	BB-
10	B1	B	-
11	-	-	B
12	B2	B	B
13	-	-	-
14	B3	B	B
15	Caa1 – Caa3	CCC+ - C	CCC+ - C
16 - 18	Default rating	Default rating	Default rating

Table 31: Internal allocation of exposures and obligors to rating classifications and external ratings

LGD method

The method to ascertain LGDs was developed successively for each rating segment. Estimation methods for borrower-specific recovery rates specific to assets and for collateral-specific recovery rates specific to borrowers (recovery from the insolvency assets) are used. The LGD is determined using the current data from the upstream systems.

When determining LGD (overall LGD) three possible default scenarios are considered. In addition to processing, restructuring of the defaulted commitment is possible. In the best case scenario recovery is possible. LGD estimation is based on observation of the workout case. In order to draw up a forecast for the loss ratio, the proceeds of sale of securities (product of the market value of the covered item and borrower-specific recovery rate specific to assets) and proceeds from the assets (product of non-collateralised exposure and collateral-specific recovery rate specific to borrowers) are used.

The models are based on historical loss events recorded in the Credit Loss Database (CLD) and analysed using statistical and econometric procedures. Based on historic default data, macro- and micro-economic factors were identified for the LGDs as a basis to develop models for forecasting the loss ratios for future loss events. In accordance with a requirement of the German Solvency Regulation the effects of an economic downturn were incorporated and so-called downturn LGDs developed. In addition information from external studies was used as a benchmark.

CCF methods

In contrast to balance sheet assets, where the future exposure can be derived from loan agreements, in the case of receivables from classic transactions not included in the balance sheet the exposure at default (EaD) must be determined using a credit conversion factor (CCF). HSH Nordbank estimates this internally. The downturn CCF is also determined, similar to the LGD method.

For transactions with unlimited future absorption different product categories and hence varying estimation procedures for the CCF are used.

When implementing guarantee facilities the CCF is calculated from the ratio of the increase in the drawdown in the year before the default and the open guarantee line. For guarantees the CCF is calculated from the ratio of the discounted drawdowns (for the default date) and the amount of the guaranteed loan. Number-weighted averages are used to calculate the individual product categories.

5.9.4 Internal process for allocation of exposures or obligors to rating classes or risk pools divided according to receivables categories

The rating process is divided into creation and determination processes. Ratings are always created by the market BU responsible. The BUs Credit Risk Management or Group Risk Management are responsible for approval of the rating.

The Rating Guideline contained in the Credit Manual stipulates for all receivables categories that – except for the retail portfolio and risks with an overall credit volume of the borrowing entity under EUR 750,000 –which are not included in the retail definition – internal rating procedures (approved by the supervisory board) shall be applied in all cases. An individual rating must be created:

for borrowers, bearers of economic risk (TWR), rating issuers (for special financing projects: for the item or the project). This applies also to the purchase of receivables without recourse;

for persons who act exclusively as support in the scope of the rating modules;

as a precondition in order to include specific securities (e.g. personal security) provided as a risk reduction to the benefit of HSH Nordbank.

Each borrower subject to rating is given only one rating for LCR and, if need be, FCR. The LCR determines the counterparty default risk without considering a foreign currency transfer risk. The foreign currency transfer risk is incorporated when the FCR is determined.

The exact triggers for the rating are also specified in the Credit Manual. Each rating must be updated by the originating BU, including risk aspects – but at the latest within twelve months – and verified and confirmed by the non-markt unit. Special risk aspects which require updating before the end of the 12 month period are specifically:

significant expansion of the counterparty default risk,

knowledge of significant new risk-related information

commitments where a currency transfer risk exists if the risk country migrates to rating class 9 or worse

defaults and recoveries.

The Working Instructions Credit Manual explain the requirements for creating a rating unit. It sets out when the rating of the legal borrower is waived as part of the rating and the loan decision process and the rating of the TWR and/or the rating donor is to be applied instead.

Exposures without an internal rating are handled within CRSR (see chapter 5.5.1).

In order to ensure comprehensive rating creation for exposure, where risk classification is required by Basel II, the Bank disposes of process quality controlling (PQC) and data quality management (DQM).

In principle the allocation of IRBA exposures and obligors to the IRBA receivables categories and the internal rating procedures is carried out in accordance with the Credit Manual with further reference to specific explanations on the scope of the individual rating modules and processes.

IRBA exposures and obligors are allocated to IRBA receivables categories or IRBA exceptions based on a customer systematic key in accordance with Section 70 (1) SolvV. The customer system encodes the business partners according to various characteristics. The most important are: entity groups (banks/public authorities/companies and organisations), location of the entity (domestic or foreign location according to the country list of the German Bundesbank, industry and legal form and differentiation between economically independent and economically dependent entities.

Specific models are developed for the various rating segments in order to determine the collateral-specific recovery rate for the non-collateralised part of the EaD. Therefore the allocation of an obligor to the various partial LGD models is based on the allocation performed as part of a rating procedure. The CCF is selected according to the product so that an allocation to rating systems is not required.

Retail banking

HSH Nordbank Group leaves receivables from retail banking in the permanent CRSA.

Participation exposures

Participations which are covered by the grandfathering regulation and hence receive a risk weighting of 100 % within the CRSA do not require an individual rating until December 31, 2017. However, ratings must be created for exposures entered into as of January 1, 2008. In accordance with an agreement in the IRBA expert committee, the rating procedures used for credit default risks can also be used for participations. Hence a separate system is not required for participation ratings. In individual cases – e.g. private equity participations – the simple risk weighting method is applied. This means the risk weights are allocated as stipulated by the supervisory authority.

For investments in funds and the underlying risk of near-fund listed certificates in the banking book the risk weighting and expected loss is determined using the ”look-through treatment” as described in Section 83 SolvV. If this is not possible, an assessment of the underlying assets, does HSH Nordbank use a risk weighting of 370%.

5.9.5 Control mechanisms for reviewing the rating system

A validation of all rating modules and of the LGD and CCF models of HSH Nordbank is performed annually in the sense of Section 106 Sentence 2 No. 5 and Section 147 SolvV. Validation of a rating module means a verification of the accuracy of forecasts and the selectivity of the rating module. This includes the following steps:

analysis of the portfolio and market development (e.g. description of the portfolio according to region and relevant customer types)

analysis of rating distributions

backtesting (comparison with actual default rates) and/or benchmarking (comparison with external ratings)

calibration (verification of the extent of allocated default probabilities)

examination of selectivity (ability of the rating module to differentiate between good and bad borrowers)

review of the model structure and design (e.g. significance and weighting of individual factors and partial models, inclusion of supporters, analysis of the frequency data were overwritten and the reasons for it, inclusion of the transfer risk)

examination of the application of ratings (e.g. analysis of data quality, verification of standard application within the framework of duplicate analyses)

The process of validation involves three steps:

The first step involves validation based on the pooled data of all federal state banks and/or federal state banks and savings banks under the lead management of the RUS and/or S Rating. Data are pooled specifically to create the largest possible and hence statistically most significant database. In cooperation with the relevant Competence Centre and relevant Support Centre, RSU performs the validation and, if necessary, the recalibration and further development of the modules on the basis of the pooled data. For the DSGV modules, pooling is carried out on the basis of data from participating savings banks and participating federal state banks. Updating is performed by S Rating und Ratingsysteme GmbH.

Since validation is performed on the basis of the pooled data, proof must be provided that the results are transferable to HSH Nordbank Group. This is done in a second step in collaboration with RSU and/or S Rating und Ratingsysteme GmbH.

In a last step further internal analyses to complete the validation and proof that the rating modules are suitable for use at HSH Nordbank are performed.

The role of HSH Nordbank during the updating phase on the basis of the pooled data depends on whether it has assumed one of the functions of Competence and/or Support Centre in respect of the module in question.

The LGD and CCF methods are also validated annually in accordance with the provisions of the German Solvency Regulation, similar to validation of the rating modules. Until 2008 the validation procedures were carried out internally. Since January 1, 2009 at the time HSH Nordbank has transferred the LGD and CCF methodology to RSU the processes for validation are also cariied out at RSU.

A similar procedure exists for DSGV modules in collaboration with S Rating.

5.9.6 Utilisation of internal estimates for purposes other than determination of risk weighted exposure in accordance with IRBA

HSH Nordbank Group uses parameters determined internally in many areas of the Group. For example, all risk parameters EaD, PD, LGD and CCF are used actively for the overall management of the Bank. The risk parameters in particular are embedded into risk-adjusted pricing of loan applications, the procedure to create loan loss provisions and determination of expected risk costs and limitation. With their inception the rating systems and the corresponding risk parameters are used in the following steering systems of the Bank:

- loan approval procedures / determination of competences
- pre- and post-calculation of individual transactions
- limitation
- reporting
- commitment monitoring
- intensified loan management/restructuring process

In addition the parameters are used for ongoing scenario calculations and in the planning and strategy process.

