

Financial Statements (1): Management's Discussion and Analysis

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Financial Review

CORPORATE STRUCTURE AND BUSINESS OPERATIONS

Legal corporate structure

Bayerische Hypo- und Vereinsbank Aktiengesellschaft (HVB AG) was formed in 1998 through the merger of Bayerische Vereinsbank Aktiengesellschaft and Bayerische Hypotheken- und Wechsel-Bank Aktiengesellschaft. It is the parent company of HVB Group, which is headquartered in Munich. Bank Austria Aktiengesellschaft (Bank Austria), which took over Creditanstalt AG in 1997 to combine the two largest banks in Austria (the other being Bank Austria Creditanstalt AG), has been part of HVB Group since December 2000. HVB Group is one of Europe's leading providers of banking and financial services.

HVB AG has been an affiliated company of UniCredito Italiano S.p.A., Genoa (UniCredit), since November 2005 and hence a major part of UniCredit Group from that date as a sub-group.

On September 12, 2006, the Management Board and Supervisory Board of HVB AG agreed to transfer HVB AG's holdings in Bank Austria Creditanstalt AG (BA-CA) and Joint Stock Commercial Bank HVB Bank Ukraine (HVB Bank Ukraine) to UniCredit, its Closed Joint Stock Company International Moscow Bank (IMB) and AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga) subsidiaries to BA-CA, and the assets and liabilities of the HVB AG branches in Tallinn, Estonia, and Vilnius, Lithuania, to AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga). An Extraordinary Meeting of Shareholders of HVB AG held on October 25, 2006 approved the corresponding contracts with more than 99.4% of the votes cast in each case. The Management Board decided to complete the transactions on January 9, 2007. The gains on disposal from the transactions listed will be largely realised in the first quarter of 2007.

The ordinary shares of HVB AG are admitted to official trading on all German stock exchanges, as well as on the Vienna Stock Exchange, Euronext in Paris and the SWX Swiss Exchange. On January 23, 2007, the Board of Directors of UniCredit (the majority shareholder of HVB AG) decided to start a squeeze-out procedure with regard to HVB shares. When the annual financial statements were prepared, UniCredit held more than 95% of the capital stock.

Information pursuant to Section 315 (4), German Commercial Code, in conjunction with the German Takeover Directive Implementation Act

The subscribed capital of HVB AG totals €2,252,097,420.00 and is divided into

- a) €2,208,436,620.00 shares of common bearer stock, broken down into 736,145,540 no par shares
- b) €43,660,800.00 non-voting shares of registered preferred stock, broken down into 14,553,600 no par shares.

The common bearer stock makes up 98.06% of capital stock and the preferred stock 1.94%.

The common stock consists of bearer or registered shares.

Shareholders holding shares of common bearer stock are entitled to attend the Annual General Meeting of Shareholders and exercise their voting rights subject to the conditions set out in Article 18 (2) of the Articles of Association. Each share of common stock is vested with one vote at the Annual General Meeting of Shareholders.

Each shareholder has the right to ask questions and speak at the Annual General Meeting of Shareholders, although the meeting chairman may limit the right to ask questions and speak as appropriate.

The shares of both common stock and preferred stock benefit from the equal disbursement of any profit distributions (dividend payment).

The preferred shares are non-voting and registered. They receive an advance share of profits of €0.064 per no par share, payable out of cumulative profit on a cumulative basis, as well as a further share in profits of the same amount as the shares of common stock. The claim to payment of the advance share of profits on a cumulative basis is granted to the holders of preferred stock as a separate right.

Shareholders holding shares of registered preferred stock are entitled to attend the Annual General Meeting of Shareholders subject to the conditions set out in Article 18 (1) of the Articles of Association.

In the event of a capital increase, the holders of common and preferred shares normally have a subscription right. The Management Board may exclude this subscription right if it is authorised to do so by a resolution adopted by the Annual General Meeting of Shareholders or by an amendment to the Articles of Association approved by the Annual General Meeting of Shareholders.

In addition, the holders of common and preferred shares enjoy the other rights granted by the German Stock Corporation Act.

Under Article 6 (2) of the Company's Articles of Association, the shares of registered preferred stock may only be transferred with the Company's approval. Compliant with Section 71 b) of the German Stock Corporation Act, treasury stock does not confer any rights to the Company. The Management Board is not aware of any restrictions regarding the exercise of voting rights or the transfer of shares that might arise from agreements between shareholders.

On November 22, 2005, UniCredito Italiano S.p.A., Genoa, informed the Company compliant with Section 21 of the German Securities Trading Act (WpHG) that it held 93.9% of the capital stock and 93.8% of the voting shares of common bearer stock in the Company, of which 0.001% indirectly, since November 17, 2005. UniCredit's ad-hoc announcement dated January 23, 2007 indicates that its interest in the capital stock of HVB AG had in the meantime risen to 95%.

The Company has not issued any shares that confer any special influence over the Company's executive bodies and hence any special control powers.

There is no distinction between control of voting rights and share with regard to employee holdings. Where Company employees have acquired Company shares, they can exercise their voting rights in the same way as any other shareholder: either in person or through a proxy.

The appointment and dismissal of members of the Management Board is based on the legal provisions set forth in Sections 84 and 85 of the German Stock Corporation Act. Under Section 179 of the German Stock Corporation Act, amendments to the Company's Articles of Association require a resolution from the Annual General Meeting of Shareholders. Such a resolution requires a majority of at least three quarters of the capital stock represented when the resolution is adopted. Article 21 (2) of the Company's Articles of Association confers to the Supervisory Board the authority to make amendments to the Articles of Association that only affect the wording but not the content (amendment of the wording).

A resolution adopted by the Annual General Meeting of Shareholders on April 29, 2004 authorises the Management Board to issue shares from the authorised capital increase (Section 202 et seq., German Stock Corporation Act) in accordance with Article 5 (2) of the Company's Articles of Association. Article 5 (2), 1 and 2 of the Company's Articles of Association is worded as follows: "The Management Board, with the consent of the Supervisory Board, is authorised until April 29, 2009 to increase the Company's share capital by issuing new shares in exchange for contributions in cash or kind, one or several times but in an aggregate volume of no more than 330,000,000 shares in a total par value of €990,000,000.00. Either only common shares or common shares and non-voting preferred stock vested with the same rights as the already existing non-voting preferred stock may be issued."

The Management Board is hereby authorised, with the approval of the Supervisory Board, to exclude the subscription rights of the shareholders in the instances listed individually in Article 5 (2) of the Company's Articles of Association in accordance with the authorisation granted on April 29, 2004.

Moreover, a resolution adopted by the Annual General Meeting of Shareholders on May 14, 2003 authorises the Management Board until May 14, 2008 to issue equity warrant bonds, convertible bonds, dividend bonds, option certificates and convertible certificates with an option or conversion right and/or conversion obligation into shares of common bearer stock of Bayerische Hypo- und Vereinsbank Aktiengesellschaft or dividend bonds (with or without option or conversion right/obligation) compliant with Section 221 of the German

Financial Review continued

Stock Corporation Act in euros or any other legal tender. The total nominal value or equivalent amount may not exceed an aggregate of €1,500,000,000.00. Under Article 5 (4) of the Company's Articles of Association, a conditional capital of €375 million is available to grant shares of common stock to the holders of bonds and certificates issued in accordance with the authorisation granted on May 14, 2003.

Furthermore, the Management Board is authorised compliant with Section 71 (1) No. 7 of the German Stock Corporation Act to buy and sell treasury stock for trading purposes by a resolution adopted at the Annual General Meeting of Shareholders held on May 23, 2006.

Moreover, the Company is permitted to buy treasury stock in the instances provided for in Section 71 (1) Nos. 1–5 of the German Stock Corporation Act.

There are no significant agreements at HVB AG that are subject to the condition of a change of control following a takeover offer.

No compensation agreements have been reached with members of the Management Board or employees in the event of a takeover offer.

In accordance with Section 171 (2) 2 of the German Stock Corporation Act as amended by the German Takeover Directive Implementation Act of July 8, 2006, the information pursuant to Section 315 (4) of the German Commercial Code is explained in the Report of the Supervisory Board in the 2006 Annual Report.

Main products, sales markets, competitive position and facilities

HVB Group offers a comprehensive range of banking and financial products and services to private and corporate customers as well as public-sector customers. Our range extends from mortgage loans and banking services for consumers, private banking, business loans and foreign trade finance through to fund products, advisory and brokerage services, securities transactions and wealth management.

Following the transfer of its interests and business activities in Austria, central and eastern Europe, Russia, the Ukraine and the Baltic states, HVB Group will in future focus on Germany as its core market within the UniCredit Group. Moreover, there is the possibility of entering markets in other regions of Europe (notably Scandinavia and Benelux). The aim is also to significantly expand investment banking operations and become the centre of competence for investment banking within the entire UniCredit Group.

BA-CA will continue to have operating responsibility for business in central and eastern Europe (CEE). Consolidating the CEE activities will significantly enhance the footprint and service range of the UniCredit Group. HVB Group is consequently in a position to offer its customers even better access to this region, thus enabling them to benefit from the transactions.

A breakdown of our offices by region is shown in Note 82 "Offices" in the notes to the consolidated financial statements.

Organisation of management and control

The Management Board of HVB AG is the management body of HVB Group. The Management Board provides the Supervisory Board with regular, timely and comprehensive reports on all issues relevant to corporate planning, strategic development, the course of business and the state of HVB Group, including the risk situation.

The Supervisory Board of HVB AG has 20 members and includes equal numbers of representatives of the shareholders and employees. The task of the Supervisory Board is to monitor and advise the Management Board as it conducts business. To support its work, the Supervisory Board set up three committees in the year under review: the Remuneration & Nomination Committee, the Audit Committee and the Negotiating Committee.

HVB AG conducts risk monitoring and risk management on a group-wide basis. The monitoring systems are geared to identifying risks at an early stage. In 2006, risk control and risk management were combined under the area of responsibility of the Chief Risk Officer, who reported to the Audit Committee of the Supervisory Board on a regular basis. Please refer to the Risk Report for further details.

A list showing the names of all of the members of the Management Board and the Supervisory Board of HVB AG is given in the consolidated financial statements under Note 83 "Members of the Supervisory Board and Management Board".

Basic features of the remuneration system

Structure of compensation paid to members of the Management Board

The compensation paid to members of the Management Board is determined by the Remuneration & Nomination Committee of the Supervisory Board. The direct compensation has three components comprising fixed and variable elements: fixed compensation, variable compensation as a bonus featuring profit-related components (short-term incentive) and a long-term incentive.

The variable components are especially important as these are linked to the achievement of the targets agreed for the financial year and the targets in the strategic plan and can exceed the fixed salary. Competitive profit-related compensation and postponing payment to the near or far future as a result of participation in the long-term incentive plan of the UniCredit Group is intended to ensure that the management is bound to the company.

To ensure that the compensation for the responsibilities assumed by Management Board members is commensurate with market conditions, an external specialist performed a market survey on behalf of HVB AG which included similar companies. The compensation payable to members of the Management Board for 2006 was stipulated by the Remuneration & Nomination Committee taking account of this survey.

The fixed salary is equivalent to the level paid in similar companies. It is disbursed in 12 monthly amounts.

The bonus is a short-term incentive, the size of which depends on certain targets agreed at the beginning of the year with all members of the Management Board being met. In 2006, these targets were specified in detail in the course of the year after completion of the three-year planning. The targets are shown in scorecards and include team targets, core targets and integration targets.

The team target for all members of the Management Board is based on the results achieved by the HVB sub-group. Some Management Board members responsible for regional divisions also have a divisional target as an additional team target. The main emphasis is placed on what are known as core targets, i.e. especially significant targets from the Management Board members' own area of responsibility. The most important tasks arising during the process of integrating HVB AG into the UniCredit Group are covered by the integration targets.

Targets mainly relating to quantities, but also some quality targets, are agreed with the members of the Management Board. A relatively narrow range is defined for meeting the quantitative targets. If the lowest value of this range is not achieved, no points are awarded for the target. If the highest value is achieved, the Management Board member receives the highest number of points previously defined for this target. The Remuneration & Nomination Committee decides on the quality targets, taking into account the vote given for the target achievement by the head of the division or the function in which the Management Board member works.

The weighted total amount of points gained from each target results in the target achievement. A bonus is paid if a specified minimum number of points is achieved. Compliant with UniCredit's treatment of this issue, the maximum bonus will be defined as the reference value from 2007. This maximum bonus can be utilised whenever a total number of 120 points is achieved in the scorecard. This means that the bonus has a maximum upper limit and a correspondingly lower percentage of the maximum bonus will be disbursed in future if targets are fully met.

Each Management Board member takes part in the Stock Option & Performance Shares Plan of the UniCredit Group (long-term incentive plan of the UniCredit Group). This plan consists of two components. On the one hand, each Management Board member is granted a certain number of options which can be exercised if the beneficiary is still working for the UniCredit Group after four years (vesting). In 2006, the Management Board of HVB AG was granted a total of 508,633 stock options. Each option entitles the Management Board member to purchase a UniCredit share at a price which was fixed before the option was issued. The option may be exercised within a period of nine years after vesting.

Financial Review continued

On the other hand, each Management Board member is promised a specific number of UniCredit shares (to be transferred free-of-charge) on condition that the relevant targets in UniCredit's strategic plan are met after three years have passed and the beneficiary is still working for the UniCredit Group. The Management Board of HVB AG received 195,333 performance shares in 2006. The targets were combined in baskets. There are baskets for the UniCredit Group and for each division. Each basket has five targets, of which three must have been met.

Members of the Management Board involved in operating activities receive the shares only if the division has achieved its target. They receive 50% of the shares if only the division has met its targets but 100% of the shares if the Group has also met its targets. The other Management Board members receive the shares if the Group has achieved its targets. HVB AG reimburses the cost of participating in the long-term incentive plan to UniCredit.

Exceptions have been made to the rules set out above for individual members of the Management Board, depending on their personal contractual arrangements. Please see the Compensation Report elsewhere in the Annual Report for further details in this regard.

Compensation paid to members of the Management Board for positions on supervisory boards of Group companies is surrendered to HVB AG.

Information on the amount of compensation paid to members of the Management Board is provided in Note 79, "Information on relationships with related parties", in the notes to the consolidated financial statements.

The Annual General Meeting of Shareholders of May 23, 2006 invoked what is referred to as the opt-out clause of the Act on the Disclosure of Management Board Remuneration and resolved that the remuneration received by Management Board members will not be disclosed on an individualised basis.

Besides direct remuneration, Management Board members have received pension commitments. Except for three members of the Management Board, the Management Board members take part in the fund-linked deferred compensation scheme (FDC) which is also available to the Bank's employees. HVB AG has fixed the contribution as 20% of the fixed salary and the short term incentive, subject to a cap of €200,000 per year. It has been agreed with the members of the Management Board that this amount of their pay would be converted, which means that, instead of a disbursed sum of money, the Management Board member receives a pension commitment to the same value from HVB AG. HVB AG credits the deferred compensation amounts to the Management Board member's capital account and invests them in a fund, currently the Pioneer Total Return Fund. HVB AG guarantees an annual return of 2.75%. A higher yield is initially used for allocation to a fluctuation reserve amounting to 10% of the separate funds for FDC. Any surplus return is credited to the Management Board member in due proportion. The fluctuation reserve is used to offset any actuarial losses. When the beneficiary becomes entitled to receive benefits, the capital credit balance is converted into a pension for life. A commitment for a fixed amount was agreed with one member of the Management Board. Contributions will be paid to a pension fund for another member of the Management Board. HVB AG has not agreed a pension commitment with a further member of the Management Board.

In addition, there are commitments in the event of the termination of Management Board activities. If a contract is not extended for reasons for which the member of the Management Board is not responsible, a transitional allowance of at least one year's salary (fixed salary and bonus), but a maximum of three years' salary depending on the length of service, is usually paid; the maximum amount is paid after 20 years. The transitional allowance is limited to the annual salaries (fixed salary and bonus) still outstanding until the age of 62 in each case. In the event that his contract is not extended, one member of the Management Board will not receive any benefits from HVB AG on account of another contract he has in the corporate group; another can receive a retirement pension.

Compensation paid to members of the Supervisory Board

The compensation paid to members of the Supervisory Board is regulated in Article 15 of the Articles of Association of HVB AG. The compensation is divided into a fixed and a variable, dividend-dependent component. Under the terms of the arrangements, the members of the Supervisory Board receive fixed compensation of €25,000 payable upon conclusion of the financial year and dividend-dependent compensation of €400 for every €0.01 dividend paid

above the amount of €0.12 per no-par share. The chairman of the Supervisory Board receives twice the compensation stated, the deputy chairmen one and a half times the compensation stated. Furthermore, the Supervisory Board is entitled to a fixed annual compensation of €120,000 payable upon conclusion of the financial year, which is used to compensate committee members on the basis of a corresponding Supervisory Board resolution. According to this, the members of the Audit Committee receive annual compensation of €20,000 each for the 2006 financial year. The chairman of the committee receives twice this amount. Where they sit on the Management Committee of UniCredit, the members of the Supervisory Board surrender to UniCredit the compensation they receive for Supervisory Board work, as the performance of Supervisory Board functions at subsidiaries is considered a typical management duty.

