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2009

# Regulatory Disclosure Report for the 2009 financial year of Aareal Bank Group

Aareal Bank Group

# Key Financial Indicators

| Euro mn | Annual Report [1] | Regulatory report [2] |
|---|---|---|
| **Regulatory capital** | **3,290** | **3,261** |
| Tier 1 capital | 2,415 | 2,386 |
| Tier 2 capital | 875 | 875 |
| Tier 3 capital | – | – |
| **Regulatory capital requirements** | **1,750** | **1,750** |
| Counterparty risk | 1,668 | 1,668 |
| Market risk | 10 | 10 |
| Operational risk | 72 | 72 |
| **Surplus** | **1,540** | **1,511** |
| | | |
| % | | |
| Tier 1 ratio | 11.0 | 10.91 |
| Total capital ratio | 15.0 | 14.91 |

[1] Amounts after confirmation of Aareal Bank AG's financial statements and approval by the Annual General Meeting with respect to the inclusion of retained earnings transferred as part of Aareal Bank AG's liable equity capital as at 31 December 2009

[2] Figures reported to the supervisory authorities as at the reporting date of 31 December 2009.

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# Regulatory Disclosure Report for the 2009 financial year

## Preface

In addition to the details contained in the Aareal Bank Group Annual Report, this Regulatory Disclosure Report explains the business policy standards and facts that are relevant for assessing our situation from a regulatory perspective. Besides providing a qualified description of the manner in which our risks are identified, evaluated, weighted and reviewed, the report also contains detailed quantitative statements about the sizes of the individual areas.

## Summary

Aareal Bank Group is subject to disclosure pursuant to sections 10 and 10a of the German Banking Act (Kreditwesengesetz – "KWG") in the 2009 financial year. This is due to the fact that Aareal Bank Group has elected to use the waiver option provided by section 2a (6) of the KWG, whereby the reports for financial holding companies or banking groups may be prepared on a consolidated basis. Aareal Bank AG, whose registered office is in Wiesbaden, Germany, is the parent institution of the Group.

The details we have published in this disclosure report are based on the Credit Risk Standard Approach (CRSA). The disclosures on the IRB approach, as required in sections 329 and 335 of the German Solvability Regulation (Solvabilitätsverordnung – "SolvV"), are therefore not applicable. This is also relevant to details concerning operational risks when applying an advanced approach, as set out in section 337 of the SolvV.

In accordance with section 320 (1) sentence 2 of the SolvV, we only reported those facts that were not already disclosed in the Group's Annual Report. In these cases, we refer specifically to the information included in the corresponding source references.

## Regulatory Capital

The legislator stipulated in sections 10 and 10a of the KWG that institutions and companies operating in the financial sector must calculate existing regulatory capital on a regular basis, and present these detailed results to the supervisory authority on specific dates.

| Euro mn | Annual Report | Regulatory report |
|---|---|---|
| **Total tier 1 capital in accordance with section 10 (2a) of the KWG** | **2,415** | **2,386** |
| Paid-in capital | 1,584 | 1,584 |
| Other eligible reserves | 655 | 653 |
| Special item for general banking risks | 154 | 132 |
| Other components of Tier 1 capital | 46 | 46 |
| Amounts to be deducted from Tier 1 capital | -24 | -29 |
| **Tier 2 capital pursuant to section 10 (2b) of the KWG** | **875** | **875** |
| Class 1 Tier 2 capital (profit-participation certificates) | 418 | 418 |
| Class 2 Tier 2 capital (subordinated equity) | 470 | 470 |
| Amounts to be deducted from Tier 2 capital | -13 | -13 |
| **Tier 3 capital pursuant to section 10 (2c) of the KWG** | **–** | **–** |
| **Amounts to be deducted from tier 3 capital in accordance with sections 10 (6) and (6a) of the KWG** | **–** | **–** |
| **Regulatory capital** | **3,290** | **3,261** |

Strict regulatory criteria are applied to the availability and sustainability of the qualifying capital when calculating regulatory capital. These provisions are not consistent with the recognition rules pursuant to the German Commercial Code (HGB) or IFRS.

Regulatory capital is determined on the basis of balance sheet items recognised in accordance with the HGB. On the other hand, the amounts shown in the "Equity" line item in the Aareal Bank Group Annual Report are calculated in accordance with IFRS.

For this reason, the details stated regarding equity correspond to the equity amounts recognised in the statement of financial position (as shown in the Annual Report) with respect to certain items only. Furthermore, a comparison is hampered – on the one hand, with respect to the regulatory and accounting treatment of the various entities within the scope of consolidation, and, on the other hand, due to the different carrying amounts applied at times for individual Group entities.

**Overview**

The regulatory capital stated as at the reporting date 31 December 2009 was based on the previous year's balance sheet. We took into account changes to balance sheet items that occurred before the end of the year only to the extent permissible, and where necessary.

The overview includes the regulatory capital stated in the report as at 31 December 2009 pursuant to sections 10 and 10a of the KWG, as well as the amounts stated after confirmation of the 2009 consolidated financial statements of Aareal Bank AG. The inclusion of retained earnings transferred as part of Aareal Bank AG's liable equity as at 31 December 2009 was subject to approval by the Annual General Meeting, which has in the meantime been given.

After confirmation of the financial statements as at the reporting date of 31 December 2008, Aareal Bank Group had total assets in the amount of € 41.0 billion. Regulatory capital as defined by the KWG totalled approx. € 2,778 million.

Compared with 2008, our regulatory capital as at the reporting date of 31 December 2009 increased to € 3,290 million, while total assets amounted to € 39.6 billion. The operating and methodical reasons for this change are explained in detail in the Group Management Report.[1)]

The composition of equity as reported in the balance sheet is explained in our Annual Report. Regulatory facts are presented in the following sections.

**Tier 1 capital**

Tier 1 capital, which amounted to approx. € 1,863 million as at 31 December 2008, increased to € 2,386 million one year later. The total amount comprises 93,8 % paid-in capital and reserves.

Aareal Bank Capital Funding LLC and Aareal Bank AG contributed € 250 million and € 128 million respectively to the Group's aggregate of issued share capital and recognised capital (€ 432 million).

Preferential participation certificates issued by Aareal Bank Capital Funding LLC are included as equity component. The total equivalent of these certificates is recognised as Tier 1 capital (so-called "innovative Tier 1 model") for regulatory purposes. The voting rights are held by Aareal Bank AG alone. The issue – rated "A" by Fitch Ratings at issuance – has an indefinite term, but can be called by the bank on the annual coupon payment date. Interest payments are dependant on Aareal Bank AG's net retained profit; interest payments omitted are not paid retrospectively. The interest payment for the financial year 2009 amounted to 7.12 %.

[1)] Aareal Bank Group Annual Report 2009: chapter "Net Assets and Financial Position" in the Group Management Report and chapter "Other Notes", Note (84) in the notes to the consolidated financial statements.

Aareal Bank AG's capital comprises approx. 42.8 million no-par value bearer shares ("unit shares"). Each share carries one vote. In the interest of achieving repayment of the silent participation by SoFFin at the earliest opportunity, Aareal Bank will not distribute any dividends to its shareholders for the 2009 financial year.

Contributions by silent partners to Aareal Bank AG in the amount of € 745 million qualify for inclusions as liable equity pursuant to section 10 (4) of the KWG, and are thus fully included as regulatory Tier 1 capital. An amount of € 525 million relates to the unlimited silent participation by SoFFin, which bears interest at 9 %. A further € 190 million of silent participations are available to us for an unlimited term, and bear interest at an average of 5.15 %. Contributions by silent partners in the amount of € 30 million bearing interest at 7.35 % expire on 31 December 2013.

Capital reserves shown as paid-up capital are generated mainly from Aareal Bank AG's business activities. Including consolidation effects, capital reserves eligible for inclusion amount to € 407 million.

Aareal Bank AG's retained earnings account for by far the largest individual share of its capital reserves.

Other Tier 1 capital components result from good-will in accordance with section 10a (6) sentences 8 and 9 of the KWG.

**Tier 2 capital**

Tier 2 capital mainly consists of profit-participation certificates in the amount of € 418 million, and subordinated liabilities (promissory note loans and bearer bonds) in the amount of € 470 million which fulfil the requirements of section 10 (5 respectively 5a) of the KWG.

The profit-participation certificates have a nominal value of € 423 million, of which € 418 million are used for regulatory purposes. Certificates in the amount of € 355 million mature in less than five years, while certificates in the amount of € 63 million mature after more than five years. The average interest for profit-participation certificates is 6.46 %.