5.9.7 Exposure values according to rating ranges (excluding retails banking) under IRBA

The rating results determined using the rating modules described above are calibrated to a standard rating scale, whereby rating classes 16 to 18 represent default classes. The individual rating classes are summarised in seven Rating ranges for greater clarity. Since a large part of receivables has a good rating and fewer receivables are included in the lower rating classes, a finer division of Rating ranges has been performed for the high quality rating classes. As at the period date the distribution shown in Table 32 was reported in accordance with Section 335 (2) SolvV.[3] The exposure value, the average default probability (∅ PD), the average LGD (∅ LGD) and the average risk weighting (∅ RW) within the rating ranges for the individual receivables categories are reported. All facts presented pursuant to Section 335 (2) SolvV comply with the circular of the Federal Bank B 40-5 / B 410-1 65.2.229.13 with regard to the details in the report sheets.

[3] Securitisations are not included in Table 30, Table 31 or 32 since they are reported separately (see Chapter 5.7). In the case of participation instruments only participations in the PD-LGD approach are used. The overall long-term participation portfolio is explained in more detail in chapter 5.8.

Receivables class	∅ PD in %	∅ LGD in %	∅ RW in %	Exposure value
Rating range 1: 1(AAAA) – 1(AA+)				
Central governments	0.0	21.8	0.2	17,990
Institutions	-	-	-	
Companies	-	-	-	-
Participation exposures[1]	-	-	-	-
Subtotal	0.0	21.8	0.2	17,990
Rating range 2: 1(AA) – 1(A-)				
Central governments	0.1	20.5	14.5	1,410
Institutions	0.0	22.4	10.4	24,925
Companies	0.1	31.8	18.7	26,959
Participation exposures[1]	0.1	69.9	74.9	56
Subtotal	0.0	27.2	14.9	53,349
Rating range 3: 2 – 6				
Central governments	0.3	24.3	42.1	374
Institutions	0.2	19.8	21.3	4,195
Companies	0.3	34.4	46.0	51,602
Participation exposures[1]	0.4	84.7	161.1	64
Subtotal	0.3	33.3	44.2	56,234
Rating range 4: 7 - 8				
Central governments	1.3	50.3	132.8	2
Institutions	1.0	28.0	74.4	231
Companies	1.1	33.8	78.7	11,483
Participation exposures[1]	1.3	65.0	199,2	82
Subtotal	1.1	33.9	79.5	11,798
Rating range 5: 9 - 11				
Central governments	3.0	43.7	128.0	63
Institutions	2.8	25.5	78.6	238
Companies	2.7	35.6	107.6	11,005
Participation exposures[1]	2.0	65.0	224.1	19
Subtotal	2.7	35.4	107.3	11,325
Rating range 6: 12 - 15				
Central governments	11.7	38.1	209.7	42
Institutions	12.9	21.8	102.0	599
Companies	13.0	39.8	193.2	4,962
Participation exposures[1]	20.0	68.8	427.0	27
Subtotal	13.0	38.0	184.8	5,631
Rating range 7 (Default): 16 - 18				
Central governments	100.0	23.0	37.5	13
Institutions	100.0	17.1	28.0	1,133
Companies	100.0	42.5	69.4	3,607
Participation exposures[1]	100.0	65.0	106.0	0
Subtotal	100.0	36.4	59.4	4,753
Total[2]				
Central governments	0.1	21.9	2.9	19,894
Institutions	4.0	22.0	15.4	31,321
Companies	4.4	34.4	56.5	109,617
Participation exposures[1]	2.3	69.1	193.5	249
Total	3.8	30.4	42.0	161,081

[1] Only participations under the PD-LGD approach; with regulatory LGD of 65% or 90%; CCF = 100%

[2] The differences in amounts are due to rounding off of figures

Table 32: ∅ PD, ∅ LGD, ∅ RW and exposure values in € m according to rating ranges (without retail banking) under the Advanced IRB Approach

5.9.8 Undrawn loan commitments and average exposure values under IRBA

Based on the rating ranges described above the assessment basis for undrawn loan commitments and the average exposure values weighted by commitment for each portfolio are given in Table 33.

Receivables class	Central govern-ments	Institutions	Companies	Participation exposures[1]	Total[2]
Rating range 1: 1(AAAA) – 1(AA+)					
Basis for evaluation of loan commitments	867	-	-	-	867
Basis for evaluation of non-derivative assets not reported in the P&L	41	-	-	-	41
∅ Exposure value of loan commitments	27	-	-	-	27
∅ Exposure value of non-derivative assets not reported in the P&L	6	-	-	-	6
Rating range 2: 1(AA) – 1(A-)					
Basis for evaluation of loan commitments	0	746	4,214	-	4,961
Basis for evaluation of non-derivative assets not reported in the P&L	45	508	1,308	-	1,862
∅ Exposure value of loan commitments	0	8	10	-	9
∅ Exposure value of non-derivative assets not reported in the P&L	25	14	46	-	37
Rating range 3: 2 - 6					
Basis for evaluation of loan commitments	0	212	14,693	-	14,905
Basis for evaluation of non-derivative assets not reported in the P&L	36	131	4,815	-	4,983
∅ Exposure value of loan commitments	0	58	17	-	18
∅ Exposure value of non-derivative assets not reported in the P&L	13	39	59	-	58
Rating range 4: 7 - 8					
Basis for evaluation of loan commitments	0	3	2,912	-	2,915
Basis for evaluation of non-derivative assets not reported in the P&L	1	19	841	-	862
∅ Exposure value of loan commitments	0	0	8	-	8
∅ Exposure value of non-derivative assets not reported in the P&L	0	10	13	-	13
Rating range 5: 9 – 11					
Basis for evaluation of loan commitments	36	0	2,753	-	2,789
Basis for evaluation of non-derivative assets not reported in the P&L	3	3	685	-	690
∅ Exposure value of loan commitments	26	0	14	-	14
∅ Exposure value of non-derivative assets not reported in the P&L	1	0	14	-	14
Rating range 6: 12 – 15					
Basis for evaluation of loan commitments	0	0	925	-	925
Basis for evaluation of non-derivative assets not reported in the P&L	30	0	361	-	390
∅ Exposure value of loan commitments	0	0	36	-	36
∅ Exposure value of non-derivative assets not reported in the P&L	6	0	76	-	71
Rating range 7 (Default): 16 - 18					
Basis for evaluation of loan commitments	18	51	693	-	762
Basis for evaluation of non-derivative assets not reported in the P&L	0	0	129	-	129
∅ Exposure value of loan commitments	13	16	19	-	19
∅ Exposure value of non-derivative assets not reported in the P&L	0	0	4	-	4
Total[2]					
Basis for evaluation of loan commitments	921	1,013	26,190	-	28,124
Basis for evaluation of non-derivative assets not reported in the P&L	155	662	8,139	-	8,956
∅ Exposure value of loan commitments	27	19	15	-	16
∅ Exposure value of non-derivative assets not reported in the P&L	13	19	48	-	45

[1] Only participations under the PD-LGD approach; with regulatory LGD of 65% or 90%; CCF = 100%

[2] The differences in amounts are due to rounding off of figures

Table 33: Undrawn credit commitments and non-derivative off-balance sheet assets under the Advance IRB Approach in € m

In the case of investment funds and listed certifications purchased by HSH Nordbank Group and included under the advanced IRB approach using the look-through approach (Section 83 (4) SolvV), an average risk weighting is determined mostly based on information provided on a regular basis by the capital investment companies. It is not possible to include this in the rating ranges, therefore disclosure of participation exposures contained in the investment funds or listed certificates is made by means of Table 34.

	Participation exposures contained in investment funds or listed certificates	
Risk weight range	**Exposure value**	**Equity required under IRBA**
0 ≤ 10%	-	-
>10 ≤ 20%	-	-
>20 ≤ 50%	-	-
>50 ≤ 100%	-	-
>100 ≤ 350%	**35**	**8**
>350% ≤ 650	**170**	**50**
>650% > 1250	-	-
1,250% / capital deduction	-	-
Total[1]	205	59

[1] The differences in amounts are due to rounding off of figures

Table 34: Exposure values and capital requirements for investment funds and listed certificates under the Advanced IRB Approach in € m

5.9.9 Loss estimates and actual losses in the lending business (IRBA)

Table 35 shows a comparison of loss estimates with actual losses in the lending business in accordance with Section 335 (2) No. 6 SolvV. Loss estimates correspond to the expected loss (EL) after minimisation of the credit risk. The EL for non-defaulting risk assets of the traditional lending business is reported (e.g. without securities of the banking book and without derivatives). Actual loss is defined as follows:

Utilisation of SSLP (for balance-sheet transactions)

\+ Utilisation of allowances (for loan commitments and off-balance sheet assets)

\+ direct write-offs

./. recoveries on receivables written off

= actual loss in the credit business

Since this disclosure is being made for the first time, no history is presented.