Information on the amount of compensation paid to members of the Supervisory Board is provided in Note 79, "Information on relationships with related parties", in the notes to the consolidated financial statements.

Internal management

One of HVB Group's most important objectives is a sustained increase of corporate value. To take account of capital market requirements and the necessity of value-based management, we have implemented the concept of dual steering. The overriding goal of value creation in the sense of shareholder value can thus be transferred to the operating divisions.

Essentially, this concept requires a return from two capital resources. One is the regulatory (or used core) capital and the other risk capital, in other words the economic capital actually required to cover risks identified on the basis of internal models. Both resources are expected to yield an appropriate return, which is derived from the expectations of the capital markets and is expected to be earned by our business units. In 2007, the dual steering will continue to be harmonised with the steering of the UniCredit Group. A detailed description of this issue is given in the Risk Report under the section entitled "Overall bank management".

ECONOMIC CONDITIONS

General economic trends in 2006

With year-on-year growth of nearly 5% in 2006, the global economy grew at around the same pace as in 2005. The engines of growth were the United States, with GDP up 3.5% in 2006, China, up 10.75%, and the emerging economies of Asia, up 7.0%. However, there was a slowdown during the year, primarily in the United States, in the wake of which GDP growth fell tangibly below the long-term average of 3.25%. The main reasons for this were the weaker fiscal stimuli, the continuing rise in the foreign trade deficit, a significant slowdown in the real estate sector and the serious problems encountered by the U.S. automotive industry. In contrast, Japan is in the midst of a prolonged period of growth. Driven by exports and business capital expenditures, GDP rose by approximately 2.0% in 2006 compared to the previous year.

The upturn in the euro area gained momentum during the past year. At 2.75%, gross domestic product (GDP) rose almost twice as rapidly as in 2005. In this context, the European economy benefited from external demand that remained strong coupled with lively domestic demand. This applies particularly to Germany, where capital spending was joined by private consumption as factors driving growth. For the first time in over a decade, Germany's GDP growth kept pace with the euro area as a whole. Turning now to the developments in detail:

- At an average of 2.5% in 2006, GDP growth in Germany was significantly higher than the 0.9% recorded in the previous year. This was the biggest rise since 2000, primarily driven by strong growth in capital expenditures by companies.
- German inflation stood at 1.8% after 1.9% in 2005. The year-on-year decline was largely due to the smaller increase in energy prices and prices set by the government.
- Unemployment averaged 4.48 million in 2006 after 4.86 million in the previous year.
- The current account surplus totalled 4.4% of GDP following on from 4.0% in 2005, helping Germany retain its position as the world's biggest exporter.
- The public-sector deficit fell significantly, from 3.2% of GDP to 1.9%. Hence Germany met the requirements of the European Stability and Growth Pact for the first time in five years.
- Long-term interest rates rose again. At the end of 2006, yields on 10-year German government bonds were at 3.95% after 3.3% in 2005. The European Central Bank raised the refinancing rate from 2.25% at the outset of the year to 3.5% in December 2006.

Financial Review continued

Sector conditions

The German banking sector enjoyed a good year in 2006 in terms of loan portfolios and total deposits. This trend was driven by continued rapid growth in the global economy coupled with a German economy expanding more rapidly than at any time since 2000 and international financial markets performing strongly. The factors underpinning net interest income created a favourable environment overall for the profitability of German banks. On the lending side, the growth rate for loans in 2006 rose again in the banking sector for the first time since 2002, even if it was still very low compared with the rest of the euro area. The total number of loans and advances increased by around 1% in 2006, after decreasing by an average of 0.6% each year between 2002 and 2005. This can be attributed to high capital spending by German companies and the loans required to fund this investment. In contrast, there was only a slight increase in the demand for credit from private households.

Total deposits grew more rapidly, with the aggregate deposits of non-banks rising by 4.5% in 2006. As with loans and advances, the main factor behind this change was the improved financial situation of companies, which preferred term money to sight deposits in 2006.

The positive contribution to net interest income made by the growth in loan portfolios and total deposits in 2006 was tempered by further pressure on interest margins during the first half of the year. Whereas banks raised their deposit rates appreciably in response to the more restrictive monetary policy pursued by the European Central Bank, long-term credit interest rates initially continued their downward path in the first half of the year. This trend reversed in the second half to almost return to the previous year's level.

Net fees and commissions' contribution to the earnings situation of German banks benefited chiefly from the very friendly financial market environment in 2006. Greater activity on the capital market again resulted in much higher trading volumes on German stock exchanges in 2006. This development was reinforced by very strong demand from institutional investors. The DAX rose by over 20% year-on-year for the second time in a row, thus creating a very favourable environment for the funds business and trading profit of German banks.

Risk provisioning developed relatively well in 2006, at least as far as the corporate sector is concerned. There was a further decline in the number of company insolvencies, whilst personal bankruptcies continued to increase.

BUSINESS SITUATION AND DEVELOPMENT OF INCOME

Major events in 2006

The integration of HVB Group into the UniCredit Group has given rise to a new reporting structure and segment structure.

Discontinued operations

The transfers agreed by the Management Board and Supervisory Board on September 12, 2006, which were approved by the Extraordinary Meeting of Shareholders on October 25, 2006, represent a discontinued operation as defined by IFRS 5, resulting in a different presentation in the individual parts of the consolidated financial statements.

The results of the discontinued operations are not shown in the income statement prepared in compliance with IFRS 5 until after the net profit after tax and minorities of "HVB Group new". The following companies and sub-groups have been defined as discontinued operations: the Bank Austria Creditanstalt Group, IMB, AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga), HVB Bank Ukraine and the HVB AG branches in Vilnius and Tallinn.

The income statement for HVB Group compliant with IFRS 5 (HVB Group new) down to the item "Net profit of HVB Group new" does not reflect the earnings power of the new HVB Group following the transactions listed, either in the past or in the future. The profit now disclosed for HVB Group new does not contain any adequate revenues offsetting the capital tied up by the holdings in BA-CA, IMB and the other units being transferred (dividends or primary revenues from the holdings). Looking into the future, the proceeds from the transactions will give HVB Group the chance to expand its core competencies and to tap additional sources of revenue.

Modified business structure (new divisions)

In conjunction with the integration of the Bank into the UniCredit Group, the activities of the new HVB Group have been restructured and divided into the following global divisions: Retail, Wealth Management, Corporates & Commercial Real Estate Financing, and Markets & Investment Banking. Also shown is a segment called "Other/consolidation" that covers Global Banking Services and Group Corporate Centre activities. The latter also contain the former RER segment and the newly defined SCP portfolio.

The reorganisation primarily affected the former Germany business segment, from which the Retail, Wealth Management and Corporates & Commercial Real Estate Financing – divided into Corporates and Commercial Real Estate Financing operations – divisions emerged. Within this, the Retail and Wealth Management divisions were created out of the former Private Customers business unit, whereas the Corporate Customers and Professionals and Real Estate business units formed the basis for the new Corporates & Commercial Real Estate Financing division. In addition, customers were transferred from the former Corporate Customers and Professionals business unit (business customer segment) to the new Retail and Wealth Management divisions.

The Markets & Investment Banking division was essentially formed out of the Corporates & Markets segment, but without the activities of the BA-CA Group and IMB.

Compliant with IAS 14.52, we also show the companies defined as discontinued operations in accordance with IFRS 5 additionally and separately from the continuing divisions and segments of the new HVB Group in a separate column headed "Discontinued operations" in our segment report.

New income statement structure

In its Interim Report for the period ended September 30, 2006, HVB Group prepared its income statement for the first time using the structure for many years used by UniCredit in its capital market communications. Furthermore, the presentation of expense items has been modified by the year-end 2006 to match the usual UniCredit practice. This means all absolute amounts in the income statement are shown with their impact on profit.

A reconciliation of the income statement structure used to date to the new income statement structure for the period from January 1 to December 31, 2005 is shown in the notes to the consolidated financial statements (Note 2, "Consistency") together with the main differences.

Adjustment of comparison periods

Due to the changes listed above, the income statement and the segment report are no longer comparable with the figures reported in the 2005 Annual Report. For this reason, we have adjusted the figures for previous years accordingly.

General comments by management on the operations of the full HVB Group

In its income statement for 2006, the full HVB Group reported a net profit of €4,420 million (2006: €642 million) after taxes and minorities, including a net gain from non-recurring items. This total comprises the net profit of the discontinued operations of €3,457 million (2005: €1,158 million), the minority interests in the discontinued operations of €677 million (2005: €389 million) and the net profit of €1,640 million recorded by the new HVB Group (2005: loss of €127 million). The net profit recorded by the new HVB Group especially reflects the good operating performance that is described in greater detail under "Operating performance of HVB Group new" below using the individual items in the income statement. Comments on the net profit of the discontinued operations are shown in the Note 39 "Income statement and earnings per share of discontinued operations" in the notes to the consolidated financial statements.

Financial Review continued

Non-recurring effects

The profit before tax of the full HVB Group totalled €5,317 million, including the non-recurring effects of €2,230 million resulting in part from the integration of HVB Group into the UniCredit Group. Of the total non-recurring effects in 2006, €362 million are attributable to the continuing operations of the new HVB Group and €1,868 million to discontinued operations.

The non-recurring effects in the new HVB Group relate to the following:

- Gains on the disposal of the Activest companies to Pioneer Global Asset Management S.p.A. totalling €543 million and the partial disposal of our holding in Münchener Rückversicherungs-Gesellschaft AG (€217 million) disclosed in net income from investments
- Valuation expenses of €130 million arising from the disposal of a portfolio of non-strategic real estate announced by the Management Board of HVB AG on December 13, 2006 included in net income from investments
- Restructuring costs of €60 million
- General provisions for losses on specific loans and advances of €55 million disclosed under net write-downs of loans and provisions for guarantees and commitments that were made possible for the first time by the preparations for Basel II causing improvements to the data records in terms of defaults by customers who are 90 days in arrears and other non-performance
- Expenses of €153 million arising from a change in the parameters used to calculate the fair value mainly of financial instruments under the categories held for trading and at fair value through profit and loss (fair-value discount) shown in a separate line called "Other non-operating expenses"

In the discontinued operations, the non-recurring effects comprise the following individual items:

- Gains of €669 million on the disposal of Splitska banka, which belongs to the BA-CA Group, and of €1,756 million on the disposal of the Bank BPH Group disclosed in net income from investments
- Restructuring costs of the discontinued operations totalling €248 million. €225 million of this total relates to the creation of provisions for reorganisation and restructuring in the Retail, Corporates, Markets & Investment Banking and Global Banking Services divisions as well as Support Services and Risk Management at BA-CA
- Non-recurring expense of €278 million in net write-downs of loans and provisions and for guarantees and commitments relating to a change of methods used by BA-CA
- Expenses of €31 million arising from a change in the parameters used to calculate the fair value mainly of financial instruments under the categories held for trading and at fair value through profit and loss (fair-value discount) shown in the income statement item called "Other non-operating expenses"

The profit before taxes totalling €1,299 million was also depressed by non-recurring effects in 2005. In addition to restructuring costs of €546 million (€108 million of which is for discontinued operations), this includes further extraordinary expenses arising from loan-loss provisions due to additional general provisions for losses on specific loans and advances totalling €147 million (€70 million of which was for discontinued operations).

Adjusted for non-recurring effects in both years, the full HVB Group performed extremely well, with profit before taxes rising by 55.0% to reach €3,087 million after €1,992 million in the previous year and net profit after taxes and minorities totalling €2,160 million, up 85.7% on the previous year.

Appropriation of profit

In the full HVB Group, €3,798 million of the unappropriated profit of €4,420 million has been transferred to reserves. The consolidated profit (which is the profit available for distribution of HVB AG) amounts to €622 million. We will propose to the Annual General Meeting of Shareholders that a dividend of €301 million be paid to the shareholders and that a further €321 million be transferred to retained earnings. The total dividend payout of €301 million is equivalent to a dividend of €0.40 per share of common stock and per share of preferred stock and an advance dividend of €0.064 per share of preferred stock.

Key capital ratios

The return on equity after taxes (based on average IFRS equity capital without change in valuation of financial instruments) of the full HVB Group amounted to 37.8% (including non-recurring effects). Even adjusted for the non-recurring effects listed, our expectations with regard to return on equity after taxes have been more than met, with a figure of 18.5% at December 31, 2006 after 10.2% in the previous year.

Besides increasing our return on equity, we also more than matched the targets stated in the Outlook section of Management's Discussion and Analysis (on page 74 of the 2005 Annual Report) in terms of a significant boost in total revenues and a substantial improvement in the cost-income ratio (ratio of operating costs to total revenues). The cost-income ratio improved by 9.4 percentage points during the year under review to 59.1%.

We were able to beat these targets for return on equity and the cost-income ratio in the new HVB Group as well.

Operating performance of the new HVB Group

As already mentioned in the section headed "Major events in 2006", we are presenting a separate income statement for the new HVB Group in compliance with IFRS 5 rules. This statement no longer contains the income and expense items of discontinued operations and shows their contribution to earnings only after net profit after tax and minorities of the new HVB Group.

Total revenues

With further year-on-year growth in net trading, hedging and fair value income as well as in net fees and commissions coupled with a favourable economic climate, further improvements to our earnings structure are becoming apparent on the operating side. Overall, total revenues increased 14.2% over the previous-year figure.

Net interest income

At €3,148 million, we almost matched the previous year's total for net interest income (down 0.6% or €18 million) despite the scheduled strategic portfolio disposals, chiefly in the Real Estate Restructuring unit. Average risk assets (compliant with the German Banking Act) declined by 7.1% year-on-year. The effects of portfolio disposals were also reflected in our segment report through the decline in net interest income in the Other/consolidation segment, whilst all other operating divisions increased or maintained net interest income compared to the previous year. At €251 million, interest and similar income from dividends and other income from equity investments almost matched the previous year's level of €259 million.

Net fees and commissions

At €1,753 million, there was a significant 1.7% year-on-year rise in net fees and commissions. However, the profit contributions made by the sold Activest companies are only included in net fees and commissions for 2006 up to the middle of the year, which has a negative effect when compared to 2005. Adjusted for consolidation and currency effects, the rate of increase in net fees and commissions totalled 7.0%. In the process, net fees and commissions from the securities and depositary business rose by around 9% in adjusted terms. In particular, sales of innovative financial products like the "HVB Best of Fonds", "HVB Flex Bonus Zertifikat", "HVB 2 x 5% Profianleihe" and the "HVB Höchststand-Zertifikat" helped to boost earnings. There was also an increase in the contributions made to profits by other service units (including commissions) and from the lending business.

Financial Review continued

Net trading, hedging and fair value income

Net trading, hedging and fair value income of the new HVB Group developed especially well. At €768 million, it is more than double the figure of €376 million reported for 2005. The net income from financial instruments classified as held for trading increased by €209 million to €673 million thanks essentially to higher dividend income arising from trading operations (up €184 million to €320 million) together with a rise of around a quarter in equity contracts to €112 million. In 2006, we report the gains realised from private equity transactions of €38 million under net trading, hedging and fair value income for the first time; these were previously shown under net income from investments.

Net other expenses/income

Net other expenses/income amounted to €32 million. A net expense of €311 million was reported for this item in 2005 on account of losses absorbed. Of the total losses absorbed in 2005, €256 million relates to HVB Immobilien AG due to the existing profit-and-loss transfer agreement with HVB AG. These include the losses of real estate subsidiaries of the HVB Immobilien AG sub-group, which was not consolidated in 2005. The major companies of the HVB Immobilien AG sub-group were fully consolidated in the consolidated financial statements of HVB Group with effect from January 1, 2006.

Operating costs

At €3,695 million, the operating costs of the new HVB Group were reduced by 4.9% compared to the previous year. In the process, the payroll costs remained stable at 0.2%, despite higher expenses for profit-related bonus payments in the Markets & Investment Banking segment, while there was a 7.5% reduction in other administrative expenses and a significant 24.2% decline in amortisation, depreciation and impairment losses on intangible and tangible assets.

In net terms, consolidation and currency effects served to reduce expenses reported under the aggregate operating costs by €11 million in 2006. In particular, the increase in expenses caused by the initial consolidation of the HVB Immobilien AG sub-group was offset by the lower expenses arising from the deconsolidation of the Activest companies, resulting in a year-on-year decrease adjusted for consolidation and currency effects of 4.6%.

Operating profit

The massive 70.0% rise in the operating profit of the new HVB Group to €2,257 million is evidence of the further progress we made in the year under review in the constant improvement of our operating profit we had already initiated in previous years, helping us to more than meet our financial targets. The rise in operating profit compared to the same period last year is a result of both the rise in total revenues and successful cost reduction measures. This efficiency gain led to a significant enhancement of the cost-income ratio (percentage of total revenues made up by operating costs), which improved by 12.4 percentage points to 62.1%.

Provisions for risks and charges

Net provisions for risks and charges increased to €164 million after €87 million in the previous year. The largest individual item in this regard is the provision for rental guarantees related to premises no longer required for banking operations that were vacated in the course of space-optimisation programmes. As a result of discontinuing the use of space, existing tenancy/leasing contracts became onerous contracts for which provisions of €60 million must be set aside to meet contractual obligations arising under what are defined by IAS 37.66 as onerous contracts. This will no longer affect our income statements in future years. In addition, this income statement item includes further provisions for rental guarantees, other provisions and accruals for risks and charges as well as provisions for litigation risks in the lending business.