Pursuant to the terms and conditions of issue, holders of profit-participation certificates have a claim on interest payments that takes preference over the profit entitlements of shareholders. Where a distribution during the term of the profit-participation certificates would cause a net loss, said interest claim would be reduced, possibly down to zero, creating a claim for backpayment during the term of the certificates at the same time.

Repayment takes place at the nominal amount (subject to any loss sharing), on the day following the Annual General Meeting passing resolutions regarding the relevant financial year. The profit-participation certificates evidence creditors' rights; they do not grant any share in the liquidation proceeds.

Interest was paid on subordinated liabilities at an average rate of 4.27 %.

Subordinated funds raised in accordance with section 10 (5a) of the KWG do not provide for any early repayment obligation. In the event of liquidation or insolvency, claims on interest and principal from these liabilities are subordinated to the claims of all other creditors, which are not themselves subordinated. This also applies to those subordinated funds raised that are not specified in detail.

As at the balance sheet date, the bank had no knowledge of any individual items exceeding 10 % of total subordinated liabilities.

**Amounts to be deducted**

Deductions of € 27 million for intangible assets are recognised in core capital, in accordance with section 10 (2a) sentence 2 of the KWG. Tier 2 capital is reduced by € 11 million from goodwill, pursuant to section 10a (6) sentences 9 and 10 of the KWG.

There are no facts that would lead to deductions from Tier 1 and Tier 2 capital in accordance with section 10 (6) of the KWG, nor are there any infringements of large-volume exposures. Securitisation items, where a risk weight of 1,250 % is applied and which are not included to determine risk-weighted assets, result in a deduction from modified available equity in accordance with section 10 (6a) of the KWG, in the amount of € 4 million. This amount was allocated in equal portions to Tier 1 and Tier 2 capital. There were no other deductions.

## Group Structure

Aareal Bank AG, whose registered office is in Wiesbaden, Germany, and is the parent institution of the Group, prepares this disclosure report in accordance with section 10a (1 to 3) of the KWG.

Aareal Bank Group is one of the leading international specialist property banks. Our business model comprises two pillars:

With 23 offices in 19 countries across three continents, our Structured Property Financing segment facilitates property projects for our domestic and international clients in more than 25 countries. Our particular strength lies in the success we have in combining local market expertise and sector-specific know-how, for financing logistics properties, shopping centres and hotels.

Our Consulting / Services segment offers a wide range of services in particular to the German institutional housing industry. Aareal Bank Group offers these clients IT systems plus related consultancy services, integrated payments systems and a comprehensive range of services for managing property portfolios.

### Consolidated companies

Aareal Bank Group comprises various controlled entities, some of which hold participating interests in each other. These entities are consolidated for accounting and regulatory monitoring purposes. Applicable accounting and regulatory rules differ in some areas in relation to their legal objectives.

Hence, the scope of consolidation created on the basis of the legal requirements differs, in terms of the number of consolidated entities, as well as regarding the method of consolidation.

The following consolidation matrix lists all Group companies for each of the two operating segments which are consolidated on the basis of regulatory aspects or which are included in consolidated financial reporting[2] as at the reporting date as their equity capital amounts to at least € 1 million. We deem it irrelevant to list the smaller or bare-shell companies.

As of the reporting date, the scope of the consolidated financial statements comprises one proportionately consolidated company which, however, is not included in the following consolidation matrix as the materiality criterion is not met.

[2] Shareholdings shown in accordance with section 313 (2) of the HGB. Aareal Bank Group prepares its financial statements in accordance with IFRS.

| | Regulatory treatment | | | | Consolidation in accordance with IFRS | |
|---|---|---|---|---|---|---|
| | Consolidation full | Consolidation pro-rata | Deduction method | Risk-weighted shareholdings | full | equity method |
| **Operating segment Structured Property Financing** | | | | | | |
| Aareal Bank Asia Ltd., Singapore | X | | | | X | |
| Aareal Bank France S.A., Paris | X | | | | X | |
| Aareal Capital Corporation, Wilmington | X | | | | X | |
| Aareal Bank Capital Funding LLC, Wilmington | X | | | | X | |
| Aareal Estate AG, Wiesbaden | X | | | | X | |
| Aareal Financial Service Polska Sp.z o.o., Warsaw | | | | X | X | |
| Aareal Gesellschaft für Beteiligungen und Grundbesitz Dritte mbH & Co. KG, Wiesbaden | X | | | | X | |
| Aareal Gesellschaft für Beteiligungen und Grundbesitz Erste mbH & Co. KG, Wiesbaden | X | | | | X | |
| Aareal Partecipazioni S.p.A., Rome | X | | | | X | |
| Aareal Participations France S.à.r.l., Paris | | | | X | X | |
| Aareal Property Services B.V., Amsterdam | | | | X | X | |
| Aareal Valuation GmbH, Wiesbaden | X | | | | X | |
| Aareal-Financial Service, spol. s r.o., Prague | | | | X | X | |
| Ankaret Invest S.A., Brussels | X | | | | X | |
| arsago Alternative Investments SPC, Grand Cayman | X | | | | X | |
| B & P / DSF Windpark GbR, Frankfurt / Main | | | X | | | X |
| BauBo Bau- und Bodenverwertungs- und -verwaltungsgesellschaft mbH, Wiesbaden | X | | | | X | |
| BauContact Immobilien GmbH, Wiesbaden | | | | X | X | |
| Deutsche Structured Finance GmbH, Frankfurt / Main | X | | | | X | |
| Deutsche Structured Finance GmbH & Co. Alphard KG, Frankfurt / Main | | | | X | X | |
| Deutsche Structured Finance GmbH & Co. Choron KG, Frankfurt / Main | | | | X | X | |
| Deutsche Structured Finance GmbH & Co. Deneb KG, Frankfurt / Main | | | | X | X | |
| Deutsche Structured Finance GmbH & Co. Titan KG, Frankfurt / Main | X | | | | X | |
| DSF Anteils GmbH, Frankfurt / Main | X | | | | X | |
| DSF Fünfzehnte Verwaltungsgesellschaft mbH, Frankfurt / Main | X | | | | X | |
| DSF German Office Fund GmbH & Co. KG, Frankfurt / Main | | | | X | X | |
| DSF LUX INTERNATIONAL S.à.r.l, Luxembourg | X | | | | X | |
| DSF Verwaltungsgesellschaft mbH, Frankfurt / Main | | | X | | X | |
| DSF Vierte Verwaltungsgesellschaft mbH, Frankfurt / Main | X | | | | X | |

| | Regulatory treatment | | | | Consolidation in accordance with IFRS | |
|---|---|---|---|---|---|---|
| | Consolidation full | Consolidation pro-rata | Deduction method | Risk-weighted shareholdings | full | equity method |
| GEV GmbH, Wiesbaden | X | | | | X | |
| Grundstücksgesellschaft Berliner Allee Freiburg mbH, Wiesbaden | | | | X | X | |
| IV Beteiligungsgesellschaft für Immobilien-investitionen mbH, Wiesbaden | X | | | | X | |
| La Sessola S.r.l., Rome | X | | | | X | |
| Main Triangel Gastronomie GmbH, Wiesbaden | | | | X | X | |
| Main Triangel GmbH, Frankfurt/Main | | | | X | X | |
| Melbourne Holding B.V., Amsterdam | X | | | | X | |
| Melbourne Onroerende Zaken B.V., Amsterdam | X | | | | X | |
| Melbourne Personnel B.V., Amsterdam | | X | | | | X |
| Mercadea S.r.l., Rome | X | | | | X | |
| Terrain-Aktiengesellschaft Herzogpark, Wiesbaden | X | | | | X | |
| Westhafen-Gelände Frankfurt am Main GbR, Frankfurt/Main | | | | X | | X |
| Woodside S.à.r.l., Paris | X | | | | X | |
| ZMP Zentral Messepalast Entwicklungs-gesellschaft mbH, Wiesbaden | X | | | | X | |
| DBB Inka | | | | X | X | |
| AllianzGI MMS I-Globalfonds | | | | X | X | |
| **Operating segment Consulting / Services** | | | | | | |
| Aareon AG, Mainz | X | | | | X | |
| Aareon Deutschland GmbH, Mainz | | | | X | X | |
| Aareon France S.A.S., Orleans | | | | X | X | |
| Aareon UK Ltd., Coventry | | | | X | X | |
| Aareon Wodis GmbH, Dortmund | | | | X | X | |
| Aareal First Financial Solutions AG, Wiesbaden | X | | | | X | |
| Aareal IT Beteiligungen GmbH, Wiesbaden | X | | | | X | |
| Innovative Banking Solutions AG, Wiesbaden | | | | X | | X |
| Deutsche Bau- und Grundstücks-Aktiengesellschaft, Berlin | | | | X | X | |
| BauSecura Versicherungsmakler GmbH, Hamburg | | | | X | X | |

### Undercapitalised entities

At present, none of the banks or financial services providers within Aareal Bank Group are undercapitalised, which would require a deduction of the holding from the parent company's liable equity.