	Loss in year under review	
Receivables class	**Estimated loss (EL)**	**Actual loss**
Central governments	**1**	**-**
Institutions	**17**	**0**
Companies	**395**	**67**
Participation exposures[1]	**1**	**-**
Total[2]	414	68

[1] Only participations under the PD-LGD approach; with regulatory LGD of 65% or 90%; CCF = 100%

[2] The differences in amounts are due to rounding off of figures

Table 35: Expected losses and actual losses in the lending business in € m

In the reporting year the loss was heavily influenced by the crisis affecting the financial markets. Losses were incurred, for example, through corresponding impairments or corrections that had a negative effect on the results or equity capital. This was caused primarily by deterioration/downgrading of the credit ratings particularly for the portfolios Shipping, Industry and Credit Investments. In addition the Bank recorded defaults on receivables for loan commitments for banks as a result of the distortion of the market. This was particularly significant for the commitments to Icelandic banks and the crash of one of the trading partners of HSH Nordbank, the US bank Lehman Brothers.

5.10 CREDIT RISK MITIGATION TECHNIQUES

5.10.1 Strategy, procedures and scope of balance sheet and off-balance sheet netting agreements

Banks are able to utilise netting agreements when determining their required equity capital which lead to a reduction in the evaluation basis and hence of the equity capital required.

In contrast to balance sheet netting[4] which is not used by HSH Nordbank, off-balance sheet netting within the framework of neeting agreements for derivatives is applied (see Chapter 5.6.6). The market assessment method is used to determine the required net assessment basis. As at the reporting date HSH Nordbank Group recorded a counterparty default risk exposure to the amount of EUR 10.8 billion (see Table 19, page 31).

5.10.2 Processes for management and approval of credit risk mitigation techniques

The Collateral and LGD Guideline issued by the Management Board defines the collateral approved by HSH Nordbank as recoverable and hence minimising default risk as well as the qualitative requirements for such collateral. Hence it also defines the benchmarks for collateral management within HSH Nordbank Group and is supplemented by detailed instructions in the process regulations for the lending business in order to ensure comprehensive collateral management. The provisions of the SolvV are an integral part of the Collateral Guideline.

Qualitative requirements for collateral are in particular legal enforceability (especially for foreign collateral), the absence of a correlation between the creditworthiness of the obligor and the value of the collateral, maturity identity between loan and collateral agreement and the existence of an objective market value.

The Bank has determined collateral-specific recovery rates based on historic realisation cases for such collateral; on this basis approved collateral can be included in the determination of the LGD. The Collateral Guideline specifies which objects (e.g. real estate, movables, receivables) and - in particular for foreign legal jurisdictions - which security instruments (such mortgage or assignment) are generally recognised. Furthermore the relevant Market-BU should ensure that in addition to the collateral agreement the individual item of collateral also meets the requirements with regard to enforceability and recoverability. In risk-relevant lending activities the recoverability of the individual collateral is checked as part of the second risk assessment.

The decision whether an asset or collateral instrument can be recognised as minimising risk is taken by a team of specialists from the BUs Credit Risk Management, Finance, Group Risk Management, Legal and Group Compliance together with the market unit.

5.10.3 Strategy and procedures for assessing and managing collateral

The assessment and management of collateral is integrated in the process to manage and approve credit risk minimisation techniques. Since the SolvV is the basis for the Collateral Guideline, for determining equity capital required collateral is only approved as minimising risk if all requirements of the SolvV are fulfilled.

An objective market value must be determined for all collateral to be approved as minimising risk. The determination of the relevant market value of collateral is undertaken on the basis of the valuation guidelines of the Bank by market-independent experts and/or is verified and confirmed by a market-independent body. The reliability of collateral value is ensured by the fact that it is recognised as risk-reducing only up to the level of the applicable collateral-specific recovery ratio. The legal validity and enforceability of the collateral is determined when formulating the loan and collateral agreements. There is a standard instruction to perform regular monitoring and revaluation of collateral: Collateral must be reviewed annually and every three years a review and revaluation of the market value for individual collateral is required. The collateral value for individual types of collateral is reviewed and revalued annually (e.g. ships). Approved collateral is recorded and maintained in a central collateral system. This system allows for regular reporting on collateral monitoring and evaluation. The recoverability and realisation possibilities for collateral are

[4] P&L netting is understood as eligibility agreements on reciprocal monies due and monies owed, netting for non-derivative transactions with subsequent collateral contributions and cross-product eligibility (using the Internal Model Method).

reviewed regularly as part of the standard loan monitoring process and when major fluctuations in the market occur.

If the collateral rights are permanently impaired, e.g. due to a decline in value or a changed legal position, an injection of collateral should be sought and/or a credit monitoring form produced in accordance with the standards of the Credit Commitment Monitoring Guidelines. In the event of default by a borrower, all collateral and, if necessary, further collateral of an affected borrower entity should be revalued. All relevant information on collateral is documented and updated in the IT system. Only collateral recognised as guideline-compliant and updated accordingly continues to be used in the Bank's management systems.

Specialists from non-market units are available for timely and competent realisation of collateral should a borrower default. Experience gained in the realisation of collateral is used to optimise the collateral management.

5.10.4 Material collateral

HSH Nordbank considers all collateral listed in the SolvV (financial collateral, guarantees, physical collateral, other IRBA collateral and eligibility agreements). In view of the portfolio and customer structure of HSH Nordbank essentially the following collateral is available:

real estate and moveables such as ships, aircraft, rail vehicles.

claims and receivables

pledges and guarantees

In addition, securities, equity interests, gold and sometimes also loan derivatives may service as collateral. Collateral can only be included in the determination of the LGD if its minimising effect on risk has not been used for the rating determination (PD). For example this means that a contract of guarantee/surety or an assignment of receivables that has already been taken into account in the rating tool or in the rating of the warrantor, guarantor/assignee as the bearer of economic risk can no longer also be accounted for as risk-reducing collateral.

5.10.5 Guarantors and counterparties for loan derivatives and their creditworthiness

If a pledge/guarantee (or a loan derivative) is to be recognised as risk-reducing collateral, an internal rating of the warrantor/guarantor must be available which is comparable with at least BB- from Fitch or S & P or Ba3 from Moody's.

In HSH Nordbank Group the main types of guarantors are primarily guarantees from central government, domestic regional authorities, banks and holding companies with first-class creditworthiness. Counterparties of loan derivatives are primarily internationally active (investment) banks or German federal state banks.

5.10.6 Market or credit risk concentration within collateral instruments

Management of potential concentration risks from eligible collateral is done related to portfolios at overall bank level, e.g. by reporting and monitoring these risks in the Risk Report. In addition it is integrated in strategic planning and limitation, since business field-related planning and limitation at the same time limits the collateral typically associated with that type of business (in particular asset collateral such as ships).

5.10.7 Overall amount of collateralised CRSA and IRBA exposure values

The following two tables show the extent of the credit risk minimisation techniques under the CRSA or Advanced IRB Approach per receivable class in accordance with Section 336 (2) SolvV. Securitisations are not included since these are shown separately (see chapter 5.7). For CRSA both financial and physical collateral as well as guarantees are included. The Advanced IRB Approach includes financial, physical and other collateral for determining the LGD. Guarantees and loan derivatives can either be included when determining the LGD or via so-called PD substitutions. The collateralised part of receivables is given the PD as guarantor. However, collateral used to calculate the PD is not reported here.

Receivables class	Financial collateral	Other and physical collateral	Guarantees/ derivatives
Central governments	-	-	-
Regional governments	-	-	-
Other public sector entities	-	-	-
Multilateral development banks	-	-	-
International organisations	-	-	-
Banks	0	-	-
Collateralised notes issued by banks	-	-	-
Companies	786	-	50

Receivables class	Financial collateral	Other and physical collateral	Guarantees/ derivatives
Retail banking	27	-	10
Items collateralised by real estate	-	1,558	-
Investment shares	-	-	450
Participations	-	-	-
Other items	-	-	-
Overdue items	36	130	1
Total[1]	848	1,688	511

[1] The differences in amounts are due to rounding off of figures

Table 36: Total amount of collateralised CRSA exposure values (without securitisations) in € m

Receivables class	Financial collateral	Other and physical collateral	Guarantees/ derivatives
Central governments	42	1	
Banks	530	311	
Retail banking	-	-	
Participations	-	-	
IRBA participation portfolio, based on default probability	-	-	
IRBA participation portfolio, model based	-	-	
IRBA participation portfolio, evaluated with single risk weighting	-	-	
Companies	5,773	39,530	1,629
Other assets not related to loans	-	-	
Total[1]	6,345	39,841	1,629

[1] The differences in amounts are due to rounding off of figures

Table 37: Total amount of collateralised IRBA exposure values (without securitisations) in € m

6 MARKET RISK INCLUDING INTEREST RATE RISK

Market risks entail potential losses that may result from detrimental changes in the market value of HSH Nordbank's positions in the trading and banking book. Among the market movements of relevance to the Bank are fluctuations in interest rates and credit spreads (interest rate risks), exchange rates (foreign exchange risks), stock prices, indices and fund prices (equity risks), and commodity prices (commodity risks), including the volatility of these.