Write-down on goodwill

In compliance with IFRS 3, scheduled write-downs have no longer been taken on goodwill since January 1, 2005. No non-scheduled write-downs of goodwill were taken in 2006.

Restructuring costs

The restructuring costs incurred in part as a result of the integration of HVB Group into the UniCredit Group amounted to €60 million in 2006. This figure includes payroll costs of €27 million and other administrative expenses (including depreciation) of €28 million. The restructuring costs of €438 million reported for 2005 essentially included additions to restructuring provisions mainly for severance pay settlements, depreciation charges on non-current assets and fees.

Net write-downs of loans and provisions for guarantees and commitments

At €933 million, net write-downs of loans and provisions for guarantees and commitments were €46 million or 4.7% below the figure of €979 million recorded for 2005. Net write-downs of loans and provisions for guarantees and commitments were affected by the non-recurring effects described in both years. Even adjusted for the non-recurring effects, there was a 2.7% decline in net write-downs of loans and provisions for guarantees and commitments to €878 million.

Net income from investments

Net income from investments recorded by the new HVB Group amounted to €671 million in 2006 and benefited from net non-recurring effects of €630 million.

These effects include gains on the disposal of the Activest companies (€543 million) and the sale of part of our holding in Münchener Rückversicherungs-Gesellschaft AG (€217 million) and valuation expenses of €130 million arising from the sale of a portfolio of non-strategic real estate announced by the Management Board of HVB AG on December 13, 2006.

In addition, gains were realised from the reduction of our shareholdings in Babcock & Brown Limited (€55 million) in the first quarter of 2006 and Lufthansa AG (€40 million) in the second quarter of 2006; these were partially offset by deconsolidation losses and write-downs on investment properties.

In 2005, the largest income items were the gains from the partial disposal of our shareholdings in Münchener Rückversicherungs-Gesellschaft AG (€208 million) and the gains realised on the sale of our holdings in Rhön-Klinikum AG (€36 million) and Premiere AG (€63 million). These were partially offset by non-recurrent expenditure of €225 million in connection with the acquisition of real estate from the fund assets of a property fund managed by the Bank's Internationales Immobilien-Institut GmbH (iii-investments) subsidiary.

Other non-operating expenses

Expenses of €153 million arising from a change in the parameters used to calculate the fair values of financial instruments classified as held for trading and at fair value through profit and loss are shown in a separate line in the income statement called "Other non-operating expenses" (changes in accounting estimates, compliant with IAS 8.32 et seq.). This involves an effect, which is non-recurrent in this magnitude, arising from the initial application of the fair-value discount which takes account of other factors influencing the calculation of the fair value and thus increases the quality of our conservative fair value calculation.

Profit before tax

The profit before tax of the new HVB Group amounted to €1,618 million including the non-recurring effects mentioned after a loss of €107 million in the previous year. Adjusted for non-recurring effects, profit before tax, at €1,256 million in 2006, would still have been more than three times as high as the adjusted figure of €408 million for 2005.

Income tax for the period

For the year under review, we are disclosing income tax income of €125 million (2005: income tax expenses of €14 million), which consists of expenses arising from current income taxes of €199 million and income from deferred taxes of €324 million.

The apparently low current income taxes of €199 million in relation to the profit before tax of €1,618 million is mainly attributable to tax-free earnings. In addition, the capitalisation of the discounted corporate income tax credit from previous years in accordance with new tax regulations had a beneficial effect.

The deferred tax income stems largely from an increase in the deferred tax assets recognised on the domestic loss carryforward of HVB AG which were not previously disclosed.

Financial Review continued

Minorities and net profit

Minorities account for €103 million of net profit. After deducting the minorities, we generated a profit of €1,640 million after a loss of €127 million incurred as a result of non-recurring effects in the previous year. Adjusted for the listed non-recurring effects in both years, we managed to increase the profit of €290 million reported for 2005 by a factor of almost four to €1,128 million in 2006.

The return on equity of the new HVB Group (based on the average IFRS equity capital of the full HVB Group, distributed to the continuing and discontinued operations in accordance with average risk-weighted assets) totals 19.3% before taxes and 22.1% after taxes. Adjusted for non-recurring effects, the amounts are 15.0% before taxes and 15.2% after taxes. Starting in the 2007 financial year, we will adjust the method used to calculate return on equity to match the controlling logic of the UniCredit Group.

Segment results by new division

The contributions of the divisions to the profit before tax of the new HVB Group of €1,618 million were as follows:

Retail	€117 million
Wealth Management	€746 million
Corporates & Commercial	
Real Estate Financing	€531 million
Markets & Investment	
Banking	€969 million
Other/consolidation	loss of €745 million

The income statements of each division, the components and targets of the divisions and comments on the performance of the divisions are described in Note 21 "Notes to segment reporting by division" and Note 22 "Income statement broken down by division" in the notes to the consolidated financial statements.

FINANCIAL SITUATION

Total assets

The total assets of the full HVB Group amounted to €508.0 billion at December 31, 2006, which represents an increase of €14.4 billion, or 2.9%, over the 2005 year-end total.

The shareholders' equity shown in the balance sheet amounts to €20.0 billion, including minority interest of €3.3 billion. The €4.6 billion growth in shareholders' equity essentially stems from the profit of €4.4 billion, of which €3.8 billion is allocated to other retained earnings and €0.6 billion of which is reported as consolidated profit.

The changes in fair values of hedging derivatives in effective cash flow hedges are disclosed in the hedge reserve. The changes in the value of these derivatives are offset by future compensating effects arising from the hedging relationships which are not yet permitted to be recorded in the balance sheet. This explains why the hedge reserve does not have any economic informative value when viewed in isolation. In particular, no shareholders' equity has been consumed since the negative changes in the value of the derivatives in the balance sheet items are offset cumulative undisclosed reserves. The available-for-sale reserve and the hedge reserve are not included for the purpose of calculating the return on equity.

Compliant with IFRS 5, an enterprise must provide and present information on the balance sheet which enables the persons for whom the annual financial statements are prepared to assess the financial impact of discontinued operations and non-current assets or disposal groups held for sale.

For this reason, the assets and liabilities of discontinued operations have to be shown in the balance sheet as well as non-current assets or disposal groups held for sale and the liabilities of disposal groups held for sale under separate balance sheet items.

Hence, the other balance sheet items (except for shareholders' equity) in the year under review only include the figures for continued operations without non-current assets or disposal groups held for sale and without the corresponding liabilities. The previous year's figures have not been adjusted. Consequently, the individual balance sheet items cannot be compared with those of the previous year. To increase transparency and facilitate assessment of the year-on-year financial performance, we have also included a pro forma balance

sheet as well as the underlying assumptions in the Note entitled "Pro forma balance sheet" in the notes to the consolidated financial statements. In this context, the continuing operations in both 2006 and the previous year are taken as the basis.

Here we will describe only the development of the individual balance sheet items shown in the pro forma balance sheet of the new HVB Group.

The total assets of HVB Group new increased by €6.6 billion, or 1.9%, to €358.3 billion. In particular, the assets of the new HVB Group increased as a result of rises of €18.6 billion in assets held for trading purposes and of €6.1 billion in placements with, and loans and advances to, other banks, whereas loans and advances to customers decreased by €15.2 billion, partly due to further portfolio disposals, and investments fell by €7.1 billion. The allowances for losses on loans and advances included as a deductible item in the assets fell by €3.2 billion.

Funding was adjusted to reflect the higher volume of lending. The main rise on the liabilities side came in deposits from other banks, up €13.2 billion. By contrast, promissory notes and other liabilities evidenced by paper were down by €6.8 billion. Shareholders' equity increased by €1.4 billion, largely as a result of the profit generated in the year under review.

Risk assets, key capital ratios and liquidity of the full HVB Group

Compared to the year-end total for 2005, the risk assets of the full HVB Group in accordance with the German Banking Act (without market risks) declined by €13.2 billion to €219.3 billion. Major factors contributing to this included the deconsolidation of Bank BPH S.A. and its subsidiaries, with risk assets totalling €9.4 billion, and the securitisation activities listed below.

The risk assets of the new HVB Group totalled €137.4 billion at year-end.

The full HVB Group continued its securitisation activities in 2006 with two new transactions: Provide A 2006-1 and Promise XXS 2006-1. The corresponding volume of lending newly outplaced totalled €7.0 billion at year-end, serving to reduce risk-weighted assets by €5.7 billion in accordance with the German Banking Act. At the same time, the Amadeus, Lombard Sec. No. 1, Promise A 2000-1, Promise A 2002-1 and Promise Austria 2002-1 transactions expired during 2006 with an aggregate lending volume of €1.8 billion. This resulted in the reversal of a reduction of €1.6 billion in risk-weighted assets compliant with the German Banking Act.

At year-end 2006, the core capital of the full HVB Group compliant with the German Banking Act totalled €18.3 billion and equity capital €27.1 billion. This gives rise to a core capital ratio (excluding market risk positions) of 8.4% and an equity funds ratio of 11.8%.

A bank's liquidity is evaluated using the liquidity ratio defined in Principle II of the German banking supervisory regulations. This figure is the ratio of cash and cash equivalents available within a month to the payment obligations falling due in this period. Liquidity is considered adequate if the ratio is at least 1.0. At HVB AG, the figure averaged 1.2 in 2006 (2005: 1.2).

Corporate acquisitions and sales

Comments on changes in the group of companies included in the consolidated financial statements are provided under Note 4 called "Companies included in consolidation".

EVENTS AFTER DECEMBER 31, 2006

At the Extraordinary Meeting of Shareholders on October 25, 2006, HVB AG submitted the agreements for the sale of its holdings in BA-CA and HVB Bank Ukraine to UniCredit, its IMB and AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga) subsidiaries to BA-CA, and the assets and liabilities of HVB AG's branch offices in Tallinn, Estonia, and Vilnius, Lithuania, to AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga) for approval. The Extraordinary Meeting of Shareholders approved the agreements with over 99.4% of the votes cast.

Financial Review continued

Conditions were set for executing the transactions. These were that official approval be obtained from the relevant authorities and that the Management Board adopt a resolution based on a legal opinion given by an external advisor confirming that the underlying resolutions at the Extraordinary Meeting of Shareholders on October 25, 2006 contain no errors which would prevent implementation of the agreements. The Management Board adopted a corresponding resolution on January 9, 2007. The following transactions were subsequently completed:

- HVB AG's 77.53% interest in BA-CA was transferred to UniCredit against payment of €109.81 per share (giving a total purchase price of around €12.5 billion in cash) on January 9, 2007,
- HVB AG's 100% interest in AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga) was transferred to BA-CA for a purchase price of €35 million in cash plus the capital increase of AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga) underwritten by HVB in August 2006 of around €40 million, on January 10, 2007, and
- HVB AG's 70.26% interest in IMB plus options on a further 2.79% interest in IMB was transferred to BA-CA for a purchase price of €1,070 million in cash on January 11, 2007.

Due to conditions that had not been met, the following transfers had not taken place by the time the annual financial statements were prepared:

- HVB AG's 100% interest in HVB Bank Ukraine to UniCredit against payment of €83 million in cash, and
- the assets and liabilities of HVB AG's branches in Tallinn, Estonia, and Vilnius, Lithuania, to AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga) for a purchase price of €1 million and €9 million, respectively, plus the difference between the carrying amount of the assets transferred and liabilities assumed.

On January 23, 2007, UniCredit announced its intention of acquiring the shares in HVB AG held by minority shareholders (squeeze-out). HVB AG will remain a joint stock corporation under German law and an operationally independent institution after the squeeze-out. The new HVB Group will be the centre of competence for the entire investment banking activities of the UniCredit Group. Furthermore, it aims to expand its market position in retail banking, corporate banking and commercial real estate financing, and wealth management with a view to securing profitable growth.

OUTLOOK

The Management's Discussion and Analysis and the rest of the Annual Report include statements, expectations and forecasts concerning the future. These forward-looking statements are based on plans and estimates that are supported by the information that is available to us at the present time. We assume no obligation to update these statements in the light of new information or future events. Known or unknown risks and uncertainties may be entailed in forward-looking statements and the actual results and developments may thus differ significantly from those expected at present. Such discrepancies may result particularly from changes to the general economic climate and the competitive situation, developments on international capital markets, the possible default of borrowers or contracting parties in commercial transactions, the implementation of restructuring measures, amendments to national and international laws, notably to tax regulations, the reliability of our risk management procedures and methods as well as other risks, some of which are described in detail in the Risk Report. The statements made in the Outlook for HVB Group are based on the structure of the new HVB Group at the outset of 2007.

General economic outlook for 2007

In 2007, global growth is anticipated to slow down somewhat, although there are no signs of a hard landing for the global economy. At just under 4.5%, GDP growth is expected to lag behind that of last year only slightly. At the same time, worldwide growth will be more evenly balanced. The United States will probably enjoy a soft landing in 2007, expanding by 2.1%, while the euro area and Japan are expected to grow at a similar pace to the U.S. economy. The emerging economies of Asia and China should remain at the top of the growth league (at just under 8% and just under 9.5%, respectively).

In the United States, the problems in the real estate and automotive sectors will initially have a restraining effect. However, lower energy prices will bring relief and boost the purchasing power of private consumers with a favourable financial market environment probably acting as a support in this regard. The slowdown in growth in the United States will probably come to an end in the first half of 2007, while capital spending will revive in the second half. This will give the U.S. economy new momentum, enabling it to return to its long-term growth potential. For the year as a whole, this will mean growth of almost 2.0% year-on-year. With GDP rising a good 2% in 2007, Japan's economy is anticipated to expand above its long-term trend for the fourth time in a row. Exports and capital spending by companies will remain important pillars of the economy. In addition, a significant recovery is expected in private consumption levels. As the economy continues to perform well, the slight upward trend in consumer prices to date is expected to increase somewhat. Hence, the Bank of Japan will probably carry out two moderate interest rate rises this year, to take the key rates to 0.75%.

Although growth in the euro area is expected to remain steady in 2007, it will lose some of its momentum in the course of a long-term normalisation process. This is suggested in part by leading indicators which, despite declining slightly, are still at a very high level. The sentiment, notably in companies, is set to remain positive. Domestic demand is anticipated to continue its revival, partly as a result of a sustained rise in employment, although there will be a slight deterioration in the outlook for exports because of the slight slowdown worldwide. For 2007 as a whole, GDP growth will thus stand at around 2% in the euro area. With GDP rising at just under 2% in Germany, growth is expected to slow down a little. This is chiefly a result of the slight deterioration in the outlook for exports due to weaker growth in the United States; in addition, a slight decline is expected in the very high growth rate of capital spending by companies in 2006. Furthermore, the increase in value-added tax that came into force at the start of the year may have led to purchases being brought forward and, in return, to private consumption decreasing, particularly at the beginning of 2007. However, the continued increase in jobs for which social security contributions are payable should restrain any decline in private consumption and ensure a moderate recovery in consumption levels as the year wears on.

Sector development 2007

Our assessment indicates a consolidation of economic growth in the economy during the 2007 financial year. The financial services industry should also benefit from these positive growth prospects. We therefore assume that the continued rise in demand for banking services will stimulate revenue growth for banks on both the retail and corporate side. At the same time, we can assume that the positive economic environment will have a further favourable impact on risk provisioning. Operating costs should feature a slightly lower increase than in 2006. In 2008, we expect German banks' profits to grow only slightly less than in 2007.

The European Central Bank is expected to raise its key rate twice, by 25 basis points each time, in the course of year. This is suggested by the stable economic performance entailing the risk of second-tier effects in inflation as well as the continued very ample supply of liquidity. In contrast, the Fed is expected to lower the key rate by a mere 25 basis points in the current year. In the United States, long-term interest rates will probably remain largely around 4.7%, the level reached at the end of 2006, as a result of slightly weaker economic growth. German yields should also rise very slowly, to 4.1%. Because the relative advantage in terms of interest rates enjoyed in the United States will decline further, the dollar is expected to move towards the 1.34 mark by the end of the year.

General economic outlook for 2008

In 2008, the global economy will show the same solid growth as in 2007. This is especially true for the United States, which should see growth accelerate slightly. In contrast, the European and German economies should keep the same growth rates as in 2007.

Financial Review continued

Key planning data for 2007

Our plans are based on the following conservative assumptions:

- the global upturn will lose some of its momentum,
- growth in gross domestic product will be close to 2% in Germany,
- the inflation rate will rise to approximately 2% as a result of the increase in the rate of value-added tax,
- long-term interest rates will remain close to 4%,
- the number of company bankruptcies will continue to decline slightly.

Development of HVB Group

A rise in earnings per share, to €0.56, has been targeted for 2007 for the UniCredit Group as a whole.

As an integral part of this corporate group, the new HVB Group will provide important financial contributions to achieving this goal.

Based on our good operating performance in the year under review, we are planning a further tangible increase in total revenues for the new HVB Group and only a slight rise in operating costs, which will lead to an improvement in the cost-income ratio. This is based on the existing group of consolidated companies following the disposal of our activities in Austria and central and eastern Europe.