### Utilisation of the "waiver" regulation

The "waiver" regulation pursuant to Section 2a (6) of the KWG allows banking groups to calculate regulatory capital on a consolidated basis only. The Group has opted for the simplified reporting scheme in accordance with sections 10 and 13a of the KWG since 30 September 2007.

Aareal Bank AG's participatory interests in its subsidiaries allows it to transfer capital from subordinated subsidiaries to Aareal Bank AG, if necessary. This can be achieved, for example, through distributions to Aareal Bank AG or by capital decreases at the subsidiaries. The bank can also request its subsidiaries to repay the liabilities.

Accordingly, there are no burdens (neither legal, nor materially factual) as per section 2a (6) sentence 1 no. 1 of the KWG to the immediate transfer of capital or repayment of liabilities by the subsidiaries to Aareal Bank AG.

As the parent institution of the Group, Aareal Bank AG operates a central risk management system for the banking group which it is also a part of. This means that the prerequisites stated in Section 2a (6), sentence 1 no. 2 of the KWG regarding the combined supervision of risk assessment, risk measurement and risk control procedures are fulfilled.

Aareal Bank AG carries out event-driven reviews to ensure it continues to fulfil the prerequisites of Section 2a (6) of the KWG.

## Capital Adequacy

Besides calculating existing regulatory capital on a regular basis, companies operating in the financial sector are also obliged to define the ratio between regulatory capital and specific risks defined for regulatory purposes.

The purpose of this calculation is to examine to what extent a bank or banking group can appropriately cushion potential defaults through existing regulatory capital.

### Calculating relevant indicators

Capital adequacy is determined by comparing regulatory capital with the total capital requirements for counterparty risk exposures, operational risks and market risk.

Overall, the ratio of existing regulatory capital and capital requirements through counterparty, market and operational risks may not fall below eight percent. This ratio is reflected by the so-called total capital ratio.

Unlike the total capital ratio, the Tier 1 ratio is determined by comparing only Tier 1 capital with the capital requirements due to counterparty, market and operational risks.

### Total capital ratio and Tier 1 ratio

The total capital ratio increased despite the difficult market environment, particularly as a result of the silent participation made available by SoFFin in February 2009 in the amount of € 525 million. In addition, the change of the total capital ratio was also influenced by our risk management, which is designed in such a way that risks are examined closely before accepting or granting loans and that the risk exposure is constantly reviewed in relation to its sustainability.

The following table provides an overview of the disclosed regulatory capital and capital requirements as at 31 December 2009.

| Euro mn | |
|---|---|
| **Regulatory capital** | **3,261** |
| Tier 1 capital | 2,386 |
| Tier 2 capital | 875 |
| Tier 3 capital | – |
| **Regulatory capital requirements** | **1,750** |
| Counterparty risk | 1,668 |
| Market risk | 10 |
| Operational risk | 72 |
| **Surplus** | **1,511** |
| | |
| % | |
| Tier 1 ratio | 10.91 |
| Total capital ratio | 14.91 |

Additional information pertaining to the individual items of the regulatory capital requirements can be found in the following chapters.

### Internal capital management

Our overall risk strategy represents the framework for risk limitation. A deciding factor for risk limits is the bank's underlying risk-bearing capacity. The overall risk shall at no time exceed the risk-bearing capacity.

The assumptions underlying the risk-bearing capacity approach, plus the concrete procedure for creating and monitoring the aggregate risk cover, plus the general management of internal capital, are all described in the Annual Report[3].

## Risk Management

Risk management deals with identifying, assessing, limiting and managing risks. Therefore, risk management is an essential part of corporate governance.

### Risk strategy

The framework for risk management of Aareal Bank Group is the business strategy as determined by the Management Board and endorsed by the Supervisory Board. This business strategy is summarised at the beginning of the chapter "Group Structure" of the present Disclosure Report and is also described in detail in the Annual Report[4].

Building on the business strategy, detailed strategies have been defined for managing risk types considered material (counterparty respectively credit risk, market price risk, liquidity risk and investment risk as well as operational risk), always taking into consideration risk-bearing capacity. Taken together, these strategies represent the Group's risk strategy. The strategies are designed to ensure a professional and conscious management of risks. Accordingly, these strategies include general policies, to ensure a uniform understanding of risks across all parts of the bank, and providing a cross-sectional, binding framework applicable to all divisions. The bank has set up adequate risk management and risk control processes to implement these strategies, and to safeguard the bank's risk-bearing capacity. Both the individual risk strategies as well as the business strategy were adjusted to adapt to the changing environment in the past financial year.

### Processes and organisational structure of risk management

Aareal Bank Group's organisational structures and workflows are consistently geared towards effective and professional risk management. Processes in the credit and trading businesses are designed to consistently respect the clear functional division

[3] Aareal Bank Group 2009 Annual Report: chapter "Risk-bearing capacity and risk limits" in the Risk Report of the Group Management Report in conjunction with the chapter "Implementation of amendments to the Minimum Requirements for Risk Management in Banks ("MaRisk")"

[4] „Aareal Bank Group 2009 Annual Report: chapter "Business Model"

of Sales units and Credit Management (in line with the Minimum Requirements for Risk Management in Banks (MaRisk), up to and including senior management level. The functional separation in both business divisions, as well as the respective process requirements and risk reporting, are described in detail in the Annual Report[5].

### Risk management and risk monitoring

Overall responsibility for risk management and risk monitoring remains with the Management Board and the Supervisory Board of Aareal Bank AG. The overview included in the Annual Report[6] shows the responsibilities assigned to the respective organisational units regarding the risk types material to the bank.

## Risk types

The following section illustrates the comments made above with regard to risk management in relation to the types of risk material to the Group.

## Credit risks

Aareal Bank defines credit risk or counterparty risk as the risk of losses being incurred due to (i) a business partner defaulting on contractual obligations; (ii) collateral being impaired; or (iii) a risk arising upon realisation of collateral. Both credit business and trading book activities may be subject to counterparty risk. Counterparty risk exposure from trading activities may refer to risk exposure vis-à-vis counterparties or issuers. Country risk is also defined as a form of counterparty risk.

### Credit risk strategy

Within the framework of the three-continent strategy pursued in the Structured Property Financing segment, Aareal Bank Group aims to build a balanced property finance portfolio, in terms of regions, products, types of property and client groups. Dependencies as well as risk concentrations are reduced through broad diversification.

The credit risk strategy sets the material aspects of Aareal Bank‘s credit risk management and policies. It is divided into the Group credit risk strategy and individual sub-strategies (lending policies) defining the type of new business the bank wishes to generate, with respect to various markets and types of business.

The organisational structure and workflows tailored towards credit risk management, as well as the implemented procedures used for measuring, managing and monitoring risk exposure, are described in detail in the Annual Report[7].The Annual Report also includes descriptions of strategies and processes used to monitor the current effectiveness of the measures taken for risk protection and risk mitigation.

### Regulatory assessment

### Calculation approach

Section 8 of the SolvV allows different approaches to be taken when calculating total risk in relation to counterparty default.

We calculate counterparty risk by means of the so-called Credit Risk Standard Approach (CRSA). This approach uses the parameters defined by the regulatory framework for calculating risk and specific standardised collateral required to mitigate credit risk exposure.

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[5] Aareal Bank Group 2009 Annual Report: chapters “Lending business” and “Trading activities” in the Risk Report of the Group Management Report.
[6] Aareal Bank Group 2009 Annual Report: chapters “Risk management – scope of application and areas of responsibility” in the Risk Report of the Group Management Report.
[7] Aareal Bank Group 2009 Annual Report: chapter “Credit risks” in the Risk Report of the Group Management Report.

## Regulatory capital requirements

The capital requirements for a transaction's counterparty risk are essentially based on the following:

1. the regulatory classification (balance sheet, off-balance sheet, or derivatives business);
2. the current amount / residual liability; and
3. the probability of default.

The borrower's credit quality is relevant for measuring the default probability of a loan. Borrowers are divided into asset classes and then weighted according to their credit rating.

The type and quality of the collateral contractually pledged by the borrower can reduce regulatory capital requirements to a certain extent.

Aareal Bank Group continued to focus consistently on its core business during 2009. Taking into consideration the overall macroeconomic and industry-specific environment, we concentrate our new business activities on our existing clients, in particular on the prolongation of existing financing projects.

Capital requirements from counterparty risks declined during the year by € 110 million to € 1,668 million.

As at 31 December 2009, no settlement or risks associated with outstanding delivery had to be taken into account when determining counterparty usage limits.