6.1 ORGANISATION OF MARKET RISK MANAGEMENT

The Management Board stipulates the methods and processes for measuring, limiting and managing market risk, and budgets an overall share of the global limit for market risks. As part of this loss ceiling, the risk arising from all transactions exposed to market risk is restricted by means of a dynamic system of loss and risk limits.

Market risk is managed directly in the Financial Markets & Institutions segment. Selected strategic positions exposed to market risks are managed by the Asset Liability Committee. Daily market risk reports ensure that the Management Board and the trading units are kept constantly informed of the level of exposure to market risks and the current limit utilisation.

In accordance with MaRisk requirements, the organisational separation of market risk controlling, settlement and monitoring on the one hand and the trading units responsible for the positions on the other is ensured at all levels. All the key methodological and operational tasks relating to risk measurement and monitoring are grouped together under the auspices of the BU Group Risk Management.

HSH Nordbank Securities S.A. is identified as a subsidiary that must be included in the Group-wide market risk controlling process. The process of limiting and monitoring risks is carried out centrally by HSH Nordbank AG. Until the beginning of 2008, market risk was measured locally in the subsidiary's risk controlling unit. Since February 2008, the market risks of HSH Nordbank Securities S.A. have been calculated on a uniform basis within the Group parent company as part of the Group's risk measurement process.

6.2 MARKET RISK MANAGEMENT

The basis of HSH Nordbank's system for measuring and managing market risk is a Value-at-Risk approach. The market risk of a position is the loss in value (in Euro) which, with a defined probability, will not be exceeded within a defined period until the position is hedged or liquidated.

Within the Bank, Value-at-Risk (VaR) is calculated using historical simulation methods. Group-wide, calculations are based on a confidence level of 99 % and a holding period of one day over an observation history of 250 trading days of equal weighting.

The most significant market risks for HSH Nordbank are interest rate risk and foreign exchange risk. Besides these risk types, HSH Nordbank's Value-at-Risk also covers equity and commodity risks, both for the trading book and the banking book. The individual market risk types are not capped by separate limits, but risk limitation is effected by the VaR limit for the Bank's overall market risk. The Value-at-Risk is limited for the various different reporting units in order to manage the market risks. There are clearly defined processes for adjusting and exceeding limits.

Market risks from the lending business and from the Bank's liabilities are transposed to the trading divisions and considered as part of the corresponding risk items. They are steered there as a part of active portfolio management and are hedged through external transactions.

In the year under review the risk measurement process for credit spread risks was developed further to complement the existing VaR methodology. Furthermore in 2009, credit spread risks are to be integrated into daily market risk limitation and reporting and their measurement methodology will be developed further, especially in relation to securitisation items. The credit spread of a bond is a premium for the default risk of an issuer. Credit spread risk refers to the danger that the value of a position may rise or fall as a result of a change in the spread. Credit spread risks are monitored with the aid of scenario analyses within the credit investment portfolio. The Management Board and the Risk Committee are informed of the results of the analyses on a regular basis.

In the context of the current capital market situation, the Bank has analysed the basis spread risks in its swap positions. Basis spread risk refers to the risk caused by market imperfections resulting from differing payment frequencies and reference interest rates on the variable part of swaps. This risk, which had been fairly negligible for the Bank until the current crisis, increased substantially on the back of the turmoil in the capital markets in 2007, during which basis spreads have widened significantly. The complete discontinuation of the relevant swap positions meant that, from the end of the first quarter of 2008, there was no longer any need to continue to calculate the VaR premium to account for this risk. A project was initiated in the year under review to integrate basis spread risks into market risk measurement, and this is due to be completed in 2009.

Backtesting

The Bank performs regular backtesting to verify the appropriateness of the Value-at-Risk forecasts. This involves comparing the theoretical daily profit / loss derived from the market performance observed on the following day with the Value-at-Risk figures for the previous day as forecast using historical simulation, assuming unchanged positions. The results of backtesting are taken into account in the ongoing development of the Bank's Value-at-Risk methodology.

Stress tests

In addition to the limit-based management of daily Value-at-Risk, regular stress tests are also carried out to determine the impact of extraordinary market fluctuations on the value of the Bank's positions.

As part of the stress tests the main risk factors are varied specifically (e.g. according to currency and maturity), in particular for the interest rate risk and foreign exchange risk. At the end of 2008, the scenario of positive interest rate movements demonstrated a potential loss of EUR 59 million. The scenario of falling exchange rates resulted in a potential loss of EUR 100 million.

Furthermore separate stress tests are performed for securities, raw materials and volatility, whereby specific shifts are used as a basis for the most important risk factors. In the year under review the stress tests were expanded to include further parametric and historic scenarios (e.g. September 11th, 2001).

Furthermore a special analysis of the interest rate risks in the banking book was performed for regular changes in cash value in a stress scenario (see below).

Noticeable impact of financial crisis on the risk situation of HSH Nordbank

In the course of the financial crisis, the disappearance of entire business models/segments used by US-investment banks, and in particular after the insolvency of Lehman Brothers the markets were characterised by significant higher volatilities. As a result, this development lead to an increase in economic market risk in the year under review. Related to this, due to diverse market turmoils until then insignifcant risks (e.g. basis spread risks) to HSH Nordbank increased considerably which put market risk positions under additional pressure. A further effect from the securitisation crisis was a sharp decline in market prices to the point of an entire absence of market transactions/sale of securitised assets.

Counteractive measures taken by HSH Nordbank were the slowdown and/or cessation of (new) business transactions. In addtion the instruments for monitoring and measuring risks were further developed in particular for the integration of basis spread risks as well as the enhancement and assessment of market price stress tests.

Already in 2007, the sub-prime crisis with its origins in the US-real estate sector resulted in writedowns due to declined market prices for sub-prime bonds and structured credit investments.

The collapse of Lehman Brothers and the banking sector in Iceland put further pressure on HSH Nordbank. This lead to considerable writedowns on the Bank's investment portfoilio whereas HSH Nordbank began in 2008 to wind down its credit investment portfolio as market conditions permit and in such a way as to minimise the ensuing losses. Further information with respect to the Credit-Investment-Portfolio are provided in the Financial Stability Forum Report 2008 of HSH Nordbank.

6.3 REPORTS ON MARKET RISK

Reporting on market risk of HSH Nordbank is integrated in the reports on overall risk (see Chapter 4.4). These are supplemented by special market risk reports (see Table 38).

Report	Recipient	Interval	Content	Objective
MaRisk /NPNM report	Overall Management Board, BUs Internal Audit, IT/ Organisation, Group Risk Management	Monthly	Market risk, profit/loss: monthly trend, NPNM status	Management Board information; overview of risk and profit/loss
Monthly market risk report	CRO (Board), BU heads BU Group Risk Manage	Monthly	Market risk development, analysis of market risks acc. to banking book/ trading book, stress tests, backtesting	Market risk reporting to the Management Board (where required with recommendations for action)
Report to the Management Board mar risk	Overall Management Board, BUs Internal Audit, IT/ Organisation, Group Risk Management	Daily	Market risk, profit/loss: daily development	Management Board information, overview of risk and profit/loss, limit utilisation

Table 38: Reports on market risk

6.4 REGULATORY CAPITAL REQUIREMENTS FOR MARKET RISK

HSH Nordbank uses the prescribed Standard Approach for determining the required regulatory capital for market risks. The regulatory capital required as a result of transactions in the trading book on the reporting date is listed in Table 39.

Market risk	Regulatory capital required
Interest rate risk	725
Equity price risk	6
Currency risk	107
Raw materials price risk	19
Other risk	-
Total	857

Table 39: Regulatory capital required for market risks in € m

6.5 INTEREST RATE RISK IN THE BANKING BOOK

Management of interest rate risk in the banking book is part of market risk management. The interest rate risk describes the potential loss of an open interest rate item which occurs as a result of a possible change in market value or cash value of a series of payment due to a potential change in yields and/or discounting factors. Discounting factors are derived from the corresponding yield curve.