Net trading, hedging and fair value income, coupled with higher net commission income from innovative products for private and corporate customers, is set to drive the increase in total revenues.

Net write-downs of loans and provisions for guarantees and commitments will remain at around the same level as the previous year.

The new HVB Group is the centre of competence for the investment banking activities of the UniCredit Group. The possibility of pooling the activities grouped together in a virtual structure at the new HVB Group is currently being considered. The first step would involve integrating the main business activities of UniCredit Banca Mobiliare (UBM), UniCredit's investment bank, in the new HVB Group. The definitive timing and nature of the integration are to be determined in the near future.

With the disposal of BA-CA, AS UniCredit Bank and IMB at the start of January 2007, the core capital ratio improved to 15.6% on a pro forma basis.

Opportunities arising from the development of general conditions and future business strategy

In the course of the combination with the UniCredit Group and as a result of the sale of the commercial activities in Austria, central and eastern Europe, Russia, the Ukraine and the Baltic states, interesting new opportunities have arisen for HVB Group to continue to grow again organically and by means of acquisitions after a period of transformation and integration:

- Exploiting opportunities arising from change and consolidation processes in Germany within the framework of a specialised business model with a clear emphasis on Germany.
- Tapping the success potential arising from the concentrated expansion of investment banking activities.

- HVB Group's prospects of realising high value-added potential and sustained earnings growth as part of a European banking group with a unique competitive profile in central and eastern European markets.
- Using more favourable funding options through a sustainably improved and secured capital base, which can also influence rating assessments.
- Leveraging the advantage from HVB Group's now high capital base and liquidity to swiftly and flexibly respond to opportunities arising on the market.
- Reduction of regional risk potential and the entailed future investment risks.
- Exploiting cost and earning synergies by optimising all production capacities, rationalising overlapping functions and enhancing processing flows.

Opportunities in terms of corporate strategy, performance and other factors

Besides the opportunities arising from our combination with the UniCredit Group, the disposals in Austria and central and eastern Europe and the strategic realignment of HVB Group, further opportunities have arisen as a result of:

- a further improvement in total revenues by creating and using new products for all customer segments through product factories with tailored solutions,
- projects to support customers demanding cross-border financial services in central and eastern European markets,
- a further reduction in operating costs achieved by strict cost management in Germany,
- an improvement in cross-selling potential in all customer groups,
- reducing risk by disposing of individual non-strategic assets, and
- a bolstering of the capital base also from sustainable earnings growth.

The economic development in the core market of Germany will also have a major impact on all of the opportunities described. An economic recovery, accompanied by improvement in the unemployment rate and a favourable trend on the real estate markets, provides positive leverage for further strong performance.

Risk Report

HVB GROUP AS A RISK-BEARING ENTITY

As a rule it is not possible to earn income in the banking business without incurring risk. By definition, risk entails the possibility of a negative future development of the economic state of HVB Group as part of the UniCredit Group. Consequently, the conscious handling, active management and ongoing monitoring of risk are core elements of the profit-oriented management of business transactions by HVB Group. This also applies to Bank Austria Creditanstalt Group and other units in central and eastern Europe until their disposal at the beginning of January 2007.

We therefore regard it as one of our core tasks to apply these considerations in order to achieve a consistent integration of profitability and risk criteria in all divisions and functions of the Bank.

MANAGEMENT AND MONITORING OF RISK IN HVB GROUP

1 Risk management

For risk management purposes the Bank defines its overall risk strategy at HVB Group level. In particular, this means determining, on the basis of the available capital cushion, the extent and manner of permissible risk exposure for the various divisions. This means that whenever risk is taken, it must be determined whether it is possible to do so, based on risk cover calculations, and whether it is worth doing so in terms of risk/reward calculations.

Through the targeted and controlled assumption of risk, the various divisions implement – with profit responsibility – the risk strategies defined for them within HVB Group. In doing so, they utilise the regulatory and economic capital allocated to them within the framework of limit systems.

2 Risk monitoring

The risk management process is accompanied by comprehensive risk monitoring, which is functionally and organisationally independent and encompasses the following tasks:

Risk analysis

Risk analysis involves the identification and analysis of risks from business activities and the development of methods for measuring them. Parallel to these activities, the available capital cushion is defined and quantified.

Risk control

In addition to the quantification and validation of the risks incurred and the monitoring of the allocated limits, the subsequent risk control process involves risk reporting, which at the same time provides management with recommendations for action when making future risk-policy decisions.

The functional segregation of risk management and risk monitoring is also taken into account in organisational structures.

3 Divisions and committees

Risk management

The divisions are responsible for performing the risk management functions within the framework of the competencies defined by the Management Board of HVB Group. Important bodies operating at HVB Group level are the Strategic Credit Committee and the Asset Liability Committee.

Strategic Credit Committee (SCC)

Strategic issues are discussed and decided on by the Strategic Credit Committee (SCC) in its capacity as a management and decision-making body with responsibility for all areas. The role of the SCC has no effect on the final decision-making authority of the Management Board on matters that cannot be delegated or those related to the Minimum Requirements for Risk Management (MaRisk).

The issues addressed by the SCC are primarily the risk strategy of HVB Group and division-related risk strategies and measures, the specification of risk tolerance, risk classification processes, credit organisation principles, risk-related aspects with regard to process/processing standards in the credit business, major changes or updates in the product range in the lending business and the amount of risk premiums (transfer prices) and country limits.

The SCC is chaired by the Chief Risk Officer, and has representatives from all the divisions and, from the back office side, Risk Control, Recovery Management and Credit & Risk Management.

Asset Liability Committee

The Asset Liability Committee makes decisions at its monthly meetings on asset/liability management of HVB AG and sets guidelines for HVB Group. The committee pursues the following key goals:

- establishment of uniform methods for asset/liability management for the entire HVB Group,
- optimum utilisation of the financial resources of liquidity and capital, and
- co-ordination of the requirements of the divisions for financial resources and business strategy.

Risk monitoring

The Chief Risk Officer is responsible for monitoring and co-ordinating important risk-policy activities within HVB Group. The activities of the Chief Risk Officer in the year under review were supported by the Audit Committee of the Supervisory Board, various units under the Chief Financial Officer and the Audit department.

Audit Committee of the Supervisory Board

In 2006, the Management Board provided the Audit Committee of the Supervisory Board with information on the entire risk situation and risk management of the Bank at four meetings. The Supervisory Board received timely, detailed reports on all risks relevant to the Bank and on the performance of the loan portfolios and credit strategies. This reflects the vital importance for the continuing existence of the company of comprehensive early recognition of all risks and the feasibility of achieving business development targets.

Chief Risk Officer

The following departments, which perform tasks for HVB Group as well as HVB AG, are under the responsibility of the Chief Risk Officer:

Risk Control

- Risk Control deals in HVB Group with market risk, credit risk, operational risk and business risk as well as risks arising from the Bank's own real estate portfolio and shareholdings/financial investments. Its tasks and competencies include ongoing, independent risk measurement and monitoring, responsibility for risk measurement methods and their ongoing development, as well as reporting to the Chief Risk Officer, the Management Board of HVB Group and the Audit Committee of the Supervisory Board.

In addition, Risk Control is responsible for economic capital measurement and aggregation as well as the implementation of uniform risk control standards, taking into account the corresponding statutory requirements and especially the regulatory requirements in HVB Group. As of the second quarter of 2007, the structure of Risk Control will be adjusted to match its redefined responsibilities within the UniCredit Group.

Credit & Risk Management

- The Credit & Risk Management department pools the credit processing units for special business transactions for the credit business of the former Germany segment and for North America, Latin America and Asia as defined in the Minimum Requirements for Risk Management (MaRisk). This essentially includes credit analysis and credit decisions along with their subsequent implementation and processing. These activities serve in particular to meet regulatory requirements, and encompass our business in the newly formed Retail, Wealth Management and Corporates & Commercial Real Estate Financing divisions. These units are supported by industry specialists who are involved in the decision-making process for credit exposures larger than €5 million for the lending business of the divisions named above and across the board for the lending business of the Markets & Investment Banking division. We see their input on credit exposure decisions as a value-added contribution in the interest of sector-oriented risk management.

Chief Credit Risk Officer

- The function of the Chief Credit Risk Officer was eliminated effective January 31, 2006, and the restructuring and workout areas, of which he was in charge, were placed under the responsibility of Recovery Management. Credit responsibility for the Americas and Asia was taken on by Credit & Risk Management, whereas credit policy was taken over by Risk Control. Credit responsibility for financial institutions was transferred to Credit Risk Banks, Institutions & Country Risk. The tasks of risk provision forecasting and portfolio analysis originally under the responsibility of the Chief Credit Risk Officer are now handled by Recovery Management. Risk Control is in charge of preparing centralised policies and operating guidelines for the entire credit business.

Risk Report continued

Real Estate Valuation and Consulting

– The Real Estate Valuation and Consulting department focuses on the valuation of individual properties and portfolios, regular updates and monitoring of property values, and the analysis and forecasting of real estate market trends. At the same time it provides support in risk assessment and management in relation to mortgage collateral and the pfandbrief business as well as the determination of economic capital pursuant to Basel II.

Chief Financial Officer

The following departments under the Chief Financial Officer provide support in risk monitoring alongside the Tax Affairs and Investments departments:

Accounting

– The Accounting department is able to identify unfavourable trends by analysing the income statements which it produces on a monthly basis. This provides an important contribution to compliance with the risk management process.

Regulatory Reporting

– The Regulatory Reporting department is responsible for reporting to the regulatory bodies with jurisdiction over the banking sector. Along with Principle I (backing of risk assets and market risk positions with own funds) and Principle II (governing the liquidity of credit institutions), this specifically includes the evidence of large exposures, loans in excess of €1.5 million and loans to directors.

Asset Liability Management

– The Asset Liability Management department controls the short-term and long-term liquidity within HVB Group to ensure that the Bank has adequate liquidity at all times and to optimise the funding costs. Key elements are co-ordinated operations on money markets and capital markets and the specification of liquidity profiles for the corresponding units. Asset Liability Management is also responsible for the balance sheet structure and measures to optimise regulatory capital as well as risk management of our investments. The measures implemented in connection with these functions serve to support our Bank's rating and return targets.

Moreover, units under the responsibility of the Chief Financial Officer – along with the Risk Control department – are involved in our Basel II project activities.

Audit

– The Audit department operates as an independent organisational unit. It reports directly to the Board Spokesman and acts on behalf of the Management Board. Although it primarily performs the internal audit function for HVB AG, it also performs tasks for HVB Group as a whole. Its duties range from a control and advisory function based on a standardised system of reporting through to complete execution of internal auditing for the subsidiaries. The Minimum Requirements for Risk Management (MaRisk) stipulate that all operational and business processes must be audited at least every three years – if useful or appropriate – and all processes subject to especially high levels of risk must be audited at least once a year.

In addition to the individual audit reports, an annual review is prepared to provide the Management Board with a comprehensive overview of all audit findings and conclusions as well as their current status. In addition, the head of the Audit department reports on current trends and results in auditing activities at the regular sessions of the Supervisory Board's Audit Committee.

The departments and committees described here reflect the status of the organisational structure at December 31, 2006. Additional organisational adjustments may take place during the integration of HVB Group into the UniCredit Group.

Where necessary, a distinction is made in the Risk Report between the full HVB Group (including the companies which, in accordance with IFRS 5, are classified as discontinued operations and non-current assets or disposal groups held for sale) and the new HVB Group (excluding the companies which, in accordance with IFRS 5, are classified as discontinued operations and non-current assets or disposal groups held for sale).

RISK TYPES AND RISK MEASUREMENT

1 Relevant risk types

At HVB Group we distinguish the following risk types:

- credit risk,
- market risk,
- liquidity risk,
- operational risk,
- business risk,
- risks arising from our own real estate portfolio,
- risks arising from our shareholdings/financial investments,
- strategic risk.

2 Risk measurement methods

With the exception of liquidity and strategic risk, we measure all risk types using a value-at-risk approach under which potential future losses are measured on the basis of a defined confidence level.

The individual risk types are aggregated at HVB Group level as part of the economic capital calculation, applying a uniform one-year holding period and a 99.95 percent confidence level across all risk types.

This aggregation takes into account risk-reducing portfolio effects, which encompass both the correlations within the individual risk types between business units of HVB Group and the correlations across the risk types.

Liquidity risk and strategic risk are measured separately. The methods applied to the measurement of these risk types are described in the relevant sections of this Risk Report.

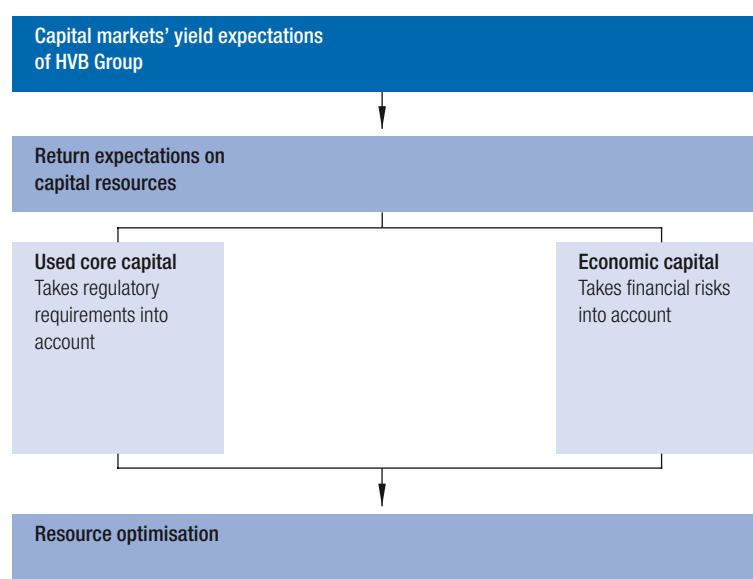
3 Development of risk measurement and monitoring methods

The methods used to measure and monitor risks are subject to an ongoing development and improvement process. This is the result of our own quality standards as well as a response by HVB Group to the more stringent statutory requirements and, to an even greater extent, the more stringent regulatory requirements (especially Basel II and the Minimum Requirements for Risk Management). In addition, differences in methodologies will be examined in the course of integration into the UniCredit Group.

OVERALL BANK MANAGEMENT

1 Dual management principle for overall bank management

The main focus of capital market-oriented management in HVB Group is on investment and the value-oriented allocation of our capital resources to business activities with attractive risk-return ratios. Within the framework of our dual management principle, the divisions are allocated both regulatory (or used core) capital and economic capital. Both resources are expected to yield an appropriate return, which is derived from the expectations of the capital markets and is expected to be earned by our business units. In 2007, harmonisation of the dual management principle with the management principles applied by the UniCredit Group will continue.



Risk Report continued

2 Regulatory capital adequacy

Used core capital

For planning purposes, the divisions are required to have core capital backing for credit and market risks equal to an average of 6.8 percent of equivalent risk assets. Furthermore, the expected return on investment is derived from the average used core capital calculated – for this purpose, excluding hybrid capital.

Management of regulatory capital adequacy requirements

To manage our regulatory capital we apply the following three capital ratios, which are managed on the basis of internally defined minimum levels:

- core capital ratio (ratio of core capital to risk assets, with or without the market risk positions weighted by a factor of 12.5)
- equity capital ratio (ratio of equity capital to risk-weighted assets)
- equity funds ratio (ratio of equity funds to the sum of risk-weighted assets and market risk positions weighted by a factor of 12.5)

More detailed information on these ratios in 2006 is contained in the Financial Review and in the notes to the consolidated financial statements (Note 76) in the present Annual Report.

Economic capital after portfolio effects

(confidence level 99.95%)

	2006		2005	
	€ millions	in %	€ millions	in %
Broken down by risk type				
Market risk	174	2.2	278	3.4
Credit risk	1,763	22.3	3,273	39.8
Business risk	595	7.5	1,098	13.3
Operational risk	791	10.0	1,056	12.8
Risks arising from the Bank's own real estate portfolio	259	3.2	347	4.2
Risks arising from the Bank's shareholdings/financial investments	584	7.4	2,181	26.5
HVB Group new	4,166	52.6		
Discontinued operations and non-current assets or disposal groups held for sale	3,751	47.4		
Full HVB Group	7,917	100.0	8,233	100.0
Capital cushion to cover risks				
Full HVB Group¹	21,947		18,807	
Utilisation, in %				
Full HVB Group¹	36.1		43.8	

¹ adjustment of previous-year values due to retroactive adjustment of IFRS disclosures

To determine the appropriate capital funding, we have essentially defined the following process:

- Based on our multi-year plan, we prepare a rolling eight-quarter projection for ongoing forecasting of our capital ratios in accordance with the German Banking Act.
- Reports on the actual ratios and significant effects on them are submitted every month to the Asset & Liability Committee, which decides on appropriate action if the actual ratios deviate significantly from plan.
- The Management Board is informed on a monthly basis on the risk asset budget utilisation of the divisions.

3 Economic capital adequacy

The future economic capital requirements of the divisions – broken down by risk type – are determined under the annual planning process in close cooperation between Risk Control and the individual operating units. After approval by the Management Board of HVB Group, the economic capital parameters are anchored in the control and reporting instruments. A comparison between the targets and the actual values of the parameters is produced on a quarterly basis and reported to the Chief Risk Officer.