Based on the CRSA calculation approach, the following regulatory capital requirements from counterparty risk exposures were determined as at 31 December 2009, by asset class.

| Euro mn | |
|---|---|
| **CRSA asset classes** | **1,668** |
| Sovereign governments | – |
| Regional governments and similar entities | – |
| Other public-sector entities | 1 |
| Multilateral development banks | – |
| International organisations | – |
| Institutions | 48 |
| Covered bonds | 9 |
| Corporates | 1,211 |
| Retail lending business | 2 |
| Items secured by property | 281 |
| Investment fund units | 36 |
| Investments | 23 |
| Securitisations | 15 |
| Other items | 17 |
| Past due exposures | 25 |

### Volume of loans and advances

The information to be disclosed in this chapter pursuant to section 327 (2) of the SolvV does not relate to the data reported to the banking regulators. Instead, the IFRS carrying amounts as reported in the consolidated statement of financial position are taken as the basis.

Collateral and specific valuation allowances are not taken into account in the reported volume of loans and advances. Thus, we follow the accounting in accordance with IFRS pursuant to which the allowance for credit losses is shown in a separate line item of the consolidated statement of financial position of Aareal Bank Group.

The data does not include all items of the statement of financial position nor does it take into account all subsidiaries of Aareal Bank Group's scope of consolidation. This restriction only has minor effects on the informational value of the disclosed volume of loans and advances in the amount of € 41,300 million, since 98 % of the assets reported in the statement of financial position, including contingent liabilities and loan commitments, are covered.

We focus on the following items as regards the volume of loans and advances reported in the statement of financial position and the derivatives volume

- Cash funds,
- Loans and advances to banks,
- Loans and advances to customers,
- Positive market values of derivative hedging instruments,
- Trading assets,
- Non-trading assets as well as
- Income tax assets.

The disclosures regarding off-balance sheet transactions are based on the contingent liabilities and loan commitments of the subsidiaries covered, as described in the Annual Report[8)].

With regard to the companies of Aareal Bank Group we consider material in this context, we focus on Aareal Bank AG, Aareal Capital Corporation and Aareal Bank France S.A. In addition, the fund Allianz GI MMS-Globalfonds, which is consolidated in accordance with IFRS, is included.

### Breakdown by major geographical segments

| Euro mn | On-balance sheet | Off-balance sheet | Derivatives | Total |
|---|---|---|---|---|
| Germany | 9,341 | 713 | 930 | 10,985 |
| Western Europe (excluding Germany) | 9,082 | 261 | 627 | 9,970 |
| Northern Europe | 3,527 | 158 | 169 | 3,854 |
| Southern Europe | 7,155 | 746 | 55 | 7,956 |
| Eastern Europe | 2,710 | 61 | 32 | 2,803 |
| North America | 3,581 | 301 | 103 | 3,984 |
| Asia/Pacific | 750 | 19 | 1 | 770 |
| Other | 953 | 9 | 14 | 976 |
| **Total** | **37,100** | **2,268** | **1,932** | **41,300** |

The presented breakdown of the volume of loans and advances by major geographical markets is based on our three-continent strategy, which covers Europe, North America and Asia, as explained in our Annual Report. The breakdown criterion used is the relevant country of domicile of the counterparty.

50 % of the loans and advances covered relate to Germany and Western Europe.

[8)] Aareal Bank Group 2009 Annual Report: chapter "Other notes", Note (82) in the notes to the consolidated financial statements.

## Breakdown by borrower group

| Euro mn | On-balance sheet | Off-balance sheet | Derivatives | Total |
|---|---|---|---|---|
| Institutions | 4,637 | 18 | 1,642 | 6,298 |
| Public-sector entities | 7,656 | 7 | – | 7,663 |
| Corporates (non-financial sector) | 23,472 | 2,222 | 282 | 25,976 |
| Private individuals | 310 | 19 | – | 329 |
| Other | 1,024 | 2 | 8 | 1,034 |
| **Total** | **37,100** | **2,268** | **1,932** | **41,300** |

We monitor the borrower groups by assigning counterparties into five groups, using the industry code defined by Deutsche Bundesbank. Commercial borrowers ("Corporates"), which account for a 63 % share, are our most important group. Public-sector entities and institutions account for roughly 34 % of borrowers relative to the total volume of receivables.

## Breakdown by remaining term to maturity

| Euro mn | On-balance sheet | Off-balance sheet | Derivatives | Total |
|---|---|---|---|---|
| Payable on demand | 1,255 | 2,268 | – | 3,523 |
| up to 3 months | 1,453 | – | 87 | 1,539 |
| more than 3 months up to 1 year | 2,635 | – | 206 | 2,840 |
| more than 1 year up to 5 years | 18,746 | – | 901 | 19,648 |
| more than 5 years | 13,011 | – | 738 | 13,749 |
| **Total** | **37,100** | **2,268** | **1,932** | **41,300** |

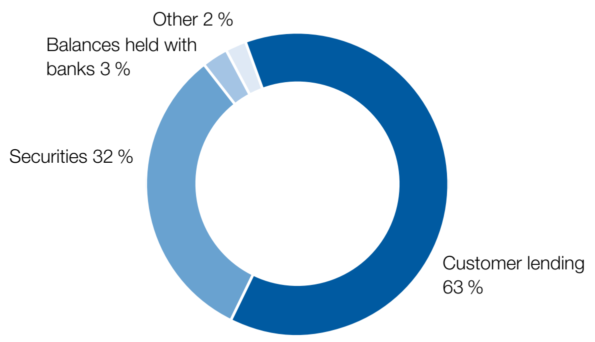
The remaining term to maturity is determined on the basis of the contractually-agreed term of all on-balance sheet and derivatives transactions. The classification of off-balance sheet transactions as "payable on demand" results from the fact that payment obligations may be incurred for Aareal Bank from the loan commitments and guarantees.

81 % of our loans and advances have a term to maturity of more than one year.

## Breakdown of on-balance sheet and off-balance sheet loans and advances

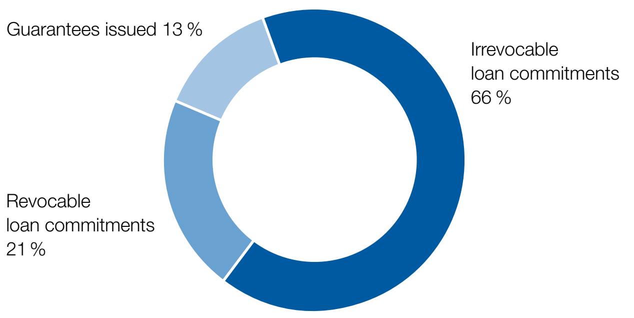
### Breakdown of on-balance sheet business

%




### Breakdown of off-balance sheet business

in %




The charts above show that property loans and irrevocable loan commitments, each group with a share of more than 60 %, account for the highest portion of on-balance sheet and off-balance sheet loans and advances.

**Allowance for credit losses**

The best way to provide for risks is to carefully review such risks before granting a loan. We embrace this fundamental principle by adopting a multi-level review process, and through our well-trained, experienced employees in the credit divisions.

As a property finance specialist, we do not only focus on the borrower's credit rating but also carry out an in-depth analysis of the value and profitability of the property pledged as collateral.

Despite all the due care taken, events occur occasionally that can lead to impairment or even default. Our credit management teams are obliged to follow certain rules for these receivables when the first signs emerge that a loan might become impaired.

Our specialised and high-volume business requires us to maintain close contact with our clients. Apart from events that can be determined objectively, such as when a loan is in arrears, or when a borrower fails to meet disclosure duties, the first signs of potential problems comprise a series of soft factors.

The responsible loan manager is informed of such soft factors, for example, by analysing performance reports. If there is evidence of events that could hamper the continuity of payments, the exposure is placed on the internal watchlist.

The intensity of the attendant measures to be taken depends on the extent of the potential default, the internal assessment of the borrower/property, plus time-related and legal issues. All events are examined on a case-by-case basis.

#### Definition of terms and allowance process

The concept of "impaired" loans is commonly used in a financial reporting context, albeit not in our credit organisation. We have therefore translated the requirements of section 327 (1) no. 1 of the SolvV to our internal processes. All loans that are more than nine days in arrears are declared to be in default.

Specific allowances for credit losses are recognised where expected future cash flows fall below the carrying amount of a loan receivable. This is the case when it is probable (due to observable criteria) that not all interest and principal payments can be made as contractually agreed. The estimated recoverable amount is determined on the basis of the present values of expected future cash flows from the asset (taking into account the marketability of collateral provided). If debt servicing can be made from the borrower's other assets on an ongoing basis, a cash flow deficit in relation to the financed project does not justify the recognition of allowances for credit losses yet. If the loan cannot be repaid upon maturity as contractually agreed, a reorganisation including prolongation is possible when the cash flow from the project or the borrower's other assets enable the borrower to meet future interest and principal payments.