The interest rate risk in the banking book is determined from the strategic items held in the bank book of HSH Nordbank without model assumptions. Modelling of early loan repayments due to special repayment and/or termination rights or due to the behaviour of investors for customer deposits is not performed. When loan transactions are concluded with optional components the existing termination rights are reported from the front-office units to the BU Group Treasury and recorded in the trading system. Risk measurement and stress testing are performed by the BU Group Risk Management on the basis of the transactions recorded in the trading and portfolio management systems.

In addition interest rate risk in the banking book has the peculiarity that its management is the responsibility of two units: ALCO defines the amount of the strategic interest rate risk at regular intervals while the BU Group Treasury manages the interest rate risk in the bank book which is derived from the customer business of the Bank (excluding customers of the BU Capital Markets Structuring & Trading). The task of Group Treasury is to bundle interest rate risks and where appropriate to transfer them to the BU Capital Markets Structuring & Trading for strategic reasons so that the latter can unwind the corresponding item.

The interest rate risks in the banking book are measured daily. Risk controlling has been reporting interest rate risks separately in the VaR histories in the banking book since the beginning of 2007. In order to determine the VaR a confidence level of 99%, a holding period of one day and a data history of 250 trading days are used.

In addition to the daily determination of the interest rate risk as part of the VaR calculation, HSH Nordbank measures the interest rate risk throughout the Group in case of an interest rate shock. The Bank uses cash analysis for this special analysis of the interest rate risk for banking book items, i.e. an evaluation is made which cash value changes would occur based on given changes in interest rates. Since January 2008 stress tests are performed monthly with a variation of +130 and -190 base points in all yield curves being performed separately for the banking book. Here the previously parallel move in yield curves is replaced by +/-200 base points and the new regulatory requirements for determining the effects of a sudden and unexpected change in interest rates are implemented in good time for the items in the banking book. HSH Nordbank carries out a large part of its transactions in foreign currencies. Therefore a breakdown according to currency makes sense. Thereby the interest rate shocks are carried out and reported separately for the most important currencies. The remaining currencies are unimportant both for reporting and for cash value purposes and therefore are not reported separately. The values in the year under review have shown that HSH Nordbank Group would always lose considerably less than 20% of liable regulatory capital with an interest rate shock of +130 and -190 base points.

The effects of an interest rate shock of +130 and -190 base points on the reporting date December 29, 2008 in accordance with Section 333 (2) SolvV are shown in Table 40. The overall amount of EUR 163 million and EUR 285 million respectively represents the balance of the cash value caused by the interest shocks for the individual currencies. A parallel shift in all yield curves by +130 and -190 base points results in a change in cash value of EUR 179 million and EUR 325 million correspondingly. The difference between the interest rate shocks for individual currencies and a parallel shift of all yield curves is due to non-linearities in the valuation of foreign currency derivatives.

	Change in cash value	
Interest rate risk	**Interest rate shock +130 base points**	**Interest rate shock -190 base points**
EUR	**-107**	**194**
USD	**36**	**-59**
CHF	**0**	**6**
JPY	**-67**	**108**
GBP	**0**	**0**
DKK	**-28**	**41**
Other	**3**	**-5**
Total[1]	**-163**	**285**

[1] The difference in amounts are due to rounding off of figures

Table 40: Interest rate risks in the banking book in € m

7 OPERATIONAL RISK

HSH Nordbank defines operational risk (OpRisk) as the risk of direct or indirect loss caused by the inappropriateness or failure of the internal infrastructure, internal processes or staff or as a result of external factors. This definition includes legal and reputation risks.

Legal risk includes, amongst other things, the potential liability to fines, penalties or to pay damages similar to fines as a result of complaints against the Bank, due to regulatory actions or out of court settlements. Reputation risk includes the threat to the image of the company and the associated effects on the future development of the financial situation and profitability of the Bank as a result of an operational risk turning into reality.

HSH Nordbank views controlling for operational risks and the promotion of the corresponding risk culture in the Group as an important part of its steering systems in order to meet the challenges of a dynamic business environment, limited possibilities of risk transfer and more demanding requirements of rating agencies and other market players.

7.1 ORGANISATION OF OPERATIONAL RISK MANAGEMENT

As the central monitoring unit the BU Group Risk Management is responsible for the development and implementation of principles and procedures for the identification, analysis, evaluation and monitoring of operational risks. It is responsible for the development and specialist management of controlling instruments, expertise and advice on operational risks, and the promotion of risk culture throughout the Group. Central risk controlling also ensures independent reporting to the management units of the Bank which are responsible for risk management.

Central controlling of operational risks is supported by a decentralised network of experts. All BUs and branches have OR officers and OR assistants who are responsible for maintaining the controlling tools and who act as an interface between central risk controlling and the pertinent BU.

All methods and procedures within the context of controlling operational risks are also employed at the Bank’s locations abroad. The subsidiaries designated as relevant – HSH Nordbank Securities S.A., HSH Real Estate AG, HSH Nordbank Private Banking S.A. and HSH Facility Management Holding AG – are integrated into operational risk from the Group-wide perspective.

7.2 MANAGEMENT OF OPERATIONAL RISK

Operational risks can affect all products, processes and organisational entities. For this reason, particular attention is paid to effective risk awareness so that the expertise possessed by the Bank’s staff can be utilised for identifying operational risks.

Loss event database

Risk events resulting from operational risks are combined for the Bank and the relevant subsidiaries in a central risk event database. The divisions concerned record the risk events locally and forward this data to the central risk controlling unit which checks the data, collates collective risk events, if applicable, and prepares analyses and reports. The results of the analysis of risk events allow preventative steps to be derived. In addition, Internal Audit examines and assesses all the Bank’s activities and processes from a risk-oriented, process-independent perspective, and identifies any measures that can be taken to reduce operational risk.

The central risk event database takes into account all risk events with a gross loss of at least EUR 2,500. A gross loss is the sum of the cash outflow, income foregone and internal resources consumed. The categorisation of risk events makes it possible to systematically analyse the causes of losses and thereby contributes indirectly to the identification of operational risk events.

Since 2006, HSH Nordbank has been participating in the exchange of information on operational risk events as part of the Operational Risk Data Consortium (DakOR) at the level of the Association of German Public Sector Banks (“Bundesverband öffentlicher Banken Deutschlands “ or “VÖB”). The Bank played a key role in the establishment of this pool.

Risk inventory

Since 2005, HSH Nordbank has carried out a Group-wide risk inventory annually. Based on the information about the risk situation of the divisions gained from this inventory, operational risk reporting to the management units is supplemented by the addition of forward-looking risk estimates to encourage the proactive management and monitoring of operational risks.

Legal risks

Pursuant to the SolvV, legal risks also fall under the definition of operational risks. The BU Legal and Group Compliance is responsible for overseeing such risks. All the divisions are given comprehensive advice on legal matters by regularly trained employees to ensure that risks are minimised, contained or prevented. A structured process with clear requirements and responsibilities serves to ensure that the Bank's contracts and agreements are kept up to date.

7.3 REPORTS ON OPERATIONAL RISK

Reporting on operational risk of HSH Nordbank is integrated in the reports on overall risk (see Chapter 4.4). Furthermore the management level is provided with special reports on operational risk and loss events on a regular basis; these are listed in Table 41.

Report	Recipient	Interval	Contents	Objective
Report to persons responsible for interdepartmental issues	BU HR, IT/Org, Leg Group Compliance well as HSH Facility Management Holding AG	Quarterly	Description of all loss events and management measures decided for the pertinent interdepartmental issues: e.g. BU HR will receive all information on losses incurred relation to employees	Creation of transparency, raised risk awareness and information to implement measures to reduce and avoid risk
Report on operational risks	BU heads, heads of foreign branches and subsidiaries	Quarterly	Description of all loss events reported by the field of responsibility incl. the management measures decided on	Creation of transparency, raised risk awareness and information to implement measures to reduce and avoid risk
Report of operational loss events to th Chief Risk Officer	CRO	Monthly	Description of all operational damage reported, information on the management measures decided on	Creation of transparency, raised risk awareness and information to implement measures to reduce and avoid risk
Report of operational loss events to th members of the Management Board	Board members	Quarterly	Description of all loss events reported in the relevant field of responsibility incl. the management measures decided on	Creation of transparency, raised risk awareness and information to implement measures to reduce and avoid risk
Report on risk inventory	Overall Management Board as as well as BU heads, heads of foreign branches and subsidiaries	Annually	Information on identified potential loss incl. the management steps decided on	Identification of operational potential loss and information on management steps decided on

Table 41: Reports on operational risk

7.4 REGULATORY CAPITAL REQUIRED FOR OPERATIONAL RISKS

In order to determine the regulatory capital required for operational risks HSH Nordbank applies the Standardised Approach. On the date of reporting the Group had a regulatory capital requirement to the amount of EUR 291 million.