Our economic capital, aggregated for the full HVB Group (including minority interests) amounted to €7.9 billion at December 31, 2006 after taking into account all risk-reducing portfolio effects. This represents an overall decline of 3.8% year-on-year. €4.2 billion of this amount relates to the new HVB Group.

In the year under review, the discontinuation of business activities and the sale of assets were also the focal point of economic capital changes. The related economic capital value at December 31, 2006 amounted to €3.75 billion. The decrease since December 31, 2005 is mainly attributable to the sale of the BPH Group and Activest business units to the UniCredit Group. The most noticeable effect on the economic capital of the new HVB Group is the reduction of our investment portfolio, primarily through the further reduction of our stake in Münchener Rückversicherungs-Gesellschaft AG, to approximately €0.6 billion. Consequently, the economic capital for credit risk, at €1.8 billion, with a stake of 22.3%, remains the most important risk item.

Economic capital after portfolio effects

(confidence level 99.95%)

	2006		2005 ¹	
	€ millions	in %	€ millions	in %
Broken down by division				
Retail	571	7.2	707	8.6
Wealth Management	138	1.7	116	1.4
Corporates & Commercial Real Estate Financing	688	8.7	830	10.1
Markets & Investment Banking	1,545	19.5	1,114	13.5
Other/consolidation	1,224	15.5	1,695	20.6
HVB Group new	4,166	52.6	4,462	54.2
Discontinued operations and non-current assets or disposal groups held for sale ²	3,751	47.4	3,771	45.8
Full HVB Group	7,917	100.0	8,233	100.0

¹ previous-year figures based on the 2006 divisional structure

² item for 2005 includes companies disposed of in the 2006 financial year

Risk Report continued

In a quarterly analysis of our ability to support risk, we measure our economic capital against the capital cushion available to us to cover risk. In addition, this sustainability analysis is carried out with a corresponding forecasting horizon as a component of our planning process.

According to our internal definition, the capital cushion is made up of IFRS capital components, participatory certificate and hybrid capital, reserves and the actual result. Minority interests are included and goodwill is deducted. The capital cushion for the full HVB Group amounted to €21.9 billion at the end of 2006 (comparable previous-year figure: €18.8 billion). The year-on-year rise results primarily from higher transfers to reserves together with an increase in the AfS reserve and lower participating certificates outstanding and hybrid capital instruments. With an aggregate economic capital of €7.9 billion, this represents a utilisation of 36.1% of the cushion.

Even taking into account the results of risk type-specific stress results, we had a substantial buffer in the capital cushion at the level of the full HVB Group over the entire financial year.

4 Risk strategy

Taking as the starting point the economic capital and the ability to cover risks, the Management Board approved a risk strategy for 2006 that is consistent with the business strategy. For 2007 this has been done for the new HVB Group which already reflects the new orientation within the planned structure of the UniCredit Group and all relevant risk types.

RISK TYPES IN DETAIL

1 Credit risk

Risk management

Credit risk is defined as potential losses arising from a customer default or downgraded credit rating. We distinguish here between the risk categories of loan default risk, counterparty risk, issuer risk and country risk.

Loan default risk

– Loan default risk is defined as the potential losses arising from commercial lending operations. It is taken into account by recognising allowances for losses on loans and advances in the balance sheet whenever specific indicators of a default have arisen in the past (incurred loss). The abstract expectation that customers could default in the future (the concept of expected loss and credit value-at-risk) must be seen separately from this.

Counterparty risk

– Counterparty risk is defined as the potential losses arising from the default or deterioration of credit ratings of counterparties with whom we have engaged in OTC derivatives transactions involving interest rates, foreign currencies, equities/indexes, or other futures or derivative transactions. It can be broken down into settlement risk, replacement risk and cash risk. For the Bank there is a settlement risk whenever payments are exchanged and, when processing the transaction, we make advance payments without being certain at the time of the payment that the counterparty will make the corresponding payment. The replacement risk is defined as the risk that the Bank must replace a transaction at less favourable market conditions following a default by the counterparty. The cash risk consists of the risk that the counterparty will not repay loans (taken out in cash). In the case of treasury products, cash risk is relevant in money trading.

Issuer risk

– Issuer risk reflects the risk from an issuer's default or downgraded credit rating. It arises in connection with the purchase of securities for own account, securities issuance and placement transactions, and credit derivatives.

Country risk

– Country risk is defined as potential losses arising from transfer/conversion restrictions, bans, or other sovereign measures imposed by the borrower's country (transfer risk). Country risk arises in cross-border transactions in foreign currencies. The credit risk of central governments and central banks is also taken into account (sovereign risk). This includes all positions from lending and trading activities, including internal transactions within HVB Group and the issuer risk associated with tradable fixed-interest securities.

Credit risk is managed on the basis of an integrated concept of clearly defined policies, approval authority structures and risk assessment processes.

With reference to credit risk, all HVB Group units that are involved in credit business must take organisational steps to segregate business origination functions ("front office") and credit risk management functions ("back office") at all levels by way of fully independent reporting lines. The back-office functions are pooled under the Chief Risk Officer. In addition, centrally positioned senior risk managers are involved in the decision-making process in all divisions for exposures in excess of a certain amount. They bear risk responsibility for their assigned portfolios and manage the sectors in accordance with the portfolio strategies adopted by the Strategic Credit Committee.

The credit equivalents (exposure values) of a given treasury transaction serve as a basis for the credit decision within the framework of the credit process, and are examined in conjunction with the exposure values from commercial lending operations. This applies both to individual credit decisions and to the management of concentration risk in HVB Group.

Country risk is managed on the basis of value-at-risk and volumes. For this purpose, a HVB Group-wide strategy is established annually and compared over the course of the year with the actual situation.

Measurement methods**Loan default risk**

We use differentiated risk measurement instruments to assess our loan default risk:

Rating analysis

– It is vitally important for us to reliably assess the default probabilities of our customers in the interest of credit decisions, pricing, future regulatory capital coverage under Basel II (under the IRB approach), and for our internal credit risk model. For this reason we place particular emphasis on the ongoing development and fine-tuning of our internal creditworthiness analysis instruments.

HVB Group has a wide range of rating and scoring processes tailored to the needs of the various customer groups. We continually optimise these systems, applying modern statistical processes, in order to ensure the best possible selectivity and forecasting accuracy with regard to the default probability of a customer.

The result of a rating or scoring process is the classification in a rating class with a ten-point scale. Rating classes 1–7 are set aside for performing loans and classes 8–10 for non-performing loans. For some processes, finer distinctions are made by subdividing each rating class into three subclasses (notches).

The rating and scoring processes are subject to continual monitoring. They are validated at regular intervals and recalibrated or fundamentally revised as required. A key aspect of this work in 2006 was in further development for private and business customers.

Internal credit risk model

– To measure credit risk, we employ an internal credit risk model to quantify and assess our loan default and counterparty risks in HVB Group. The advantage of this internally devised model is that its methodology and parameters perfectly match our portfolio and that it can be updated at any time to take account of new knowledge. Country risk is also assessed using a portfolio model.

Risk Report continued

Expected loss

- For purposes of credit risk measurement, we distinguish between the expected loss and the unexpected loss (expressed as credit value-at-risk). The expected loss reflects the default losses expected from the current loan portfolio over the next twelve months, taking into account the assigned ratings and the collateral on hand.

To calculate the expected loss, the exposure at default is calculated as stipulated by Basel II. For loan default risk and country risk, this amount is equal to the line utilisation at the reporting date plus portions of the unused, externally committed credit lines. The calculation takes into account differences in the risk inherent in various credit types.

A credit equivalent is computed as a calculation basis for OTC derivatives (counterparty risk): the so-called expected exposure. The credit equivalent is equal to the current fair value of a transaction increased by the amount of the so-called add-on, a premium for potential future market movements. The counterparty exposure calculated in this way takes into account both risk-reducing netting agreements and dynamic collateral contracts that oblige the counterparty to provide collateral on a daily basis to match the fair value of current transactions.

The parameters assumed for measuring the exposure at default and the loss given default are based on long-term statistical averages derived from internal defaults and losses, and from external reference parameters.

Credit value-at-risk

- The credit value-at-risk (unexpected loss) provides information about the maximum negative deviation of the possible loss from the expected loss (99.95% probability) within one year. This potential loss is backed by economic capital as a safety cushion, taking portfolio effects into account.

Scenario analysis

- The credit value-at-risk is calculated under the assumption of normal conditions. Scenario analysis helps us to simulate the effects of future macroeconomic trends or exogenous shocks and quantify their impact on the potential losses in the credit portfolio of HVB Group. The analysis includes multi-year forecasts of interest rate trends, economic growth and unemployment, but also such events as extreme changes in the price of oil or political crises. The results of these scenario evaluations are used to manage and limit loan default and country risk.

Risk-based and market-oriented pricing

- To optimise the loan portfolio and hence enhance the profitability of our lending business, we apply a pricing methodology with an orientation towards the risk-reward ratio. The credit margin takes into account the internal rating, collateral coverage, loss ratios, internal costs, maturity, existing country risks and the contribution of the loan to the diversification of the HVB portfolio. This methodology ensures coverage of the processing and risk costs while reducing to a minimum any future price changes resulting from Basel II. To ensure consistency with capital markets, we carry out regular benchmarking of our lending margins against market prices.

Implementation of Basel II

- A core element of the new Basel Capital Accord in the area of loan default risk is a stronger differentiation of risk for regulatory capital requirements for loan default risk according to customers' rating classes and the collateral structure of the transactions. This applies in particular to the most sophisticated approach, the so-called IRB Advanced Approach, which our Bank intends to implement as of 2008. The related implications from Basel II are moving the regulatory viewpoint towards the economic viewpoint of risk-adjusted management, which is already established as an approach within our Bank through our internal instruments.

In the context of Pillar 1, we continually improved the methods for risk assessment through the use of scoring and rating processes, adjusting and streamlining the internal processes accordingly. In the area of validation and calibration, we have extended the rating processes already implemented for rating procedures to the estimation of loss quotas and the size of exposures. This process utilises information both from the Bank's own experience in liquidation of collateral and externally available benchmarks. We already assess our collateral on the basis of recovery rates. We regard the usage of these processes as Basel II-compliant. In the year under review we also finalised the so-called Basel II calculation engine and adapted it to the requirements of the German Solvency Ordinance (SolvV).

With regard to the requirements of Pillar 2 and Pillar 3 under the Basel II regulations and the EU Directive, the departments concerned have carried out a comprehensive in-house audit. The requirements of Pillar 2 were met through the on-schedule implementation within our Bank of the Minimum Requirements for Risk Management of the German banking supervision authorities. These include the treatment of concentration risk, stress-testing (of individual risk types and overall bank risk) and the determination of the ability to cover risk.

Through the participation of our Bank in the Quantitative Impact Study QIS 5.0 we have already had the opportunity to use the operational risk systems and the Basel II calculation engine.

Measuring country risk

- At HVB Group, we measure country risk mainly by using short-term and medium-term country ratings. The country ratings consist of two components: empirically calibrated statistical models permit the determination of default probabilities and loss quotas on the basis of macroeconomic factors. Moreover, the assessment of political considerations and other soft facts is a crucial factor for the final rating of states as assigned by HVB Group's independent Economic Research department. Along with the probability of default and the loss ratio, the measurement of country risk takes the structure of transactions into account.

A portfolio model building on this information is used to calculate the value-at-risk stemming from country risks for HVB Group every month. Due to the small number of countries, country portfolios tend by their nature to be rather undiversified. For this reason an accurate reflection of the portfolio and diversification effects among countries, regions and loan default risks (exceeding the Basel II standards) is an integral part of our portfolio management. The use of an internal portfolio model thus enables us even today to achieve important management effects anticipated as the Basel II requirements go into effect.

Risk monitoring

Risk monitoring takes place at two different levels:

- at the level of individual exposures,
- at the portfolio level.

Individual exposures are monitored in both lending and trading operations with the aid of classical monitoring systems such as rating analysis and early warning systems. Individual exposure limits serve to limit the risks assumed.

At HVB Group level, loan default risk concentrations with subsidiaries are limited by credit ratings together with a uniform methodology for all subsidiaries. For this purpose we use a database encompassing all exposures to borrowers within HVB Group worldwide. This ensures that information is regularly provided on concentrations of loan default risk and related limits.

Counterparty risk and issuer risk

We employ limit systems as a key element of our management and control of counterparty risk and issuer risk to prevent the unintended and uncontrolled increase of our risk positions. These systems are available online at all key HVB Group facilities engaged in trading activities, except for the Bank Austria Creditanstalt Group, where limits are monitored using separate systems. Each new trade is immediately entered and applied to the corresponding limit within an appropriate time frame. For counterparty risk, this applies to both replacement risk and settlement risk. For the latter, the risk for the future value date is limited and monitored right from the time the Bank enters into the transaction, so that a concentration of payments on a single value date is prevented beforehand. This enables each trader to check current limit utilisation and lets the risk controller perform direct limit monitoring for each counterparty or issuer.

Risk Report continued

Country risk

Country risk is managed on the basis of the measurement methods described above with the aid of regional value-at-risk limits. Transactions with high levels of country risk are given a higher weighting for inclusion in regional risk limits than transactions with low levels. In taking this approach, we are striving to limit country risk while implementing risk-oriented portfolio management and an exposure management based on transaction potential. In addition, country risk management works with volume limits for each country, broken down by product risk group.

All credit risks are also monitored at the portfolio level. Particular attention is paid to country, industry or regional concentrations and their impact on the Bank's ability to support risk.

Another instrument for risk monitoring, particularly at the portfolio level, is internal reporting. In compliance with the Minimum Requirements for Risk Management (MaRisk), the Management Board and the Audit Committee of the Supervisory Board must receive a report on the credit portfolio on a quarterly basis. In addition, risk reports are produced with a special focus on specific divisions, products or industries.

Quantification and specification

A decrease of €34.3 billion (8.5%) in loan default and counterparty risk was recorded in the year under review. The driving forces behind this decline were the ongoing systematic reduction of the Real Estate Restructuring (RER) portfolio, the sale of BPH in Poland and a strategically targeted reduction of the lending portfolio in Germany.

The structure of the credit risk portfolio in terms of industries is essentially unchanged, despite the disposal of more than one third of the HVB Group portfolio as the decline affected all industry groups. The biggest decreases arose among retail customers, and banks and insurers. The trend in regional distribution reflects company strategy with a decrease in exposure in the Germany region. The sale of the Bank Austria Creditanstalt Group and other HVB Group companies has led to exposure in Austria and central and eastern Europe being almost completely eliminated.

Apart from an increase in the Wealth Management division, exposure declined by between 5% and 10% in all divisions.

The quality of the core portfolio remained stable. The core portfolio is defined as the HVB Group portfolio minus the exposures assigned to RER. The sale of the Bank Austria Creditanstalt Group and other HVB Group companies in central and eastern Europe affected all rating classes to the same extent, resulting in a sharp decline in each class. Exposure in rating classes 9 and 10 declined by almost half.

The risk contribution from the divisions has changed, as reflected in the distributions of expected loss and value-at-risk. Both expected loss and value-at-risk decreased in the Retail division. The risk share of Markets & Investment Banking rose to make up almost half of the total value-at-risk in the activities remaining with HVB Group, on account of the large volumes involved. The share of risk from Corporates & Commercial Real Estate Financing declined slightly, whereas in Wealth Management, it remained stable at a low level.

Loan-loss provisions

Our total loan-loss provisions, including allowances for losses on guarantees and indemnities, declined by €3.2 billion to €6.3 billion in 2006, taking into account write-offs taken on the lending portfolio of €3.8 billion.

Loan default risks

We created a total loan-loss provision of €0.9 billion for loan default risks in 2006. More detailed information can be found in the notes to the consolidated financial statements (Notes 35 and 46) in the present Annual Report.