Property loans for which allowances have been recognised are referred to internally as non-performing loans. The loans remain in this category until problems have been fully remedied, or the loan has been settled. Uncollectible (residual) receivables are written off against specific allowances for credit losses recognised previously, or written off directly.

In addition to allowances recognised for individual receivables, a portfolio impairment allowance is created for receivables that are not written down specifically. The risk parameters used for calculation are primarily based on the average loan-to-value ratio of the Group's property financing portfolio, which is determined in regular intervals.

Provisions for loans are set aside for commitments to third parties if utilisation is probable and the amount of the commitment can be reasonably estimated. Provisions are measured on the basis of the best estimate of the expenditure required to settle the obligation, in accordance with IAS 37.36. If utilisation in the short term, i.e. within twelve months, from the obligation is not expected, the provision will be recognised at present value.

In addition to the allowance process for property lending, the Annual Report[9] includes a description of the impairment process for securities belonging to the IFRS categories „Available-for-Sale" (AfS), "Held to Maturity" (HtM) and "Loans and Receivables" (LaR).

## Quantitative disclosures

The breakdown of past due and impaired loans and advances and the related allowances by important regions, borrower groups and contractual maturities as required by section 327 (2) no. 5 of the SolvV is fully included in the Annual Report[10]. The amounts stated therein relate to the consolidated financial statements in accordance with IFRS.

As at 31 December 2009, property financing under management[11] with a total volume of € 710 million was subject to specific valuation allowances, which amount to € 202 million. Portfolio-based valuation allowances on loans and advances to customers amount to € 100 million as of the reporting date.

79 % of the borrowers are assigned to the Corporates Asset class, and 19 % to the Private Individuals class. However, the retail business is no longer part of Aareal Bank Group's core business. Since Aareal Bank's lending business is focused on commercial property financing, we do not believe that a further breakdown of the "Corporates" borrower group would provide any additional information.

Allowances for country risks were not necessary in the financial year 2009. We also did not recognise any impairments for derivatives, since these are recognised at fair value through profit or loss pursuant to IFRS.

[9] Aareal Bank Group 2009 Annual Report: chapter "Basis of accounting", Note (6) in the notes to the consolidated financial statements.
[10] Aareal Bank Group 2009 Annual Report: chapter "Reporting on Financial Instruments", Notes (74) and (75) in the notes to the consolidated financial statements.
[11] Property financings under management include the property financing portfolio managed for Deutsche Pfandbriefbank AG.

## Development of allowances for credit losses and provisions

Allowances for credit losses and provisions in accordance with IFRS developed as follows during the course of the year:

| (Euro mn) | Specific allowances for credit losses | Portfolio impairment allowance | Provisions in the lending business |
|---|---|---|---|
| **1 January 2009** | **150** | **85** | **38** |
| Additions | 133 | 15 | 8 |
| Charge-offs | 55 | – | 7 |
| Reversals | 45 | – | 11 |
| **31 December 2009** | **183** | **100** | **28** |

Exchange-rate-related changes are not taken into consideration in the table as a result of the insignificant amount of € 0.4 million.

### Rating

A key element of the economic and regulatory assessment is the borrower's credit rating. This rating is determined by rating agencies that are recognised by the regulatory authorities. These agencies' assessments and valuations facilitate a uniform classification of borrowers across all banks. The ratings of governments, banks and exchange-listed companies, as well as investment fund units and securitisations, are generally assessed externally.

We have retained the three agencies; Fitch Ratings, Moody's Investors Service, and Standard & Poor's, to classify borrowers and guarantors in accordance with section 42 (1) of the SolvV. The ratings determined by these three agencies apply for all the aforementioned rating-related asset categories in relation to the Credit Risk Standard Approach. Assessments by export credit insurance agencies are not used.

Loans and advances rated by at least one rating agency are deemed as "rated" CRSA exposures pursuant to section 44 of the SolvV. All other items are considered to be "unrated" exposures in accordance with section 45. In line with our business model as a leading international property specialist, most of our exposures are in the "Corporates" and "Collateralised by property" asset classes, which are reported as unrated CRSA exposures with the prescribed standard risk weighting.

This is due to the fact that, in line with our business orientation, many receivables from property project finance and property management companies (plus other special purpose property entities) do not have any external rating.

At present, we have no transactions in our portfolio for which an issue rating has been migrated to receivables or such, for which a comparable rating is determined pursuant to section 45 (2) of the SolvV.

### Derivatives

Derivatives are defined for regulatory purposes as unconditional forward transactions or option contracts that are structured as a purchase, exchange or other acquisition of an underlying instrument, and which are settled in the future (section 19 (1a) of the KWG).

The bulk of Aareal Group's derivatives positions have been entered into in order to hedge interest rate and currency risk exposure, and for refinancing purposes.

## Internal capital allocation

Within the framework of the economic capital model for credit risks, derivatives are taken into account in the amount of their positive market value plus the regulatory add-on, determined depending on the type and term of the transaction. The netting agreements concluded by the bank to reduce counterparty risks within the trading business are taken into account in the calculation. This also applies to additional agreements on the furnishing of collateral.

### Collateral and allowance for credit losses

The procedures for accepting collateral are described in the Group Annual Report [12].

No allowance for credit losses was recognised for derivatives, since these are recognised at fair value through profit or loss pursuant to IFRS.

### Impact of a rating downgrade on collateral to be furnished

Some of the collateral agreements the bank has entered into provide for a reduction in the allowance and the minimum transfer amount under the collateral agreement in the event of a downgrade of the bank's external rating. These individual agreements are stored in the bank's systems. Rating changes at the bank and its counterparties are directly taken into account in the calculation of the collateralisation claim through an import of the ratings. This may lead to the bank having to provide additional collateral, regardless of the development of the default risk.

### Valuation approach

The equivalent value of derivatives and the related counterparty risk are determined using the mark-to-market method (sections 18 et seq. of the SolvV) for the purpose of regulatory reporting.

### Regulatory capital requirements

The aggregate positive replacement value for our derivatives contracts subject to reporting requirements stood at € 1,932 million at year-end 2009. This amount is reduced to € 601 million through netting agreements and collateral provided.

A netting arrangement can be established by mutual consent through a netting agreement, provided that an institution has both monetary claims on, and monetary liabilities to the same counterparty. The relief resulting from netting amounts to € 1,005 million. Additional relief is provided through collateral covering derivatives transactions in the amount of € 326 million.

The preceding overview shows the effects of netting and collateral eligible for inclusion on positive replacement values, broken down by type of contract.

We held no individual contracts based on credit derivatives or commodities as at 31 December 2009.

The counterparty risk for all contracts remaining after netting and collateral amounted to € 989 million as at 31 December 2009. The resulting capital requirement amounts to € 36 million.

| (Euro mn) | Before netting | Reduction through netting | Reduction through collateral | After netting |
|---|---|---|---|---|
| **Positive replacement value** | **1,932** | **1,005** | **326** | **601** |
| Interest rate | 1,579 | – | – | – |
| Currency | 351 | – | – | – |
| Equities / index | 2 | – | – | – |

[12] Aareal Bank Group 2009 Annual Report: chapter "Credit risk mitigation" in the Risk Report of the Group Management Report.

At present, we neither use credit derivatives to hedge individual contracts, nor do we act as a broker or a buyer of derivatives.

We placed around € 650 million in credit default swaps on the market [during the 2009 financial year].

### Credit risk mitigation

The procedures for accepting collateral within the scope of the lending decisions, and their regular review from an economic perspective, are explained in the Annual Report [13].

The regulatory inclusion of the collateral reflects our conservative hedging strategy. The collateral employed fulfils not only the extensive impairment checks and enforcement reviews that are part of the credit process, but also all direct and indirect standards – such as the German Securities Trading Act or the German Mortgage Bank Act – that are required within the scope of solvency reporting.

Not all economically viable collateral is eligible for regulatory purposes: only certain types of impersonal collateral, indemnities and guarantees can be used in order to reduce the capital requirements. The eligible collateral must also meet a series of qualitative requirements.

Forms of collateral that are economically viable in our business, such as the pledging of investments held by a borrower, do not qualify as collateral from a regulatory perspective. Commercial property collateral is eligible for inclusion in accordance with the Credit Risk Standard Approach of the Solvency Ordinance, albeit not for mitigating credit risk. Loans secured by a real property lien are included instead in a separate asset class.

[13] Aareal Bank Group 2009 Annual Report: chapters "Credit risk mitigation" in the Risk Report of the Group Management Report.