Operational risk	Regulatory capital required
According to Standardised Approach	**291**
Total	**291**

Table 42: Regulatory capital requirements for operational risk in € m

8 LIQUIDITY RISK

HSH Nordbank divides its liquidity risk into insolvency risk and liquidity maturity transformation risk. Insolvency risk refers to the danger of the Bank not being able to meet its own payment obligations or refinancing requirements as they fall due, or not to the desired extent. Liquidity maturity transformation risk refers to the risk that a loss may occur as a result of the differing fixed-conditions maturities for assets and liabilities, known as liquidity maturity transformation positions, and the fluctuations in the Bank's own refinancing premium. The Bank deploys a variety of instruments to measure, manage and limit its liquidity risks.

8.1 ORGANISATION OF LIQUIDITY RISK MANAGEMENT

The BU Group Treasury division is in charge of liquidity management. This includes ensuring solvency at all times, managing liquidity as a resource within the Bank, and planning refinancing requirements.

The BU Group Risk Management is responsible for methods to measure and limit liquidity risks within the Group. In addition it performs risk measurement and limit monitoring as part of the daily reporting process. This supports the BU Group Treasury in planning liquidity for all maturity ranges and enables it to counter possible risks at an early stage.

Within the Group controlling of liquidity risks HSH Nordbank Securities S.A. is the only relevant subsidiary to be integrated in group liquidity risk observation. Management also includes the special purpose entities Carrera and Poseidon.

The Bank has an emergency plan which contains a catalogue of measures and regulated procedures and responsibilities should a liquidity crisis occur. The Liquidity Policy defines the basic parameters of the Group in dealing with liquidity and the associated risks.

8.2 MANAGEMENT OF LIQUIDITY RISK

Measurement of liquidity risk

To measure the Bank's risk of insolvency and its funding requirements, transactions impacting its liquidity are converted into cash flow figures, and incoming and outgoing payments are assigned to maturity bands to produce a liquidity maturity statement. The difference between incoming and outgoing payments is the liquidity excess or shortfall (gap) in the individual maturity bands. The following serve as a measure of the risk of full or partial insolvency:

- Individual gaps for the first to the 14th day, to show concentrations of outgoing payments, and
- Cumulative gaps from day one to 12 months, to show future liquidity requirements.

Liquidity maturity statements are compiled on a regular basis at the Group level, for the Bank as a whole, for foreign branch offices and for HSH Nordbank Securities S.A. In addition to all balance sheet business, these statements include loan commitments granted, guarantees, transactions with forward value dates and other off-balance-sheet business. Maturity scenarios are used for a number of positions to map economic maturities more effectively. Factors such as possible minimum levels of deposits and current accounts and the realisation periods and amounts of assets are always modelled conservatively. In addition to compiling the liquidity maturity statement in the equivalent of euros, a separate liquidity maturity statement of all business dealings in US dollars is complied on a daily basis, in order to adequately manage the Bank's US dollar position. These liquidity maturity statements are compiled on the basis of a normal-case examination.

Since the autumn of 2008 the crisis in the financial market has worsened. In order to evaluate the main effects of this critical market environment on the liquidity situation of the Group, the Management Board and BU Group Treasury are informed daily of the results of a stress liquidity development report. The stress case includes, for example, the difficult refinancing conditions and further cash flows under worst case scenarios. In addition the liquidity potential offered by ECB eligible marketable assets are taken into account as immediately liquidatable with central banks with certain valuation haircuts applied ("ECB eligible marketable assets measure"). Both parameters combined mean that the liquidity situation in the stress liquidity development report is presented more negatively than in the normal case report.

As a reaction to the liquidity shortage in the markets HSH Nordbank developed a VaR approach for the first time as early as the end of 2007 to quantify the liquidity maturity transformation risk and implemented it on 1 January 2008. This long-term/structural liquidity risk represents the risk of an increase in refinancing costs from open liquidity items. The Liquidity-Value-at-Risk (LVaR) is calculated through historical simulation (confidence level 99.9%) of the liquidity spread and its present value effect on transactions which would theoretically be necessary to be able to close the current maturity transformation item immediately. In doing so it is assumed that these hypothetical closure transactions could actually be effected in the market and that complete refinancing is therefore possible. This model assumption was not fulfilled in part in the year under review. As planned, at the beginning of 2009 the definition of the LVaR was refined based on the data collected in the course of the year under review. Analyses have shown that the maturity transformation risk in the year under review was overestimated by the conservative LVaR approach used. An adjustment was required to represent the actual risk situation of the Bank more accurately. For example, the gaps were closed by utilising the covered funding potential and residua from customer deposits were included.

Limitation and monitoring of liquidity risks

In the context of the risks of insolvency, limits are set both on the individual gaps and the cumulative gaps for the first 14 days. Furthermore, limits are applied to the cumulative gaps for six additional maturity bands of up to 12 months.

The liquidity cover potential is the respective ceiling for the cumulative gaps of the individual maturities and is composed of a securities portfolio which is maintained as a precaution in the event of a crisis (crisis liquidity), additional liquid securities and loan notes on the basis of their convertibility into cash, unsecured funding options and secured potential funding from the issue of Pfandbriefs and central bank-eligible commercial loans. The liquidity cover potential components are examined and validated on an ongoing basis in accordance with internal minimum requirements. To keep the likelihood of the ceilings being used in full or exceeded as low as possible, only 80 % of the available liquidity cover potential is allocated to a limit in each case.

The BU Group Risk Management calculates and monitors the utilisation of the limits every day and reports its findings to the Management Board and to the BU Group Treasury. In the event of limits being exceeded, the BU Group Treasury implements appropriate measures and the BU Group Risk Management monitors the implementation of these measures. In addition, the Management Board and the responsible management units receive monthly aggregate updates on all risk-relevant key figures and developments regarding liquidity gaps.

The Liquidity-Value-at-Risk for the liquidity maturity transformation risks is calculated by the BU Group Risk Management every month and passed on to the Management Board and the responsible management unit. Limitation is implemented at the Group level and is a component of the risk-bearing capacity concept.

Financial market crisis generates ongoing high limit utilisation

The financial markets continued to be plagued by considerable tension in 2008 and highly restrained investor behaviour resulted in very limited refinancing opportunities for much of the year under review. Primarily in the second quarter of 2008, HSH Nordbank was able to exploit temporary signs of slight easing on the markets to effect refinancing activities, primarily with loan notes and private placements with medium-term maturities. The further deterioration in the market situation since September 2008, which was first and foremost triggered by the insolvency of the US investment bank Lehman Brothers, also put considerable pressure on the liquidity situation of HSH Nordbank. The Bank therefore increasingly made use of the liquidity provided by the central banks for short-term maturities in its collateral pool.

In addition, in the year under review the following measures were taken to ensure Group liquidity:

- In November 2008 the Financial Market Stabilization Fund (SoFFin) approved the application of HSH Nordbank for a framework guarantee of up to EUR 30 billion. In December 2008 two tranches, correspondingly guaranteed, with maturities of three and/or six months were issued to the total amount of EUR 10 billion, deposited with the ECB and partially hypothecated.
- Increase in the collateral pool by identifying additional central bank-eligible assets (e.g. commercial loans) and delivery to the relevant central banks
- Increase in the cover pool in order to effect covered issues
- Pricing commensurate with the risks involved and restrictive allocation of loans and irrevocable loan commitments
- Disposal of assets, e.g. from within the credit investment portfolio, and portfolio restructuring
- Increased refinancing via central banks

These measures meant that it was possible to minimise the extent to which the limits and ceilings for the risk of insolvency triggered by the financial market crisis were exceeded, even if the problem could not be eliminated entirely.

In addition to the daily normal-case consideration, which is based on the assumption of business development in a normal market environment, HSH Nordbank has also been performing daily market liquidity stress tests since autumn 2008 in order to take the ongoing critical market development into account.

Backtesting

In the year under review, HSH Nordbank expanded its procedure for backtesting the model assumptions to include rollover credit, for example. This involves verifying how business is presented in the liquidity maturity statement on the basis of statistical evaluations of the historical cash flows. In addition, the Bank developed the process of calculating the haircuts on its securities portfolios and the checking and adjusting of its funding potential. Additional backtesting activities will be required in 2009.