Breakdown of loan default exposure and counterparty exposure by industry sector

€ billions	2006	2005
Industry sector		
Retail customers	51.1	81.5
Banks and insurers	42.1	86.2
Construction	34.6	59.7
Food, consumer goods, services	24.5	50.2
Chemicals, health, pharmaceuticals	12.1	13.9
Utilities	11.5	15.0
Transportation	10.4	13.4
Other	9.1	12.3
Public sector	8.6	29.5
Mechanical engineering, steel	6.2	10.7
Electrical, IT, communications	6.0	8.1
Automotive	4.9	8.0
Media, printing, paper	4.7	6.7
Mineral oil	3.9	6.4
HVB Group new	229.7	
Discontinued operations and non-current assets or disposal groups held for sale	137.6	
Full HVB Group	367.3	401.6

Breakdown of loan default exposure and counterparty exposure by region

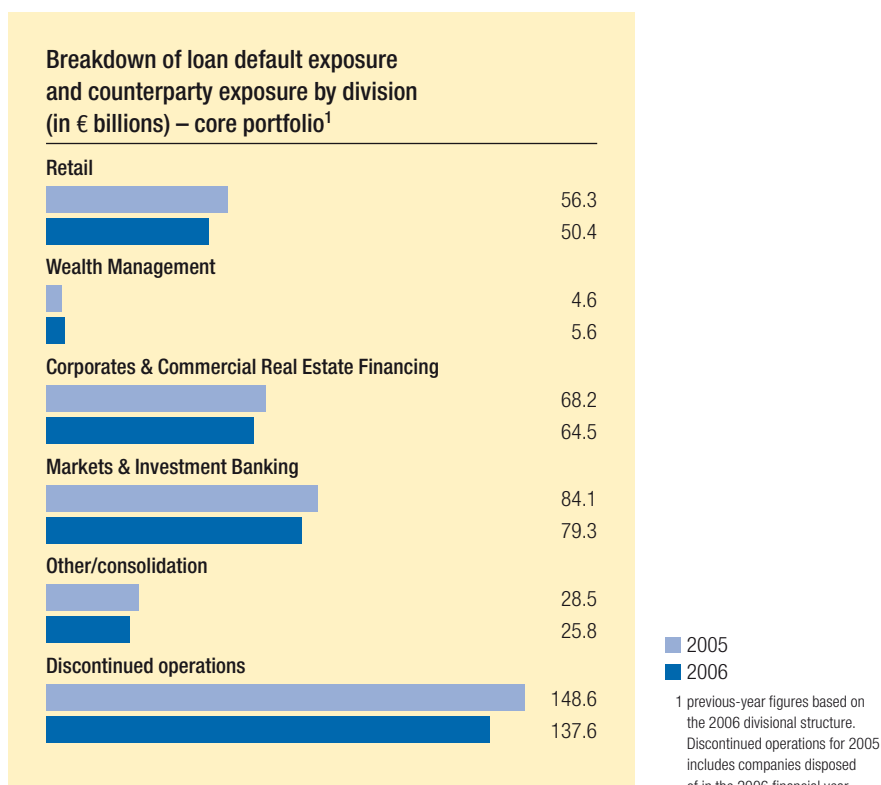
€ billions	2006	2005
Region		
Germany	158.7	185.7
Rest of Europe	39.2	53.6
North America	13.4	17.6
Other	10.1	19.2
Asia	3.1	3.9
Japan	2.8	2.7
Austria	1.2	79.4
Central and Eastern Europe	1.2	39.5
HVB Group new	229.7	
Discontinued operations and non-current assets or disposal groups held for sale	137.6	
Full HVB Group	367.3	401.6

Risk Report continued

Breakdown of loan default exposure and counterparty exposure by rating class – core portfolio

	2006		2005 ¹	
	€ billions	in %	€ billions	in %
Rating				
Free of credit risk	7.8	2.1	13.5	3.5
Not rated	7.9	2.2	18.8	4.8
Rating 1–4	109.8	30.2	220.5	56.5
Rating 5–8	93.5	25.8	124.6	31.9
Rating 9–10	6.6	1.8	12.9	3.3
HVB Group new	225.6	62.1		
Discontinued operations and non-current assets held for sale or disposal groups	137.6	37.9		
Full HVB Group	363.2	100.0	390.3	100.0

¹ previous-year figures based on the 2006 divisional structure



Breakdown of expected loss, and of loan default risk and counterparty risk (value-at-risk) by division – core portfolio

in %	EXPECTED LOSS		VALUE-AT-RISK	
	2006	2005 ¹	2006	2005 ¹
Division				
Retail	13.7	16.0	7.6	10.7
Wealth Management	0.9	0.9	0.7	0.9
Corporates & Commercial Real Estate Financing	15.4	16.4	16.4	17.4
Markets & Investment Banking	22.1	15.4	28.3	19.7
Other/consolidation	16.1	14.9	8.0	10.1
HVB Group new	68.2	63.6	61.0	58.8
Discontinued operations and non-current assets or disposal groups held for sale ²	31.8	36.4	39.0	41.2
Full HVB Group	100.0	100.0	100.0	100.0

¹ previous-year figures based on the 2006 divisional structure

² item for 2005 includes companies disposed of in the 2006 financial year

Financial derivatives

HVB Group uses financial derivatives primarily to manage market price risk (in particular risk arising from interest rate fluctuations and currency fluctuations) arising from trading activities. They also serve to provide cover for on- and off-balance-sheet items within asset/liability management or, in the case of credit derivatives, to manage credit risk.

At year-end 2006, the total nominal amount of worldwide derivative transactions of the full HVB Group amounted to approximately €2,713 billion.

However, the nominal amounts do not reflect the potential risk inherent in derivative transactions, whereas the positive fair values are relevant for purposes of default risk as replacement values for the OTC derivatives. They represent the potential costs that HVB Group would incur to replace all of the original contracts with equivalent transactions in case of simultaneous default by all counterparties.

Without taking risk-reducing effects into account, the maximum counterparty risk (worst case scenario) for the full HVB Group at year-end 2006 totalled €41.5 billion (December 31, 2005: €47.5 billion).

In accordance with Principle I of the banking supervisory regulations, and taking into account the risk-reducing effects of existing, legally enforceable bilateral netting agreements and the provision of collateral provided by borrowers, credit equivalents (counterparty risk including add-on) for the full HVB Group totalled €20.1 billion (December 31, 2005: €19.5 billion) and the remaining risk after risk weighting amounted to €5.9 billion (December 31, 2005: €5.4 billion).

The tables below provide detailed information on the nominal values and fair values of the overall derivative transactions and credit derivative transactions of HVB Group.

Risk Report continued

Derivatives transactions

€ millions	NOMINAL AMOUNT					FAIR VALUE			
	RESIDUAL MATURITY			TOTAL	TOTAL	POSITIVE		NEGATIVE	
	UP TO 1 YEAR	1 – 5 YEARS	MORE THAN 5 YEARS	2006	2005	2006	2005	2006	2005
Interest rate derivatives	548,351	521,308	398,182	1,467,841	1,952,534	19,062	37,310	20,502	37,668
OTC products									
Forward rate agreements	50,254	251	—	50,505	99,208	22	48	11	56
Single-currency swaps	366,245	452,540	343,730	1,162,515	1,541,569	16,927	34,239	18,213	34,429
Interest rate options									
– purchased	15,119	31,381	27,644	74,144	80,758	2,084	3,021	—	—
– written	9,293	28,618	26,808	64,719	80,719	—	—	2,278	3,177
Other interest rate derivatives	294	4	—	298	10,395	3	2	—	6
Exchange-traded products									
Interest rate futures	48,948	8,514	—	57,462	66,223	—	—	—	—
Interest rate options	58,198	—	—	58,198	73,662	26	—	—	—
Foreign exchange derivatives	156,295	75,478	27,496	259,269	323,298	3,872	4,542	3,679	4,949
OTC products									
Foreign exchange forwards	113,927	20,254	252	134,433	186,823	1,758	2,631	1,951	2,988
Cross-currency swaps	14,856	50,516	26,018	91,390	81,916	1,723	1,237	1,391	1,473
Foreign exchange options									
– purchased	12,454	2,248	645	15,347	29,202	391	674	—	—
– written	15,058	2,460	581	18,099	25,357	—	—	337	488
Other foreign exchange derivatives	—	—	—	—	—	—	—	—	—
Exchange-traded products									
Foreign exchange futures	—	—	—	—	—	—	—	—	—
Foreign exchange options	—	—	—	—	—	—	—	—	—
Equity/index derivatives	98,797	100,089	6,367	205,253	197,605	10,396	4,699	10,602	5,434
OTC products									
Equity/index swaps	14,384	4,521	495	19,400	—	484	—	228	—
Equity/index options									
– purchased	21,477	25,767	703	47,947	60,301	6,629	4,669	—	—
– written	23,294	41,567	3,110	67,971	83,009	—	—	6,836	5,359
Other equity/index derivatives	107	223	—	330	1,208	17	30	—	75
Exchange-traded products									
Equity/index futures	9,819	—	—	9,819	10,118	—	—	—	—
Equity/index options	29,716	28,011	2,059	59,786	42,969	3,266	—	3,538	—
Credit derivatives¹	36,148	142,713	73,207	252,068	139,688	2,748	903	3,231	1,743
Other transactions	1,348	1,316	407	3,071	2,290	295	117	291	122
HVB Group new	840,939	840,904	505,659	2,187,502		36,373		38,305	
Discontinued operations and non-current assets or disposal groups held for sale	296,427	155,822	73,191	525,440		5,139		5,474	
Full HVB Group	1,137,366	996,726	578,850	2,712,942	2,615,415	41,512	47,571	43,779	49,916

¹ For details of credit derivatives, please see the tables "Credit derivatives" and "Credit derivatives by reference asset" below.

Derivatives transactions by counterparty type

€ millions	FAIR VALUE			
	POSITIVE		NEGATIVE	
	2006	2005	2006	2005
OECD central governments (and central banks)	141	337	133	286
OECD banks	24,849	41,072	26,139	42,805
OECD financial institutions	8,888	3,598	9,604	5,496
Non-OECD central governments (and central banks)	91	76	54	—
Non-OECD banks	71	31	98	89
Non-OECD financial institutions	188	51	140	59
Other companies and private individuals	2,145	2,406	2,137	1,181
HVB Group new	36,373		38,305	
Discontinued operations and non-current assets or disposal groups held for sale	5,139		5,474	
Full HVB Group	41,512	47,571	43,779	49,916

Risk Report continued

Credit derivatives

€ millions	NOMINAL AMOUNT					FAIR VALUE			
	RESIDUAL MATURITY			TOTAL	TOTAL	POSITIVE		NEGATIVE	
	UP TO 1 YEAR	1 – 5 YEARS	MORE THAN 5 YEARS	2006	2005	2006	2005	2006	2005
Banking book	462	2,149	11,688	14,299	15,003	485	235	798	804
Protection buyer									
Credit default swaps	323	979	7,537	8,839	10,139	462	163	53	10
Total return swaps	—	—	2,000	2,000	2,000	—	—	327	343
Credit-linked notes	45	65	515	625	261	2	—	2	254
Other	—	—	—	—	—	—	—	—	—
Protection seller									
Credit default swaps	49	1,091	1,606	2,746	2,550	21	19	415	197
Total return swaps	—	—	—	—	—	—	—	—	—
Credit-linked notes	45	14	30	89	53	—	53	1	—
Other	—	—	—	—	—	—	—	—	—
Trading book	35,686	140,564	61,519	237,769	124,685	2,263	668	2,433	939
Protection buyer									
Credit default swaps	6,609	68,463	35,218	110,290	54,212	393	248	1,614	236
Total return swaps	11,726	1,606	235	13,567	10,221	329	4	—	173
Credit-linked notes	57	310	284	651	153	15	—	4	153
Other	—	—	—	—	—	—	—	—	—
Protection seller									
Credit default swaps	5,536	68,525	25,503	99,564	50,483	1,524	221	477	374
Total return swaps	11,706	1,503	33	13,242	9,578	—	171	327	3
Credit-linked notes	52	157	246	455	38	2	24	11	—
Other	—	—	—	—	—	—	—	—	—
HVB Group new	36,148	142,713	73,207	252,068		2,748		3,231	
Discontinued operations and non-current assets or disposal groups held for sale	827	3,762	1,505	6,094		15		14	
Full HVB Group	36,975	146,475	74,712	258,162	139,688	2,763	903	3,245	1,743

Credit derivatives by reference asset

€ millions	NOMINAL AMOUNT				TOTAL 2006	TOTAL 2005
	CREDIT DEFAULT SWAPS	TOTAL RETURN SWAPS	CREDIT-LINKED NOTES	OTHER		
Public-sector bonds	14,240	—	553	—	14,793	5,109
Corporate bonds	196,111	28,606	781	—	225,498	72,725
Equities	—	—	—	—	—	—
Other assets	11,088	203	486	—	11,777	61,854
HVB Group new	221,439	28,809	1,820	—	252,068	
Discontinued operations and non-current assets or disposal groups held for sale	4,390	—	1,704	—	6,094	
Full HVB Group	225,829	28,809	3,524	—	258,162	139,688

Country risk year-on-year

In the year under review, the exposures of the full HVB Group entailing country risk decreased by €17.8 billion to €82.8 billion.

Approximately 94.3 percent of the total exposure are from countries with rating classes 1–4 (investment grade). Of the exposure in rating classes 5–8, a volume of €2.3 billion (4.8%) was in rating class 5.

The business strategy of HVB Group is also reflected in the development of the exposure and the value-at-risk for each country. This is the cause of a significant increase in the country value-at-risk for countries in eastern Europe. Decreases in the exposure, by contrast, are related primarily to treasury transactions in rating classes 1–4.

The portfolio of the new HVB Group displays good regional diversification. The majority (53%) of the exposure of the new HVB Group is related to low-risk western Europe (rating class 1).

The top 10 countries also include mainly low-risk countries in western Europe, North America and Asia.

Country exposure¹ and country value-at-risk by rating class

€ millions	EXPOSURE		VALUE-AT-RISK	
	2006	2005	2006	2005
Rating				
Rating 1–4	45,244	95,850	35	115
Rating 5–8	2,714	4,771	31	76
Rating 9	3	51	0	8
HVB Group new	47,961		66	
Discontinued operations and non-current assets or disposal groups held for sale	34,877		207	
Full HVB Group	82,838	100,672	273	199

1 net of collateral; excluding transactions with loan-loss provisions

Risk Report continued

Country exposure¹ by region and product category

€ millions	LENDING		TRADING		ISSUER RISK		TOTAL	
	2006	2005	2006	2005	2006	2005	2006	2005
Region								
Africa	327	755	190	203	7	8	524	966
North America	1,755	5,054	2,156	6,934	302	2,891	4,213	14,879
Eastern Europe	3,785	11,885	640	5,372	63	701	4,488	17,958
Central and South America	2,578	3,070	2,115	8,010	1,270	1,306	5,963	12,386
Asia/Pacific	4,033	4,989	3,058	6,395	134	691	7,225	12,075
Western Europe	6,868	14,551	17,931	26,148	749	1,709	25,548	42,408
HVB Group new	19,346		26,090		2,525		47,961	
Discontinued operations and non-current assets or disposal groups held for sale	19,069		10,510		5,297		34,877	
Full HVB Group	38,415	40,304	36,600	53,062	7,822	7,306	82,838	100,672

¹ net of collateral; excluding transactions with loan-loss provisions

HVB Group new: top ten countries by exposure¹ across all rating classes

€ millions	EXPOSURE		VALUE-AT-RISK	
	2006	2005	2006	2005
Country				
UK	18,595	32,449	0	0
Cayman Islands, off-shore	3,662	7,138	7	20
Switzerland	3,633	5,757	0	0
USA	2,510	12,078	0	0
Russia	1,531	1,989	10	10
Japan	1,517	3,055	0	0
Norway	1,310	1,272	0	0
Turkey	1,288	1,912	13	17
Cayman Islands, on-shore	1,174	3,700	2	4
Canada	905	2,337	0	0
HVB Group new	36,125		32	
Discontinued operations and non-current assets or disposal groups held for sale	17,111		23	
Full HVB Group	53,236	71,687	55	51

¹ net of collateral; excluding transactions with loan-loss provisions

2 Market risk

Risk management

Market risk is defined as the potential loss arising from an adverse change in the financial market prices of our positions in the trading or banking book. Market risk comprises the risk categories interest rate, foreign exchange, equity and credit spread risk.

Our market risks are managed in the Markets & Investment Banking division and in the various treasury units or asset/liability units of our subsidiaries.

Measurement methods

For purposes of day-to-day risk measurement and management, we quantify the value-at-risk on the basis of a confidence level of 99% and a holding period of one day. On account of the joint management of the trading and banking books, the value-at-risk is also shown as an aggregate value. The risks inherent in the trading books continue to be shown separately for regulatory purposes. To determine and allocate the economic capital requirements for market risks, this value-at-risk, like other risk types, is scaled to a confidence level of 99.95% and a holding period of one year, taking portfolio effects (diversification) into account.

To calculate the value at risk at HVB AG, we employ an internal model in full use that was given full regulatory approval at the end of 2005. The model is based on a Monte Carlo simulation approach.

We check the appropriateness of the methods used to measure market risk by means of periodic back-testing that compares the value-at-risk (VaR) calculations with the market value changes (hypothetical P/L) derived from the positions. The results of this back-testing confirm the high quality of our internal risk model.

In addition, appropriate procedures are applied within HVB Group.

In addition to calculating the value-at-risk, we continually conduct stress tests for HVB Group to determine the potential losses in our market risk positions resulting from extreme market movements and worst-case scenarios. The scenarios we examine range from large movements in interest rate, currency and equity markets through to disruptions in the underlying volatilities. Further scenarios are also considered for HVB AG, such as the widening of the credit spread or changes in the correlations. This also includes scenarios used in the UniCredit Group.

Market risk from trading positions: HVB Group new

(value-at-risk, 99% confidence level, one-day holding period)

€ millions	AVERAGE 2006 ¹	Dec. 31, 2006	Sept. 30, 2006	June 30, 2006	March 31, 2006	Dec. 31, 2005
Interest rate positions (incl. credit spread risks)	12	12	9	10	15	11
Foreign exchange positions	5	3	4	6	7	5
Equity/index positions	5	4	5	5	5	9
Diversification effect ²	(8)	(6)	(7)	(9)	(9)	(9)
HVB Group new	14	13	11	12	18	16

¹ arithmetic mean

² because of the diversification effect between the risk categories, the total risk is less than the sum of the individual risks

Risk Report continued

Risk monitoring

The risk positions in the trading and banking books are monitored using a uniform, hierarchical limit system that restricts the loss potential from market risk. The risk limits are approved annually by the Management Board of HVB Group and are not permitted to be exceeded.