#### Calculation approach

We use the so-called "comprehensive" method of the Credit Risk Standard Approach to take into account financial collateral.

Collateral classified as guarantees for regulatory purposes includes indemnities (including similar) obligations and guarantees, as well as credit balances held with third parties and assigned to us. Collateralising loans through balances saved under home loan and savings contracts, life insurances and fund units, is insignificant in our business model and not used within the scope of the regulatory framework.

#### Qualitative standards

All collateral we use to mitigate credit risk within the scope of solvency reporting is guaranteed or issued by public-sector entities, banks or other guarantors. Securities and bonds from other issuers are not taken into consideration, even though they would qualify on a case-by-case basis from a regulatory perspective.

All the qualitative requirements for including collateral are reviewed in advance by Credit Management and documented in the credit file. This is relevant to general requirements such as the legal enforceability, as well as minimum requirements specific to collateral.

In a few instances, we apply the transitional regulation in accordance with section 339 (17) of the SolvV for the inclusion of guarantees. If the prerequisites for the treatment of letters of indemnity no longer apply, the collateral is no longer eligible for inclusion.

Derivatives and repurchase transactions are entered into by Aareal Bank exclusively with financial institutions with investment-grade ratings.

In addition, interest rate hedges are entered into with borrowers to a small extent. The creditworthiness of the relevant counterparty is taken into account in the structure of the individual transaction.

## Collateral value

Collateral values are updated automatically on a daily basis. The procedure takes into account the current account balances and securities prices, as well as the translation of securities held in a foreign currency at the official foreign currency rates. In addition, the collateral value depends on the creditworthiness of the provider of collateral.

Regulatory haircuts based on criteria related to quality, term / lifetime or currency, are applied prior to netting.

## Collateral eligible for inclusion

Collateral in the amount € 1,171 million was applied within the scope of credit risk mitigation. This figure includes € 326 million of collateral included for derivatives transactions.

At 61 %, financial collateral (especially pledged cash amounts) accounts for the bulk of collateral types eligible for inclusion.

Eligible guarantees and indemnities comprise guarantees provided by various guarantors and cash deposits with third parties.

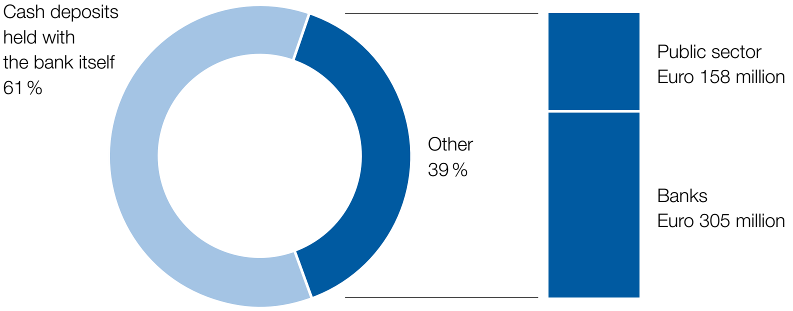
The following overview shows the guarantor structure of the collateral eligible for inclusion as at 31 December 2009.

The effect of such collateral on the assessment basis pursuant to section 49 of the SolvV is shown below, broken down by CRSA asset class:

| Euro mn | Financial collateral | Guarantees |
|---|---|---|
| **CRSA asset class** | **997** | **166** |
| Institutions | 967 | – |
| Corporates | 30 | 156 |
| Past due exposures | – | 10 |

### Overview of collateral

% | Euro mn




As Aareal Bank is an international property specialist, the financial collateral and guarantees used to mitigate credit risk represent only a marginal share of its aggregate collateral. By comparison, the loans secured by charges on residential and commercial property included for solvency reporting amount to around € 7.6 billion.

As set out above, this also only represents a part of the full picture. The economic value of all collateral to which we are contractually entitled remains at a much higher level.

## Risk concentrations

The qualitative and quantitative processes to assess and control risk concentrations are described in the Annual Report[14]. Since charges on real property used as collateral are very important in our bank, we refer to the graphical breakdown of the property financing volume by region and by property type.[15]

[14] Aareal Bank Group 2009 Annual Report: Risk Report of the Group Management Report, particular chapter "Implementation of amendments to the Minimum Requirements for Risk Management in Banks ("MaRisk")"

[15] Aareal Bank Group 2009 Annual Report: chapter "Credit risks" in the Risk Report of the Group Management Report.

## Impact of collateral eligible for inclusion

Identical types of collateral react differently, depending on what transactions they can be offset against.

This is due to the composition of the CRSA exposure as defined by section 48 of the SolvV. This takes into consideration the CRSA assessment basis pursuant to section 49, and the CRSA conversion factor (CCA) in accordance with section 50 of the SolvV.

The CRSA conversion factor ensures that lower regulatory capital requirements are calculated for loan commitments and other off-balance sheet transactions than for on-balance sheet receivables.

The following table shows CRSA exposure amounts by risk weight, both before and after mitigating credit risk.

| Euro mn | before credit risk mitigation | after credit risk mitigation |
|---|---|---|
| **Risk weighting** | **40,361** | **39,364** |
| 0 % | 11,077 | 11,229 |
| 10 % | 1,175 | 1,175 |
| 20 % | 4,103 | 3,144 |
| 35 % | 1,353 | 1,353 |
| 50 % | 6,084 | 6,099 |
| 75 % | 35 | 35 |
| 100 % | 16,311 | 16,218 |
| 150 % | 223 | 111 |
| > 150 % | – | – |

Cash deposits and guarantees differ in relation to their mathematical way of implication:

- Cash deposits reduce the assessment basis to which the risk weighting and conversion factor are applied.
- Guarantees do not impact on the assessment basis, but on the risk weighting. A guaranteed loan is taken into consideration in the guarantor's asset class, with the assessment basis and risk weighting of the guarantor.

For the purposes of clarity, the collateralised portion of receivables is no longer reported in the borrower's asset class, but in that of the guarantor. The relevant amounts are included with the guarantor's risk weighting when calculating the regulatory capital requirements.

## Netting agreements

To reduce counterparty risk in Aareal Bank's trading business, the master agreements for derivatives and securities repurchase transactions (repos) used by the bank provide for various credit risk mitigation techniques, via mutual netting agreements.

The derivatives master agreements used by the bank contain netting agreements to reduce prepayment risk at a single transaction level (payment netting), and arrangements for the termination of individual or all transactions under a master agreement (close-out netting). This covenant is subject to (international) legal risks. Aareal Bank reviews these legal risks, and evaluates the statements included in international legal opinions with regard to the validity of netting based on criteria such as product type, jurisdiction of registered office and branch office of the counterparty and individual contract supplements. In doing so, we decide for each individual transaction whether or not netting is possible. The bank uses close-out netting which is eligible from a regulatory perspective for all transactions with financial institutions, with additional collateralisation agreements existing in most cases. In contrast, we do not use netting relevant for regulatory purposes with other counterparties (e.g. transactions with borrowers).

For repo transactions, depending on the counterparty, payment or delivery netting is agreed upon; contract documentation also generally provides for close-out netting. However, we do not use netting relevant for regulatory purposes in the context of repurchase transactions.

## Securitisation

An institution can act as originator, sponsor or investor of a securitised transaction. The relevant role in the securitised transaction can have different consequences for regulatory purposes.

Acting as originator, an institution securitises a limited portion of its assets, which it places on the capital market as tranches that are structured by (credit) quality.

As investor, an institution buys securitised assets from other banks. Given that the issuer can default, and interest and principal payments are therefore not guaranteed, this risk requires a regulatory calculation and must be backed by equity.

### Roles in the securitisation process

Three tranches of the transactions terminated in 2008 remained from our previous originator activities, which we do not include in accordance with section 249 of the SolvV. We reported securitised exposures originated for the last time at the end of September 2008.

Aareal Bank Group is currently not acting as an originator of securitised transactions, but is involved solely as an investor on the market.

### Investment principles

We invest exclusively in mortgage-backed securities (MBS) and asset-backed securities (ABS) within the scope of traditional securitisations that have an excellent external rating. These securities are held as medium- to long-term investments within the framework of our liquidity strategy. No new investments were made in 2009.

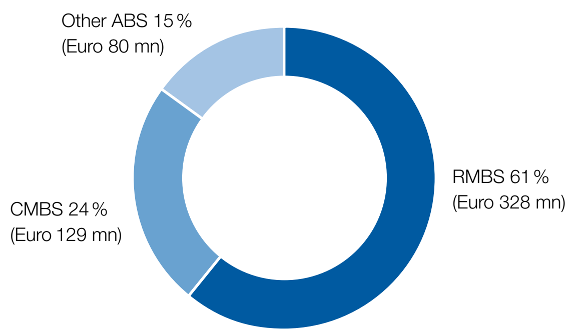
We do not invest directly or indirectly in the US sub-prime market. We also have no collateralised debt obligations (CDO) or US Residential Mortgage-Backed Securities (RMBS) on our books; it is these securities in particular that have resulted in significant write-downs for other banks.