Stress testing

The regular stress tests of the Bank for insolvency risk incorporate extraordinary scenarios and their effect on the Group's liquidity situation into the examination of risks. Specifying these scenarios involved identifying the risk and thus the key parameters for all transaction types in the liquidity maturity statement which change the cash flow profile in the relevant stress case. For example, inflows could be lower or later and outflows higher or earlier than expected. Within the various stress models, market-specific scenarios (e.g. global recession) and scenarios specific to the bank (e.g. a downgrade of HSH Nordbank AG) are examined. In addition, in view of the current liquidity crisis in the markets, HSH Nordbank also examine a stress scenario, in which it is assumed that the current liquidity crisis will deteriorate further. In the year under review, HSH Nordbank made the assumptions for this scenario considerably more conservative. The stress tests are based on an analysis of historical events and hypothetical models. In each of these scenarios, it is assumed that some of the maturing loans to customers have to be extended and refinanced, while the options for extending repayment terms for deposits are to some extent restricted or not at all possible, resulting in a financing gap. In addition, the model assumes that large numbers of credit facilities that the Bank has granted are drawn down and that the Bank's own issues and securitised liabilities are redeemed early. The frequency with which the stress test results are reported to the Management Board and the BU Group Treasury was shortened to a fortnightly cycle in 2008.

Both the market-specific and Bank-related stress scenarios of December 2008 demonstrate that the Bank's liquidity requirements are covered by the liquidity potential for a number of weeks, in spite of the severe worst-case assumptions. The results demonstrate that the Bank is sufficiently prepared for the aforementioned crises.

In the year under review, the Bank developed a methodology for computing stress scenarios for the liquidity maturity transformation risk.

Liquidity ratio of HSH Nordbank AG

The liquidity ratio as stipulated by the German Liquidity Regulation (LiqV) is the regulatory parameter for liquidity risks. HSH Nordbank actively manages its liquidity ratio with the help of targeted market transactions. For internal management, the Bank observes a lower limit which is above the regulatory minimum of 1.0. At between 1.18 and 1.35, the liquidity ratio was above the regulatory minimum throughout the year under review. The average for 2008 was 1.25.

8.3 REPORTS ON LIQUIDITY RISK

Reporting on liquidity risks of HSH Nordbank is integrated in the reports on overall risk on principle (see chapter 4.4). Furthermore regular special reports on liquidity risks are compiled; these have been summarized in Table 43.

Report	Recipient	Interval	Contents	Objective
ALCO meeting on liquidity risk	ALCO	Monthly	Current liquidity situation Stress testing	Risk determination and management
Group liquidity risk	Management Board	Monthly	Illiquidity risk, stress testing, structural liquidity situation Liquidity maturity transforn risk	Risk determination and management
Daily liquidity report	BUs Group Treasury and Group Risk Manage	Daily	Illiquidity risk on a daily basis (gap limit, limits for accumulated liquidity requirements), liquidity development report	Risk determination and management

Table 43: Reports on liquidity risk

9 OTHER RISK

9.1 COMPLIANCE RISK

Compliance risk encompasses legal and regulatory sanctions or financial losses due to failure to adhere to laws, regulations and guidelines as well as organisational standards and codes of conduct. Specifically, risk management in compliance entails the management of risks arising in connection with transactions in financial instruments and the associated provisions of the German Securities Trading Act (“Wertpapierhandelsgesetz” or “WpHG”) as well as risks related to fraud prevention and fraud identification, preventing money laundering and examining financial sanctions.

The compliance requirements on financial institutions have increased considerably in recent years. This can be attributed on the one hand to new legal and regulatory requirements, such as those introduced as a result of the financial market crisis, and to significant compliance risk events in the international financial services sector on the other. HSH Nordbank has responded by continuously developing its compliance system and taking market standards into account.

Some of the project achievements of 2008 were the implementation of a risk-oriented customer acceptance process in accordance with the Third EU Money Laundering Directive, the development of monitoring instruments in the financial sanctions area, and comprehensive communication and training measures relating to capital market compliance, money laundering and financial sanctions for all the Bank’s relevant employees. In particular in view of the strategic realignment of HSH Nordbank, the Bank will continue to develop its compliance instruments in 2009.

9.2 STRATEGIC RISK

Strategic risk is the danger of financial loss being incurred as a result of long-term decisions which are erroneous or based on incorrect assumptions, particularly with respect to the performance of individual areas of business or the banking sector as a whole.

In reaction to the financial market crisis, HSH Nordbank began to substantially focus its activities on the basis of the classification and prioritisation of its business activities as laid down in its 2007 strategy process. Its strategic risk is therefore being limited by the resultant reduction in the complexity of, amongst other things, the Bank’s target customers, its network of locations and its product portfolio. In addition, the strategic and organisational alignment of its core activities was scrutinised in order to sustainably secure and consolidate the Bank’s competitive position. These activities include the structure of internal processes for client business and, in particular, the development of processes to strengthen the Bank’s back-office activities and its risk culture.

10 APPENDIX

10.1 CONSOLIDATION MATRIX

		Treatment under supervisory law				Consolidation under IFRS
		Consolidation		Deduc-tion method	Risk-weighted	Full
Type of company / company		Full	Propor-tional			
CI	Bürgschaftsbank Schleswig-Holstein GmbH			X		
CI	HSH N Finance (Guernsey) Ltd.	X				X
CI	HSH Nordbank Private Banking S. A.	X				X
CI	HSH Nordbank Securities S.A.	X				X
FSI	CPM Luxemburg S.A.				X	X
FSI	CPM Securitisation S.A.				X	X
FE	Adessa Grundstücksverwaltungsgesellschaft mbH & Co. Vermietungs- KG*)				X	X
FE	AGV Irish Equipment Leasing No. 1 unLtd.	X				
FE	AGV Irish Equipment Leasing No. 7 Ltd.		X			
FE	Alchemy Investment Plan (HLB) LP	X				
FE	Alchemy Plan (HSH) LP	X				
FE	Alida Grundstückverwaltungs- GmbH		X			
FE	Amentum Capital Ltd.	X				
FE	AMVW Gesellschaft für Mobilienverwertung GmbH Co. KG		X			
FE	Arbutus GmbH	X				
FE	Asian Capital Investment Opportunity Ltd.	X				
FE	AVUS Fondsbesitz und Management GmbH	X				
FE	Azur Grundstücksverwaltungsgesellschaft mbH & Co LBSH KG			X		
FE	BIG Anteilsverwaltungs- GmbH		X			
FE	BIG BAU Investitionsgesellschaft mbH			X		
FE	BIKO Grundstücks - Verwaltungs- GmbH & Co. KG		X			
FE	BTG Beteiligungsgesellschaft Hamburg GmbH			X		
FE	BTO Grundstücksvermietungs- GmbH & Co. Verwaltungs- KG	X				
FE	Burgville Investments Ltd.	X				
FE	BuWi Beteiligungsholding GmbH	X				
FE	CPM Advisers Ltd.		X			
FE	CRE Financial Group LLC	X				
FE	Credaris Portfolio Management GmbH	X				
FE	DAL Geschäftsführung GmbH		X			
FE	DAL GmbH & Co. KG		X			
FE	DMS Beteiligungs GmbH	X				
FE	Dolana Grundstücksverwaltungsges. mbH & Co			X		
FE	Dol-Zircon Grundstücks Verwaltungs- GmbH & Co. Obj. Hamburg KG		X			
FE	DSK Beteiligungs- GmbH	X				
FE	Dynamene GmbH	X				
FE	Ealing Investments Ltd.	X				X
FE	Endor Beteiligungs- GmbH & Co. KG II	X				
FE	Endor Beteiligungs- GmbH & Co. KG VI	X				
FE	Endor Beteiligungs- GmbH & Co. KG VII	X				
FE	Endor 8. Beteiligungs- GmbH & Co. KG	X				X
FE	Equilon GmbH	X				X