Whenever limits in subportfolios are exceeded, an escalation process is triggered immediately and the reduction of the positions in question is monitored closely. In 2006 there were no major instances in which limits were exceeded. Market Risk Control has direct access to the front office systems used in trading operations, enabling it to perform spot checks on the risk situation on an intraday basis as well.

Management is informed daily of the exposure to market risk, limit utilisation, and the profits and losses within HVB Group. The results of the risk analyses, including the results of the back-testing and stress tests, are reported on a monthly basis.

Quantification and specification

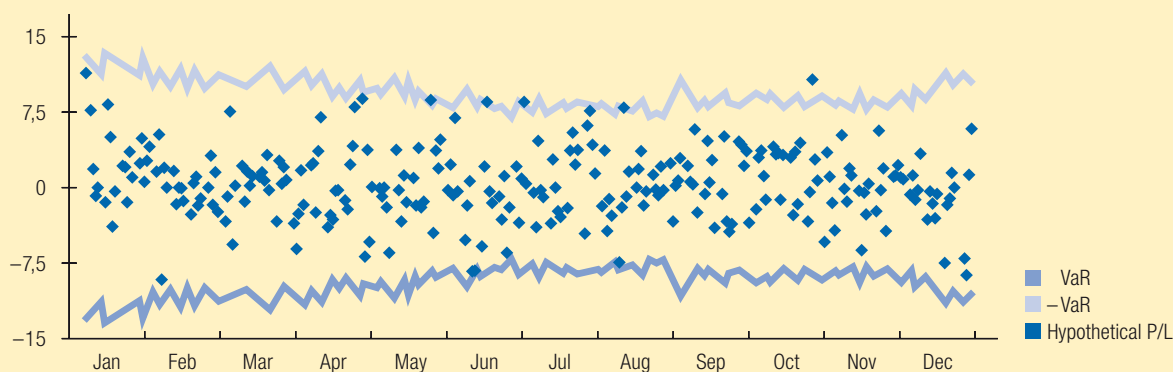
The table shows the aggregate market risks of our trading positions in the new HVB Group for last year.

At €0.17 billion, the economic capital for market risks at the new HVB Group has fallen since last year.

At year-end, the banking book of the new HVB Group contained market risks of €13 million (2005: €20 million; one-day holding period).

In addition, regular stress tests and scenario analyses are carried out on the banking books of HVB AG that reveal the loss potential in case of extreme market movements.

Back-testing of internal model: Trading activities HVB AG 2006
(€ millions)



In compliance with the Basel II requirements, the change in the market value of the banking book in case of an interest rate shock amounting to 200 basis points is compared with the Bank's eligible equity funds. With a notional utilisation of 6.4% of its regulatory equity capital at December 31, 2006, HVB AG is well below the outlier value of 20% required by the banking supervisory authorities.

As part of the earnings perspective, a dynamic simulation of the net interest income is carried out for HVB AG on a quarterly basis. The future trend in net interest income is simulated in various scenarios in relation to business volume and interest rates. Assuming a constant volume of business, a parallel upward interest shock of 200 basis points would result in a €165 million decrease in net interest income within the next 12 months.

3 Liquidity risk

Risk management

We distinguish three categories of liquidity risk:

Short-term liquidity risk

– Short-term liquidity risk (narrowly defined liquidity risk) represents the risk that the Bank will not be able to meet its payment obligations in full or in time.

Funding risk

– Funding risk represents the risk that additional refinancing funds will be available only at higher market interest rates.

Market liquidity risk

– Market liquidity risk represents the risk that the Bank will be able to liquidate assets on the market only at a discount.

The rules and principles of liquidity management are specified in a Liquidity Policy passed by the Management Board, and are implemented by the operational business units. Implementation – for short-term liquidity risk and the funding risk – is co-ordinated and tracked by Asset Liability Management.

Market liquidity risk is managed by the people responsible for the various portfolios as they perform their defined market-related tasks. As a result, it is included in the measurement of market risk, so that reference should essentially be made to the measurement and monitoring instruments listed for market risks.

Measurement methods

Short-term liquidity risk

To measure short-term liquidity risk, daily cash flow reports are produced and offset against the available liquidity reserves, which consist primarily of the available highly liquid securities. On the basis of these two components, cumulative limits are determined for the most important units of HVB Group, ranging from the next banking day up to one month.

Furthermore, stress scenarios based on the liquidity profiles of the units of HVB Group are simulated, and the limits are adjusted accordingly as required. In addition to this internal measurement methodology, we are subject to the regulatory standards defined in the Liquidity Principle II.

Funding risk

To measure funding risk, long-term funding needs are determined through a co-ordinated process, taking the expected business trends into consideration. This funding plan is updated regularly. The funding targets derived from this process ensure a balanced maturity structure of assets and liabilities within defined maturity buckets.

Market liquidity risk

Fair value adjustments (FVAs) are used to reflect the market liquidity risk of securities and derivatives in the accounts for both the trading book and the banking book. The FVAs include a discount for close-out costs, non-liquid positions and model risks related to the assessment of fair values.

Risk Report continued

Risk monitoring

The monitoring of our liquidity situation has been entrusted to our Asset Liability Management unit. It essentially comprises the analysis, classification and management of cash flow gaps across all maturities. This enables us to identify liquidity risks early and limit mismatches through limits and funding targets. Compliance with the allocated limits is monitored on a daily basis. We keep appropriate liquidity reserves on hand for defined stress situations. The target volumes and instruments derived from the funding targets are implemented in consultation with Treasury Management while optimising costs.

The local treasury units are responsible for observing developments in the various local markets. These units submit regular reports to Asset Liability Management.

The Asset Liability Committee and the Management Board are kept regularly informed about the current liquidity and funding situation. A contingency plan is in place to deal with liquidity bottlenecks. It describes the distribution of responsibilities, internal reporting requirements, decision-making powers and potential counter-measures.

Quantification and specification

Conditions on the money markets and capital markets remained favourable during the year under review. Risk premiums on capital markets for funding costs again declined slightly compared to 2005. The disposals of participating interests in the course of 2006 resulted in a further improvement of the liquidity situation of HVB AG.

Short-term liquidity risk

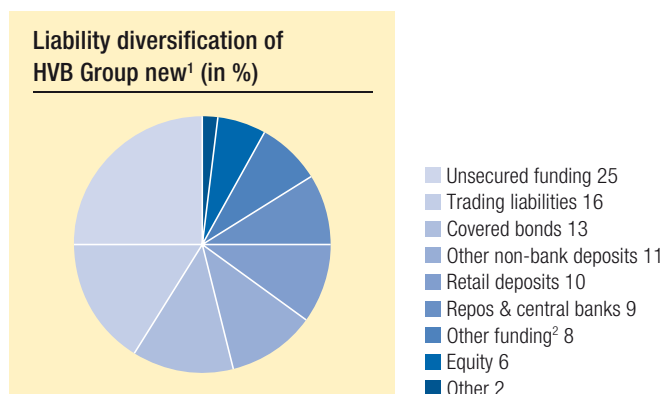
Within the framework of our short-term liquidity limit system, which operates under conservative assumptions, we showed an overall positive balance of €9.9 billion in the new HVB Group for the next banking day at the end of December 2006 (full HVB Group: €15.4 billion).

The portfolio of highly liquid securities eligible as collateral for central bank borrowings and available at short notice to compensate for unexpected outflows of liquidity amounted to €7.6 billion at year-end (full HVB Group: €12.6 billion).

The requirements of the regulatory Liquidity Principle II were met at all times by the relevant units of HVB Group during the year under review. In 2006 the funds available to HVB AG exceeded its payment obligations for the following month by an average of €20.2 billion.

Funding risk

The funding risk of HVB Group is quite low due to our broad funding base with regard to products, markets and investor groups. This enables us to obtain adequate funding for our lending operations even during difficult market phases. The new HVB Group refinanced a volume of €10.7 billion on the capital market in 2006 (full HVB Group: €14.4 billion). With their high credit quality and liquidity, our Pfandbrief mortgage bonds still remain one of the most important funding instruments.



¹ total assets of the new HVB Group €355 billion (full HVB Group: €508 billion); covered bonds and unsecured funding as per tables below

² including deposits from non-consolidated subsidiaries and special funding (e.g. KfW)

Breakdown of covered bonds: HVB Group new

	€ billions
Mortgage Pfandbriefs	19.0
Jumbo Pfandbriefs	21.5
Public Pfandbriefs	5.2
Public Jumbos	1.9
HVB Group new	47.6

Breakdown of unsecured funding: HVB Group new

	€ billions
Promissory notes	9.2
Bank deposits	37.3
Certificates of deposit and commercial papers	10.3
Other liabilities evidenced by paper (capital market)	19.1
Subordinated liabilities (capital market)	12.1
HVB Group new	88.0

4 Operational risk**Risk management**

We define operational risk as the risk of losses resulting from inadequate or failed internal processes, human errors, technological breakdowns or external events. Under Basel II, this definition also includes legal risks.

The identification, analysis and management of operational risk are the responsibility of each HVB Group subsidiary or that of the relevant divisions and functional units. The activities are guided by a tool-based operational risk management process defined internally within HVB Group and implemented by HVB Group since 2004. These will take into account the requirements of Basel II, in particular the Basel Committee's "Sound Practices for the Management and Supervision of Operational Risk".

The operational risk managers in the various units are responsible for the operational implementation of the process, which involves in particular the collection, analysis, evaluation and quality assurance of risk data and the planning of appropriate measures with continual monitoring of important risks.

Our Legal Department is responsible for managing legal risk. It monitors compliance by HVB Group companies with the statutory regulations and the recognised principles of case law. For HVB Group companies with their own legal departments, it performs this function in close co-operation with these departments.

In the course of integration into the UniCredit Group, the standards and procedures applied were gradually harmonised during 2006. This process will continue in 2007. The previous HVB Group operational risk system for collecting loss data and determining risk will gradually be applied as a platform for the entire UniCredit Group when modifications are complete.

Measurement methods

We employ the loss distribution approach to quantify the operational risk of HVB AG. Our quantification model for this purpose uses internal and external loss data to determine the loss distributions. We compensate for the shortage of data in some areas through scenario analysis. A Monte Carlo simulation is used to calculate the value-at-risk figures, taking into account risk-reducing measures such as insurance. By taking into account factors related to internal control and the business environment, we adapt the risk distributions and/or the measurements to the current risk profile.

The risk values for the subsidiaries are derived from the operational risk measured in this way for HVB AG and supplemented by the values obtained on the basis of similar methods from the Bank Austria Creditanstalt Group.

Risk Report continued

When determining capital adequacy in HVB Group for regulatory purposes within the Basel II framework, we will implement the Advanced Measurement Approach (AMA). This approach has been agreed within the UniCredit Group for use by HVB AG and selected subsidiaries with effect from January 1, 2008 and will subsequently be rolled out in the remaining major subsidiaries. The AMA calculation will be carried out in the future using a standardised measurement model that will be applied across the entire UniCredit Group.

Risk monitoring

In the year under review, the focus was on implementing the operational risk management process in the interest of performing a comprehensive risk survey of HVB AG and important HVB Group companies for the first time. In this process, important risks were identified and recorded along with risk-reducing measures. In addition, ongoing monitoring was implemented on the basis of an early warning system based – wherever possible – on indicators.

As part of regular and comprehensive reporting, the Chief Risk Officer, the Management Board of HVB Group and the Audit Committee of the Supervisory Board are kept informed by Risk Control on any loss events that occur and important operational risks and their management. This provides the basis for any measures deemed necessary.

Quantification and specification

The economic capital for operational risks of the new HVB Group amounted to €0.8 billion at the end of 2006.

The following measures were the most important steps taken during the year to minimise operational risk and avoid possible losses for HVB Group:

Divisions and companies of HVB Group:

- In HVB Group the insurance programme was surveyed and reviewed to obtain a basis for further optimisation.
- Retail/Corporates & Commercial Real Estate Financing: Further reductions were achieved in risks in the securities process by implementing measures such as linking the order entry system to the portfolio management system, the implementation of additional checking mechanisms for order entry and increasing the straight-through processing rate for transferring domestic custodial accounts.
- Markets & Investment Banking: Important measures included improvements in liquidity management (money market/foreign exchange cash management). At the same time the straight-through processing rate was increased for transactions handled in foreign currency payment systems and the items reconciled between the front office, back office and accounting units.
- Financial Markets Service Bank GmbH: The introduction of new systems and the optimisation of existing ones raised the level of process automation while increasing the flexibility in the products handled. In addition, existing processes were streamlined and optimised, resulting in a further reduction in settlement risk.

Handling crisis situations:

- The crisis and emergency management organisation of HVB Group demonstrated its ability to perform by its appropriate and effective responses to real situations and drills.
- A project has been underway since the beginning of 2006 to prepare the Bank for a worldwide flu epidemic (pandemic). In accordance with the pandemic plan developed in this project, the preparations of HVB Group will be organised to ensure that business operations can continue.
- The Business Continuity Management (BCM) working group of HVB Group has identified and assessed the main processes critical to business operations. The results will be included in the uniform BCM Policy of HVB Group due to be introduced in 2007.

IT risks:

- HVB Information Services GmbH classifies its IT projects on the basis of specific risk criteria to further reduce risk through early identification and analysis of potential problems.

Legal risks:**Real estate finance/financing of purchases of shares in real estate funds**

- HVB AG will not suffer negative legal consequences if customers cancel their property loan agreements under the Doorstep Transactions Act. According to the law and the opinion on this subject expressed in the ruling by the German Supreme Court, the customer, who is required to demonstrate that the conditions for cancelling the contract have been met, must repay the outstanding loan amount to the Bank, including interest at customary market rates, even after cancellation of the loan agreement. According to the ruling by the European Court of Justice dated October 25, 2005, the relevant German legal provisions do not contravene European law. The European Court of Justice also called for the investment risk to be assumed by the Bank in certain cases because of a failure to explain the right to cancel the contract. However, this applies only if the customer can prove that he would not have made the investment if he had been aware of this right; in addition, the German Supreme Court has decided that the Bank would only have to assume the investment risk in case of culpable actions. Consequently, the Bank does not expect the more recent court rulings to have negative effects either. In addition, the Bank's claim to repayment remains in effect even if the borrower issued an invalid proxy to a third party and the Bank relied on the validity of the proxy. Experience gained to date shows that there are no legal risks in such cases. The most recent judgement from the German Supreme Court also confirms the already narrow conditions for an explanation and advisory obligation on the part of the Bank. In cases of institutionalised collaboration, the German Supreme Court (in a decision dated May 16, 2006) makes it easier for investors to provide evidence of violations of the explanation obligation. This new concept in legal opinion will only be fully explained by decisions in individual cases in the future.
- If the Bank finances the purchase of shares in real estate funds for the borrower with a loan not secured by a real property lien, the borrower can – if the transaction is a so-called related transaction – dispute the claim of the financing bank to repayment of the loan on the basis of objections which the borrower is entitled to assert against the seller or agent in the fund transaction because of improper advice. Consequently, the Bank has no claim against the borrower to repayment of the loan if it utilised the sales organisation of the agent arranging the sale of shares in the fund, the loan was disbursed directly to the fund, and the investor was misled when purchasing the shares or if the borrower enjoys the right to cancel such agreements. The ruling also stated that the borrower in each individual case would have to demonstrate that these prerequisites were met. From today's standpoint, we assume that these circumstances will apply, if at all, only in exceptional cases.

Court proceedings of HVB AG shareholders

- Shareholders have filed suit against the re-election of the shareholder representatives to the Supervisory Board and the election of the auditor for the 2004 financial year at the Annual General Meeting of our Bank on April 29, 2004. This suit was also rejected on second appeal by the Munich Higher Regional Court in a ruling dated January 18, 2006. A shareholder has filed an appeal with the German Supreme Court against the denial of leave to appeal.
- A shareholder has filed a separate action seeking a declaration that the annual financial statements for 2004 are null and void, claiming that the nomination and election of the auditor of the financial statements at the Annual General Meeting of Shareholders in 2004 were null and void. Because of the decision of January 18, 2006 of the Munich Higher Regional Court mentioned above, we do not expect this suit to succeed.
- Moreover, some of the parties who filed the legal challenge have filed a motion requesting the removal from the Commercial Register of the capital increase carried out in spring 2004, stating that the appointment of Supervisory Board members in the Commercial Register in 2004 and the annual financial statements are null and void. In view of the result of the proceedings described above, we expect Munich Registration Court to reject the motion.