Furthermore, we hold no securities which are backed by monoline insurers.

As at 31 December 2009, our portfolio of purchased securitised exposures is comprised as follows:

**Securitised positions purchased**

%




All of the securities are carried on the balance sheet, and are allocated to the "Loans and Receivables" measurement category. Please refer to the Annual Report for information on the valuation method used.[16] Every ABS security currently carried on the balance sheet and reported for regulatory purposes has an external rating from one of the nominated rating agencies (Fitch Ratings, Moody's Investors Service, or Standard & Poor's). More than 80 % have a triple-A or equivalent rating.

### Regulatory capital requirements

For the reasons stated above, risk-weighted position values are only calculated for purchased securitised exposures. These are treated as default risk exposures on the balance sheet, in line with the Credit Risk Standard Approach, and the risk weighting determined on the basis of the external rating.

[16] Aareal Bank Group 2009 Annual Report: chapter "Reporting on financial instruments", Note (67) in the notes to the consolidated financial statements.

The exposure amounts pursuant to section 239 of the SolvV totalled € 537 million on 31 December 2009. Given that these solely comprise securities rated by a rating agency approved by the regulatory authorities, the risk weightings for assessed CRSA securitisation exposures are calculated according to section 242 of the SolvV.

Total exposure is broken down by the current risk assessment as follows:

| Euro mn | |
|---|---|
| **Investor exposure** | **537** |
| 20 % risk weighting | 462 |
| 50 % risk weighting | 39 |
| 100 % risk weighting | 15 |
| 350 % risk weighting | 17 |
| Deduction or 1,250 % risk weighting | 4 |

Investor positions had a risk-weighted exposure value of € 188 million as at 31 December 2009

## Investment Risks

### Investment risk strategy

Aareal Bank Group acquires equity investments strictly for the purpose of positioning the Group as an international property financing specialist and provider of property-related services. While the standard banking risks mainly exist within Aareal Bank AG and the equity investments in banks, the other subsidiaries are frequently exposed to a variety of other risks. Due to their special character, these risks cannot be measured and managed using the same methods and processes. There, these risks are centralised in a separate risk category called "Investment risks" and included in the centralised risk management system through an investment risk controlling concept.

In general, all types of investments contribute to investment risk. The main focus of investment risk controlling, however, is on operating non-bank shareholdings, as these companies have business models different from that of Aareal Bank AG. The statistical methods and procedures applied in the banking business such as VaR models are generally not suitable to assess the risks of these companies. For this reason, we pursue a qualitative approach for investment risk control which attempts to estimate the risk content on the basis of the balance sheet and income statement analyses conducted within the scope of investment risk controlling. The investments covered are classified into different risk classes. Each risk class has specific risk weightings which are used to translate the carrying amount of the investment into a risk-equivalent value. Based on this risk-equivalent value, Risk Controlling monitors compliance with the limits for investment risks.

Based on the type, scope, complexity and risk level of transactions, processes should be set up for the early identification of risk potential and for controlling and monitoring these risks in accordance with the minimum requirements for the lending business.

This requirement is complied with through a risk-adequate investment controlling system within the framework of implementing the investment strategy, where the different autonomy requirements of investments are accounted for.

The controlling philosophy of Aareal Bank Group defines to which extent the business activities of the investments are influenced and who exercises this influence. The controlling philosophy also determines the structure for controlling equity investments. A distinction has to be made between a direct and an indirect influence on the investments.

In case of a direct influence, information is requested proactively, and the Group headquarters are involved in material business decisions. In case of an indirect influence, the investments have more discretion (autonomy) as regards business decisions.

Various mixtures are possible between these two extremes. The higher the significance of an investment, the higher the importance which is attached to regular reporting. In this context, Investment Controlling above all fulfils an information and control function. In addition, specific support provided for individual investments may be one of the tasks within the framework of the management of the equity investments.

Moreover, risk control and risk monitoring is supplemented by various reviews which the department or the companies are subjected to:

Pursuant to the minimum requirements for risk management (MaRisk), the equity investment management has to be reviewed in reasonable time intervals by Internal Audit. This also involves system reviews (organisational structures and workflows, risk management and controlling, internal control system), taking into consideration the principles for a risk-oriented review. In addition, the investments themselves are subjected to a review performed by the Group Audit department of Aareal Bank AG.

In accordance with MaRisk, the auditor has to get an overview of equity investment management and its organisation, the related risks as well as the internal control systems and procedures and has to assess the appropriateness and effectiveness of the processes and procedures. Furthermore, the subsidiaries and equity investments are also subjected to a review by an auditor, unless exemptions are reasonable due to immateriality.

Pursuant to MaRisk, risks from investments have to be included as part of the overall risk reporting of Aareal Bank AG. For this purpose, the investment risks are determined and assessed by the Corporate Development unit. The Risk Controlling unit reports to the Management Board as regards investment risks within the framework of regular risk reporting, also on a quarterly basis.

Our business model comprises the two segments Structured Property Financing and Consulting/Services. Investments in the banking book reflect the medium to long-term strategic objectives of our business model.

### Structured Property Financing

- We enter into strategic investments to support our property financing activities, particularly abroad.
- Special-purpose entities within the scope of foreclosed assets are used to secure real property liens.

### Consulting / Services

- Strategic investments allow us to offer the institutional housing sector in Germany (as well as selected European countries) services and products for managing residential property portfolios and processing payment flows.
- Investments in companies that provide the Group and third parties with other property or IT services.

## Regulatory assessment

### Measurement and accounting policies

According to section 340e (1) of the HGB, investments must be valued in accordance with the principles applicable to tangible fixed assets (section 253 (1 and 2) of the HGB), provided they do not serve business operations on a permanent basis, in which case they must be valued according to the rules prescribed for current assets (section 253 (1 and 3) of the HGB).

Subsidiaries established for the purposes of shelf companies, bare-shell companies or as a limited company serving as a general partner, are carried at cost at the time of purchase or production. This is due to the fact that there is no active market for holdings in these companies; moreover, they generally do not act in an operative capacity, so that it is impossible to determine projected figures or carry out a company valuation based on this data.

We do not draw up plausibility considerations or derive a market value for investments (predominantly in accordance with the book value in line with the HGB) where the costs to obtain or derive information relevant to valuation (for example, target income statement, target balance sheets) would be inappropriate given the benefit provided by the information.

Alternatively, a valuation is carried out using the DCF method, provided the necessary projected figures are available.

Investments that are not consolidated under IFRS or accounted for at equity are recognised at fair value in the IFRS consolidated financial statements. Changes in the valuation are recognised directly in equity, in the revaluation surplus.

All factors that are included in the company valuation are documented and disclosed to the external auditors.

From a regulatory perspective, the investment vehicles are generally recognised on the basis of their carrying amounts with a 100% risk weighting, in line with the Credit Risk Standardised Approach pursuant to section 37 of the SolvV.

## Valuations

The following table shows aggregate investments in our banking book in relation to their strategic objective, excluding investments consolidated for regulatory purposes. These are companies that are included as risk-weighted assets in the report in accordance with section 10 of the KWG. The Segment "Other" includes all investments with a shareholding of not more than one percent.

The following overview compares the book values calculated in accordance with the HGB with fair values. Goodwill is considered as a shareholding in a non-Group company and is not taken into account.

Fair values are calculated using the methods described above.

| Euro mn | Carrying amount (HGB) | Fair value |
|---|---|---|
| Structured Property Financing | 151 | 152 |
| of which listed | 10 | 11 |
| Consulting / Services | 90 | 90 |
| Other | 3 | 3 |

## Result from equity instruments

The following disclosures relate to the Group as a whole.

During the year under review, we bought two and sold four companies within the Group. On aggregate, these transactions had no effect on income.

Other investments we continue to hold comprise undisclosed revaluation gains of around € 1 million calculated in accordance with the HGB. These do not impact on Tier 1 capital or Tier 2 capital. German commercial law does not require us to determine unrealised revaluation gains or losses.

## Index certificates

The explanations in this chapter so far have related to our classic shareholdings where one company of the Aareal Bank Group invests into another company using capital contributions, shares and similar types of investments.

We also take into account index certificates within the CRSA asset class "Equity investments" for the presentation of counterparty risks resulting from the underlying instrument.