	Treatment under supervisory law				Consolidation under IFRS
	Consolidation		Deduction method	Risk-weighted	Full
Type of company / company	Full	Proportional			
FE European Capital Investment Opportunity Fund Ltd.	X				
FE Feronia GmbH	X				
FE gardeur Beteiligungs- GmbH	X				
FE GBVI Gesellschaft zur Beteiligungs-Verwaltung von Immobilien mbH & Co. KG	X				
FE GLB GmbH & Co. OHG		X			
FE GmbH Altstadt Grundstücksgesellschaft			X		
FE GOAL Verwaltungs- GmbH & Co. Projekt Nr. 3 KG	X				
FE Godan GmbH	X				
FE HGA Fondsbeteiligungs- GmbH	X				
FE Gropius-Haus GmbH	X				
FE H/H Capital Management GmbH		X			
FE H/H Consulting GmbH		X			
FE HGA Fondsbeteiligungs- GmbH	X				
FE HGA Mikado I AG & Co. KG	X				
FE HGA Mitteleuropa III GmbH & Co. KG	X				
FE HGA Mitteleuropa IV GmbH & Co. KG		X			
FE HGA Mitteleuropa V GmbH & Co. KG	X				
FE HSH Asset Management S.A.	X				X
FE HSH Capitalpartners GmbH	X				
FE HSH Corporate Finance A/S	X				
FE HSH Corporate Finance GmbH	X				X
FE HSH Facility Management Holding AG	X				
FE HSH Financial Market Advisory AG	X				
FE HSH Invest GmbH	X				
FE HSH Investment Management LLC	X				
FE HSH Investment Management S.A.	X				X
FE HSH Money EuroPlus				X	X
FE HSH N Auffang- und Holding GmbH & Co. KG	X				
FE HSH N Composits GmbH	X				X
FE HSH N Financial Securities LLC	X				
FE HSH N Funding I	X				X
FE HSH N Funding II	X				X
FE HSH N Quartett I GmbH & Co. KG	X				
FE HSH N Quartett II GmbH & Co. KG	X				
FE HSH Private Equity GmbH	X				X
FE HSH RE Beteiligungs- GmbH	X				X
FE HSH Real Estate AG	X				X
FE HSH Real Estate Lux S.a.r.l.	X				
FE HSH Real Estate Treuhand GmbH	X				
FE Swift Capital Partners Institutional 2007 S.A.	X				
FE IHG Inamori Beteiligungs GmbH & Co. KG	X				
FE Int. Fund Service and Asset Management S.A.	X				X
FE Jantar GmbH	X				X
FE Kontora GmbH	X				
FE Lamantos GmbH	X				
FE Leashold Verwaltungs- GmbH & Co. KG	X				X
FE Lebus L.P.		X			X

	Treatment under supervisory law				Consolidation under IFRS
	Consolidation		Deduction method	Risk-weighted	Full
Type of company / company	Full	Proportional			
FE Marc Marco Polo Ventures GmbH & Co. KG	X				
FE Mesitis GmbH	X				X
FE Minerva GmbH	X				X
FE Minimoa GmbH	X				X
FE NBV Beteiligungs GmbH, Hamburg			X		
FE Neptun Finance Partner S.a.r.l.	X				
FE Neptun Finance Partner II S.a.r.l.	X				
FE Neptun Ship Finance (Luxembourg) S.a.r.l.	X				
FE Neptun Ship Finance Partner S.a.r.l. & Cie, SECS	X				
FE New Raven First Management GmbH	X				
FE New Raven Second Management GmbH	X				
FE Niederelbe Beteiligungs GmbH	X				
FE Northern Diabolo (Holdings) S.a.r.l.		X			
FE NSH Finance (Luxembourg) S.A.			X		
FE Nubes GmbH	X				X
FE Pellecea GmbH	X				
FE Perseus Investment LP	X				X
FE PL Projekt Anlagen Leasing Beteiligungs- GmbH & Co.		X			
FE PL Projekt - Anlagen Leasing Beteiligungs- GmbH		X			
FE Pluton Grundstücksverwaltungs- GmbH & Co. KG		X			
FE Pregu GmbH	X				X
FE Prime 2006-1 Funding LP			X		
FE Quartett II Blocker GmbH	X				
FE SCHU-WES Verwaltungs- GmbH & Co. Obj. Schenefeld KG	X				
FE SLK GmbH für Immobilien Leasing & Co. KG Obj. Berlin-Pohlst.		X			
FE Solent Holding II GmbH, Kiel	X				
FE Sotis S. a. r. l. , Luxemburg	X				X
FE Spheros Management Holding GmbH	X				
FE Swift Capital 1 Europäische Fondsbeteiligungs- GmbH & Co. KG	X				X
FE Teukros Canada Inc. Halifax	X				
FE Teukros GmbH	X				
FE Thestor GmbH	X				X
FE Verwaltungsgesellschaft Gartenstadt Wismar	X				
FE White Sails Limited, Grand Cayman (Cayman Islands)	X				
ABSE EBanking Services Nord GmbH	X				
ABSE Unterstützungs- Ges. d. Hamburgischen Landesbank GmbH	X				
Oth AHL 2				X	X
Oth AVUS Grundstücksverwaltungs- GmbH	X				
Oth BTA HSH Beteiligungsgesellschaft Altstercampus mbH		X			
Oth Carrera Capital Finance Ireland Ltd.*)				X	X
Oth Carrera Capital Finance Ltd.*)				X	X
Oth Discovery (Deka-Fonds)				X	X
Oth Hambornberg Immobilien- und Verwaltungs- GmbH				X	X
Oth Hamborner AG				X	X
Oth HGA Capital Grundbesitz und Anlage GmbH				X	X

	Treatment under supervisory law				Consolidation under IFRS
	Consolidation		Deduc-tion method	Risk-weighted	Full
Type of company / company	Full	Propor-tional			
Oth HGA New Office Campus-Kronb. GmbH & Co. KG		X			
Oth HGA/Colonia CareConcept 1 Fondsgesellschaft mbH & Co. KG	X				
Oth HSH Quartett III GmbH & Co. KG	X				
Oth HSH RE VP Land Ltd.	X				
Oth HSH Real Estate Asia Pacific Pte. Ltd.	X				
Oth HSH Real Estate Care Invest GmbH	X				
Oth HSH Real Estate US Invest LLC.	X				
Oth Kaplon GmbH & Co. KG	X				
Oth PANTA Zweiundneunzigste Grundstücksgesellschaft mbH & Co.KG	X				
Oth Poseidon Funding Limited*)				X	X
Oth LB Immo Invest GmbH	X				X
Oth LB Invest GmbH	X				
Oth Must 4 GmbH & Co. KG	X				
Oth Rasmus Purchase No. 1 Ltd.*)				X	X
Oth Rasmus Purchase No. 2 Ltd.*)				X	X
Oth Rasmus Purchase No. 3 Ltd.*)				X	X
Oth Rasmus Purchase No. 4 Ltd.*)				X	X
Oth Rasmus Purchase No. 6 Ltd.*)				X	X
Oth Rasmus Purchase No. 7 Ltd.*)				X	X
Oth Rasmus Purchase No. 8 Ltd.*)				X	X
Oth Real Estate Venture Capital Fonds 1 GmbH	X				
Oth Resparc Funding LP I				X	X
Oth Resparc Funding LP II				X	X
Oth Resparc Funding LP III				X	X
Oth Semos Verwaltungs GmbH I	X				
Oth Semos Verwaltungs GmbH II	X				
Oth Semos Verwaltungs GmbH III	X				
Oth Semos Verwaltungs GmbH IV	X				
Oth Spielbank SH GmbH & Co. Casino Flensburg KG				X	X
Oth Spielbank SH GmbH & Co. Casino Kiel KG				X	X
Oth Spielbank SH GmbH & Co. Casino Lübeck-Travemünde KG				X	X
Oth Spielbank SH GmbH & Co. Casino Stadtzentrum Schenefeld KG				X	X
Oth Spielbank SH GmbH & Co. Casino Westerland auf Sylt KG				X	X
Oth Spielbank SH GmbH				X	X
Oth Terranum "die Zweite" AG & Co. KG	X				
Oth Terranum Gewerbebau Verwaltungs- GmbH	X				
Oth Turis 1. Beteiligungs GmbH & Co. KG	X				
Oth Turis 2. Beteiligungs GmbH & Co. KG	X				
Oth Turis 3. Beteiligungs GmbH & Co. KG	X				

Table 44: Consolidation matrix

*) Special Purpose Vehicel

CI: Credit institution (Section 1(1) German Banking Act)

FSI: Financial services institution (Section 1(1a) German Banking Act)

FE: Financial enterprise (Section 1(3) German Banking Act)

ABSE: Ancillary banking services enterprises (Section 1(3c) German Banking Act)

Oth: Other

10.2 MAIN GUIDELINES OF CREDIT MANUAL

Guideline	Content and aim
Credit guideline	Regulation of the transaction-related environment for the lending business, e.g. definition of the terms loan and borrower, overall responsibility of the Management Board, information and approval obligations with regard to Risk Committee and/or the Supervisory Board
Loan decisions (Competence Guideline)	Competence Guideline to regulate processes and responsibilities with regard to loan decisions based on the management indicator "regulatory economic capital required"
Risk assessment	Regulation of processes and responsibilities for first and second risk assessment in accordance with MaRisk
Collateral and LGD Guidelines	Collateral and LGD Guideline to regulate the cornerstones of collateral management incl. LGD methodology; qualitative requirements for collateral; definition of collateral to reduce risk and process for approving new collateral
Rating	Rating procedures, application, reasons and processes
Commitment monitoring	Regulation of risk-based commitment monitoring and documentation/decision template
Valuation guidelines for real estate, airplanes, ships, rail vehicles, other movables	Procedure and methodology to identify and determine the pertinent values for receiving collateral to reduce risk
Default definition	Definition of a default and recovery of a borrower in accordance with Basel II and description of the relevant processes

Table 45: Main guidelines or fundamentals of the Credit Manual

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