Risk Report continued

- In addition, shareholders have filed a legal challenge against resolutions adopted by the Annual General Meeting of our Bank on May 12, 2005. In a ruling dated December 22, 2005, Munich Regional Court sustained the suit to the extent that it related to the approval of the actions of Supervisory Board members for the 2004 financial year because the report of the Supervisory Board did not mention the withdrawal of the appeal against the ruling of Munich Regional Court I of April 15, 2004 and the fact, resulting from that ruling, that the election in 2003 was null and void. Munich Regional Court I dismissed the suit against the election of the Supervisory Board members and the auditor of the financial statements; the ruling is not yet final. The non-ratification of the actions of the Supervisory Board members at the Annual General Meeting of May 12, 2005, on which another resolution was passed at the ordinary general meeting on May 23, 2006, has no material effect on the Bank.
- Furthermore, shareholders of our Bank have filed suit against the resolutions of our Annual General Meeting of May 23, 2006, approving the spin-off and take-over agreement of March 29, 2006 and the master agreement of January 16, 2006 in conjunction with the transfer of a loan portfolio to a company in the Goldman Sachs Group. In the so-called release motion filed by our Bank in response to this suit, the Munich Regional Court on September 27, 2006 stated that the suits filed against the spin-off are no impediment to their being entered in the Commercial Register, since the suits are obviously without foundation. Munich Higher Regional Court rejected the filed suits on February 12, 2007, meaning that the release ruling is final.
- Numerous shareholders have filed suit contesting the resolutions adopted by our Bank's Extraordinary Shareholders' Meeting on October 25, 2006 approving the sale and transfer of the shares held by our Bank in Bank Austria Creditanstalt AG and HVB Bank Ukraine to the UniCredit Group, the shares held by our Bank in International Moscow Bank and AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga) to Bank Austria Creditanstalt AG, and the branches in Vilnius and Tallinn to AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga), asking the court to declare these resolutions null and void. In addition some shareholders have filed suit asking the court to order HVB AG to provide further information

regarding questions which they claim were not fully answered at the Extraordinary Shareholders' Meeting, and in particular to provide a full interpretation of the business combination agreement with the UniCredit Group. In the view of the Bank these claims are without merit. Among the prerequisites stipulated in the purchase and transfer agreements for the execution of the transactions is due diligence on the part of the Management Board in ensuring, on the basis of a report prepared by an external legal consultant, that the approval resolutions contain no errors that would represent an impediment to the execution of the contract in question. After the Management Board adopted a resolution for this purpose, the shares held by our Bank in Bank Austria Creditanstalt AG were transferred to the UniCredit Group, and in International Moscow Bank and AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga) to Bank Austria Creditanstalt AG, at the beginning of January 2007. With regard to the transfers of the branches in Vilnius and Tallinn to AS UniCredit Bank, Riga (formerly HVB Bank Latvia AS, Riga), and the shares held by our Bank in HVB Bank Ukraine to UniCredit Group, other conditions remain to be met.

Special proceedings regarding the cash settlement for Vereins- und Westbank AG

- The extraordinary shareholders' meeting of Vereins- und Westbank AG on June 24, 2004 approved the transfer of shares of minority shareholders of Vereins- und Westbank AG to HVB AG; after settlement of the legal challenges to this move, HVB AG paid the minority shareholders of Vereins- und Westbank AG an increased cash settlement of €26.65 per share (the "€26.65 settlement"). Notwithstanding this arrangement, numerous minority shareholders have exercised their right to have the €26.65 compensation reviewed in special judicial proceedings pursuant to Section 1 (3) of the Act on the Procedure Regarding the Compensation of Minority Shareholders. In a ruling dated March 2, 2006, Hamburg District Court increased the cash settlement to €37.20 per share on the basis of its own assessment; the Bank has appealed against this decision. We assume that, at most, a small additional payment will have to be made to the squeezed-out shareholders of Vereins- und Westbank AG. More detailed information could have a negative effect on the legal position of HVB AG in the pending proceedings.

Claims asserted by the bankruptcy liquidator of a corporate customer

- In 2002 a corporate customer of HVB AG filed for bankruptcy. The liquidator subsequently asserted claims out of court against a consortium made up of several banks. HVB AG had a share in this consortium amounting to approximately 9.25% of the outstanding credit facilities. The banks participating in the consortium have

appointed a bankruptcy law specialist to review the related issues. The expert does not believe that the liquidator is in a particularly strong position and advises the banks in the consortium to reject the out-of-court claims. At present the outcome related to the out-of-court claims is uncertain. Although we are of the opinion that the above-mentioned claims are unfounded, a successful lawsuit on the part of the liquidator would result in a claim against HVB AG in the low nine-figure range (in euros).

Trade tax allocation/Hypo Real Estate

- Up to and including 2001, HVB AG charged or reimbursed trade tax (Gewerbsteuer) to various subsidiaries which comprised a single entity with HVB AG or its legal predecessors for trade tax purposes. Hypo Real Estate Bank AG and Hypo Real Estate International AG have now filed a lawsuit demanding repayment of approximately €62 million plus interest for alleged overpayments and asserting supposed rights to information. On the basis of legal opinions obtained on this matter, HVB AG believes that the plaintiffs are not entitled to their claims.

EU antitrust proceedings and claims of consumer protection associations

- In June 2002 the European Commission imposed an approximately €30 million fine on Bank Austria Creditanstalt AG for alleged illegal collusion in connection with interest rates, prices of various banking products for retail customers and other terms. In the same connection, fines totalling approximately €94 million were imposed on seven other Austrian banks. On December 14, 2006 the European Court of Justice reaffirmed the reason for the fine and the amount; even if Bank Austria Creditanstalt AG appeals against this decision or loses an appeal, there will be no major detrimental consequences for Bank Austria Creditanstalt AG. Austrian consumer protection associations and politicians have announced their intention of possibly asserting damage claims against the banks involved in the above-mentioned proceedings, including Bank Austria Creditanstalt AG. In our view it is uncertain from a legal standpoint whether a violation of Article 81 of the EC Treaty provides grounds for damage claims of individual customers under civil law, and we also regard

such lawsuits as unfounded for a number of reasons. Furthermore, Austrian consumer protection associations have alleged that banks in Austria have been charging their customers excessive interest and fees in contravention of Austrian consumer protection laws. Whether and to what extent such claims are justified depends on the individual circumstances and various legal issues which to date have not been finally resolved by the Austrian courts. We believe that the declaration by Bank Austria Creditanstalt AG that it will comply with the settlement arrangements entered into by the Austrian Savings Banks Association with the Austrian consumer protection associations will largely avert detrimental consequences for HVB Group.

Treuhandanstalt litigation

- A pending lawsuit against Bank Austria Creditanstalt AG is related to alleged claims of the Treuhandanstalt, the predecessor of the Bundesanstalt für vereinigungsbedingte Sonderaufgaben ("BvS"), against Bank Austria (Schweiz) AG, a former subsidiary of Bank Austria Creditanstalt AG. One of the claims in the proceedings is that the former subsidiary participated in the embezzlement of funds from companies in the former East Germany. BvS seeks damages in the amount of approximately €128 million plus interest. However, we believe that these claims are unfounded.

5 Business risk

Risk management

We define business risk as adverse, unexpected changes in business volume and/or margins that cannot be attributed to other risk types. It can lead to serious losses in earnings, thereby diminishing the market value of a company. Business risk can result above all from serious deterioration of the market environment, changes in the competitive situation or customer behaviour, but may also result from changes in the legal framework.

As part of its cost and income responsibility, each business unit is responsible for the operational management of business risk.

Risk Report continued

Measurement methods

The economic capital arising from business risk is measured on the basis of a value-at-risk approach. For this purpose, income and cost volatilities are determined at division level and, with due consideration given to correlations, a value-at-risk is calculated that represents the possible fluctuations in the company value associated with business risk.

Risk monitoring

Economic capital arising from business risk is calculated and analysed by Risk Control and reported to the Chief Risk Officer and the Audit Committee of the Supervisory Board.

Within the framework of monthly reporting by the Accounting department, interim revenues and costs of the business units are tracked as levers of business risk by comparing the actual figures with the budgeted targets.

Quantification and specification

The calculated economic capital for business risks of the new HVB Group amounted to €0.6 billion at year-end 2006.

The Process Redesign and Optimisation (PRO) efficiency programme launched in 2004 was successfully continued in 2006. Only a few measures remain to be implemented in 2007. The project is expected to fully achieve all of its goals.

In cost management terms, HVB Group will also benefit from the pooling of volumes within the UniCredit Group and the systematic exchange and implementation of best-practice approaches to cost-cutting. In 2007, additional savings will be achieved through a large number of further cost-cutting measures covering all major cost categories. More details on PRO and cost management can be found in the section on Global Banking Services in the present Annual Report.

6 Risks arising from our real estate portfolio

Risk management

We classify potential losses resulting from market fluctuations of our real estate portfolio under this risk type. This includes the portfolio of the property ownership companies of HVB AG and its special-purpose companies and shareholding companies, as well as the portfolios of the HVB Group subsidiaries.

HVB Immobilien AG is responsible for portfolio management and disposal, property and facility management, restructuring, land development and the rental of the properties under its jurisdiction. At the operational subsidiaries of HVB Group the subsidiaries themselves are responsible for managing their real estate holdings.

Measurement methods

We measure our real estate risks using a value-at-risk approach based on the market value of the properties and historical volatilities. The volatilities are determined using real estate indexes for office rents. In addition, risk-reducing correlations between individual regional property markets are included.

Risk monitoring

Economic capital for real estate risk is calculated and analysed by Risk Control and reported to the Chief Risk Officer and the Audit Committee of the Supervisory Board.

At HVB Immobilien AG a risk monitoring system was introduced in 2003 to systematically identify, measure, analyse and monitor real estate risks as well as the known external and internal risks associated with the company. A risk inventory was also carried out in 2006, and these inventories and regular reporting will be continued in the future. This will ensure comprehensive risk transparency and serve to create an even keener awareness of risk.

Quantification and specification

The economic capital relating to our real estate portfolio amounted to €0.3 billion at the end of 2006 for the new HVB Group. The real estate portfolio of the new HVB Group is located primarily in Munich, which accounts for 31% of the total.

7 Risks arising from our shareholdings and investments

Risk management

We classify changes in the market prices of our portfolio of listed and unlisted shareholdings and financial investments under this risk type. Operational subsidiaries of HVB Group are excluded, whose risks are already separately identified and recorded as part of the other risk types.

The Management Board is responsible for managing our entire portfolio of shareholdings/financial investments (including operational subsidiaries of HVB Group).

Measurement methods

Under the value-at-risk approach, the risk inherent in our investments is calculated on the basis of their market values and volatilities, which, in the case of investments in listed companies, are determined using the share price fluctuations. In the case of investments in unlisted companies, we apply the book values as market value estimates as well as the volatilities of industry-specific indexes. To reflect the recent past more adequately in our risk calculations, we perform an exponential weighting when calculating the volatilities, taking the long-term holding period of investments into account.

Risk monitoring

Risk Control calculates and analyses the economic capital for shareholdings and financial investments, and reports it to the Chief Risk Officer and the Audit Committee of the Supervisory Board.

The task of investment controlling falls to the Holdings department, which is under the responsibility of the Chief Financial Officer. This department uses auditors' reports, annual reports and interim reporting instruments to regularly verify the value of our investments. This ensures that substantial negative changes in value are recognised early, analysed, and reported to the Chief Financial Officer.

Quantification and specification

By actively managing our financial investments, Asset Liability Management successfully continued its efforts to reduce market risk and particularly cluster risk in the course of 2006. Major moves included the further reduction of our stake in Münchener Rückversicherungs-Gesellschaft AG and the disposal of our holding in Deutsche Lufthansa AG.

Economic capital of the new HVB Group decreased by approximately €0.4 billion to €0.6 billion.

8 Strategic risk

Risk management

Strategic risk results from management being slow to recognise important trends in the banking sector or drawing false conclusions about these trends. This may result in fundamental management decisions that may prove to be disadvantageous in terms of the Bank's long-term goals and may be difficult or impossible to reverse.

As a part of corporate management, the management of strategic risk lies within the area of responsibility of the Management Board, which determines the risk positioning of HVB Group by defining the Bank's strategic orientation.

Measurement methods

Strategic risk is measured primarily by qualitative methods. For this purpose, we continually monitor the domestic and international markets while subjecting our own strategic positioning to an ongoing review process.

Risk monitoring

As part of our long-term planning, the Management Board regularly reviews the defined strategy of HVB Group. This ensures that we can respond to changing conditions as required with adjustments to the business model or the business processes. When deriving strategic initiatives of this kind, the Management Board conducts close consultations with the Supervisory Board, in particular with the Audit Committee.

Risk Report continued

Quantification and specification

Risk from overall economic trends

A particular risk that could impede the strategic reorientation of HVB Group stems from the overall economic trend. The regional focus on the German core market results in a greater dependency on the state of the German economy than in the past. However, the differing trends in the markets served by the global Markets & Investment Banking division also affect the net asset, financial and earnings position of our Bank.

The trend in the economic situation in Germany was clearly positive, thus presenting good growth opportunities. However, there are still risks associated with Germany's structural problems. Although the economic upswing energised the employment market for the first time in a long while and produced a turnaround in the area of regular employment, the regional core business segment of HVB Group remains difficult in view of the high unemployment level overall, which remains substantial, high bankruptcy figures and the persistent fragility of domestic demand. Additional factors in the public sector are the high level of public debt and the deficits in the statutory social insurance system. In view of the restrictive fiscal policy signals in 2007 in the form of increases in value-added tax and insurance tax rates by three percentage points and the elimination of other tax breaks, the dynamic trend can be expected to continue at a somewhat slower rate.

In addition there are uncertainties related to trends in foreign currency exchange rates and commodity prices.

Consequently, the risk factors listed above could individually or cumulatively prevent us from achieving the financial goals we have set, or could prevent us from fully achieving them.

HVB Group is one of the largest lenders to the German Mittelstand. In addition, our Bank is one of the leading providers of personal and business loans in Germany. The business environment described above has repeatedly led to increases in loan defaults and loan-loss provisions in the past. If the economic environment proves weaker than currently expected, we cannot preclude the possibility that provisions for losses on loans and advances will remain at a high level.

Risks from the restructuring of the corporate group/integration risks

The business combination of HVB Group with the UniCredit Group initiated in 2005 and the related integration projects may result in unforeseen difficulties that may also have a negative impact on the net asset, financial and earnings position of our Bank. In the year under review HVB Group established a divisional structure corresponding to that of the UniCredit Group for carrying out its business activities in its regional core market. This fulfils a key prerequisite for successful operations in the market in the long term, but could also lead to the temporary loss of customers. In addition, this restructuring means that new types of processes will be carried out in the early phases which could entail risks because of their complexity.

Finally, the success of the integration projects will depend to a decisive degree on key staff members remaining with our Bank. If HVB Group loses key employees in the further course of the business combination, this could represent a difficulty for the ultimate integration of HVB Group into the UniCredit Group.

The transfer at the beginning of 2007 of the investments in Bank Austria Creditanstalt Group and other units in central and eastern Europe certainly took place at a favourable time, resulting in substantial sales proceeds; however, the search for equivalent re-investments entails risks. With the proceeds from these transactions the Bank has the manoeuvring space to push ahead with both organic and acquisition-driven growth in the German banking market, gain access in northern European regions to markets similar to those in western Europe, expand its core competencies in specialised niche areas, optimise its regulatory capital and repurchase hybrid financing when it makes economic sense to do so. However, relinquishing the growth and income potential in the markets and business segments we have sold, combined with the uncertainty regarding when the gains on disposal can be reinvested in attractive targets, may have detrimental effects on the financial situation of our Bank. Even if the Management

Board of HVB Group is convinced that the gains on disposal can be profitably reinvested, we cannot preclude the possibility that investments will be made later than planned, or that a smaller amount will be invested, possibly on unfavourable or less favourable terms. In addition, the Management Board is convinced that the stronger focus on the German market than in the past represents an enormous opportunity, in view of the available funds, to significantly expand the Bank's position in the German market as the German economy gains strength; however, this focus also means less regional diversification. The concentration on a market currently regarded as difficult could have detrimental effects on our Bank's net asset, financial and earnings position.

It is uncertain whether the regional focus on Germany can be fully or at least largely offset through investments in the Benelux countries and/or Scandinavia or in selected niche markets or through the future function of HVB AG as a centre of competence for investment banking for the entire UniCredit Group.

As a result of the above-named gains on disposal, HVB AG is in a position to expand its existing investment banking business and in particular to integrate the investment banking activities of other units of the UniCredit Group into HVB Group. However, the pooling of all investment banking activities within the UniCredit Group could also result in risks over and above those resulting from tying up equity capital. This is because investment banking generally involves not only greater earnings opportunities, but also greater risks and more exposure to cyclical effects than conventional banking activities.

The possible difficulties listed above could individually or cumulatively have negative effects on the financial situation of our Bank.

Hard-fought marketplace

Our Bank must face up to intense competition as a result of focussing on the market for financial services in Germany and investment banking. This is the case especially in commercial banking in HVB Group's core market, in particular due to excess capacity in the retail banking business. In these markets, HVB Group is competing against public sector banks and co-operative banks as well as other private sector German and international banks, some of which – as in the case of certain public-sector banks – are still backed by state guarantees.

Through the new corporate structure, HVB Group intends to further improve its market position and income situation. Nevertheless, it is possible that a further increase in the intensity of competition – triggered, for instance, by further national or cross-border bank mergers – could have negative effects on the net asset, financial and earnings position of HVB Group.