Due to the purpose of the investment, the index certificates are assigned to the non-trading book (liquidity reserve). Under the German Commercial Code, index certificates are measured strictly at the lower of cost or market.

As at 31 December 2009, the carrying amount of the index certificates calculated pursuant to

HGB and included in solvency reporting totalled € 11.9 million.

## Market Price Risks

Market price risk is broadly defined as the threat of losses due to changes in market parameters. At Aareal Bank, the relevant parameters for market price risks mainly consist of interest rates, equity prices and exchange rates.

Risk Controlling uses the latest methods and tools for the measurement and analysis of market risks. Up-to-date reporting to management on the Group's risk profile provides decisive input for all short, medium and long-term investment decisions. Value-at-risk (VaR) has established itself as the method for measuring general market price risk. This concept, as well as stress testing and sensitivity analysis used as further methods to measure market risks, is described in detail in the Annual Report[17].

Risk management, especially with regard to market and interest rate risks of the banking book, is performed within the Treasury division and supported by the Risk Controlling division through risk reports and risk assessments. Based on the daily market risk report, all changes of the present value in all currencies are analysed on a daily basis; if necessary, risk-reducing measures are taken. In addition, the general interest rate and market risk situation is discussed during the weekly meetings in the Transaction Committee. The Transaction Committee comprises the Management Board member responsible for Treasury, the Head of Treasury as well as the heads of the Treasury departments. The Transaction Committee makes decisions with regard to the general approach with respect to the management of market and interest rate risks.

In the area of market price risks, we monitor and control concentration risks, particularly in respect of the relevant risk factors (interest rate risks, currency risks etc.), products and individual companies of the Aareal Bank Group.

**Market risk strategy**

Our exposure to the capital market is based on a responsible and sustained strategy. Identified risks are offset, for example, through hedging agreements.

Interest rate positions from the current lending and refinancing business, which are intended to be hedged, are closed out using interest rate derivatives. Generally, we use one-to-one hedges to meet IFRS hedge accounting criteria. Macro hedges, where IFRS hedge accounting cannot be used, are an exception to this.

In line with our strategy, we ensure that we maintain a largely neutral position in each currency. The aggregate foreign currency position is therefore well below the threshold of 2 % of regulatory capital stipulated in section 294 (3) of the SolvV on a regular basis. The reporting requirement arises, among other things, due to the fact that the aggregate of asset and liability items in all foreign currencies exceeds capital when translated into euros.

The lending and refinancing business in foreign currencies is managed using money market transactions and FX swaps in the respective currency. The currency positions from accumulated lending and refinancing margins are reviewed regularly and closed out in a timely fashion. Basic risks from differing fixing dates are largely avoided for each currency by selecting suitable roll dates.

We do not invest in precious metals, other commodities and raw materials. Similarly, there are currently no amounts to be included for net equity or equity index positions. We calculate the regulatory capital requirements for foreign currency risk based on the rights and obligations as well as investments in foreign currencies.

[17] Aareal Bank Group 2009 Annual Report: chapter "Market price risks" in the Risk Report of the Group Management Report.

### Regulatory assessment

We do not use an internal model for the regulatory assessment of market risk, but employ standard regulatory procedures instead.

The option according to section 300 (2) of the SolvV, and the duration method pursuant to section 302 of the SolvV, are used to calculate the general price risk.

We do not apply any lump-sum weighting amounts for investment fund units in accordance with section 307 (1) sentences 1 and 2 of the SolvV.

The following overview shows the regulatory capital requirements from market risks for the different segments:

| Euro mn | |
|---|---|
| **Market risk positions** | **10** |
| Currency | 10 |
| Net interest position | – |
| Other items | – |

### Interest rate risk in the banking book

Whilst the net interest position is calculated to determine regulatory capital requirements for market risk, the calculation of interest rate risk does not impact on the capital representation for regulatory purposes.

Interest rate risk is broadly defined as the threat of losses due to changes in market parameters. From an economic perspective, interest rate risk represents a key variable for observing market price risk.

#### Measurement method and basic assumptions

Aareal Bank uses the VaR concept to measure general market price risks. The VaR for market price risks quantifies the exposure as a negative divergence from the current aggregate value of the bank's financial transactions.

A variance-covariance approach (delta-normal method) is used throughout the Group to determine the VaR indicator on a daily basis. Statistical parameters used in the VaR model are calculated directly from 250-day historical data maintained within the bank. The loss potential is determined applying a 99 % confidence interval and a ten-day holding period.

By its very nature, VaR calculations are based on numerous assumptions regarding the future development of the business, and the related cash flows. Key assumptions used include current account balances which are factored into calculations for a period of two years, using the average residual amount of deposits observed in the past. Loans are taken into account using their fixed-interest period (for fixed-rate exposures), or using their expected maturity (variable-rate exposures). Aareal Bank's equity is not taken into account as a risk-mitigating item. This tends to overstate VaR, demonstrating the conservative approach adopted in our risk measurement processes – together with considering only contractual maturities.

Based on the daily market risk report, all changes of the present value in all currencies are analysed; if necessary, risk-reducing measures are taken. In addition, the general interest rate situation is discussed during the weekly meetings in the Transaction Committee. The Transaction Committee makes decisions as regards the general approach with respect to the management of interest rate risks.

| | Interest rate shock (in bp) | | Present value change (Euro mn) | |
|---|---|---|---|---|
| | + | - | Decrease | Increase |
| EUR | 130 | -190 | -96.9 | 108.7 |
| GBP | 163 | -99 | -7.8 | 4.8 |
| USD | 185 | -108 | -8.5 | 5.5 |
| Other | – | – | -4.0 | 4.5 |
| **Total** | **–** | **–** | **-117.3** | **123.4** |

### Impact of an interest rate shock on profit or loss

The underlying interest rate shock scenarios stipulated by the banking regulators for external reporting purposes (including parallel shifts of +130/-190 basis points for euro zone interest rates, and +185/-108 for US Dollar interest rates) resulted in a present-value change of € -117 million and € +123 million, respectively, for all currencies as at 31 December 2009.[18] Of the currencies reviewed in the table above, the euro is the most important individual currency for us, with a -97/€ +109 million change in present value.

The ratio of the sum of all currencies relative to Aareal Bank AG's capital (in accordance with section 10a of the KWG) for these interest rate shock scenarios is 3.8 % as at the reporting date. This figure is down on previous years, and well below the maximum limit of 20 %.

## Operational Risks

Operational risk is defined for regulatory purposes as the risk of losses resulting from inadequate or failed internal processes or systems, from human error, or from external events. This definition also includes legal risks. In contrast, strategic, reputational and systematic risks are not included.

[18] The calculation was carried out only for Aareal Bank AG and for its subsidiaries Aareal Bank France S.A. and Aareal Capital Corporation.

Ultimately, in contrast to other risk types, operational risks always represent the disruption of the production process. If the components of the production process change, the situation as regards operational risks within the company changes as well.

Risk Controlling is responsible for the central coordination of all aspects related to controlling operational risks, including the authority to select methods for identifying and monitoring of risks and loss events. This also includes risk reporting.

### Strategy for the treatment of operational risks

The strategy pursued by the bank, which is based on specialised individualised businesses, results in less standardised and mechanised processes and workflows as compared with institutions that focus on standardised businesses. The consequence of this for Aareal Bank is that the operational risk is more strongly characterised by the categories People / Employees and Processes and less strongly by the categories Systems / Technology and External Events.

The insights described herein result in a conscious and rigorous risk strategy in connection with the treatment of operational risks. Within the framework of this risk strategy, a decision is made with regard to avoiding (incl. relevant risk mitigation strategies), accepting / entering into or transferring / hedging risk positions. Deciding factors for the related decisions are both the economic reasonableness of the decisions and the bank's risk appetite. The aim of all these efforts is to generate a balanced risk profile on the basis of a regularly applied risk analysis.

Against the background of this risk environment, we generally avoid a concentration of operational risk exposure. This is achieved, among other things, via adequate long-term measures as well as through the consistent implementation of a precisely defined set of controlling instruments for the identification and monitoring of operational risks and resulting loss events. These instruments are tailored to the bank and its specific risk profile.

### Instruments used to control operational risks

Operational risks and the resulting loss events are systematically identified, assessed, monitored and addressed, if necessary, using controlling measures within Aareal Bank under the framework of a regular cycle. Risk identification is made via the instruments Self Assessment (early risk identification) and risk inventories (risk identification and monitoring), as well as maintaining and monitoring a loss database.

#### Stress tests

Various stress tests are conducted at Aareal Bank in the context of operational risks. The results are reported to the Management Board on a quarterly basis and serve as an indicator for developments potentially jeopardising the continued existence within the category of operational risks.

#### Backtesting

Annual back-testing is performed for the risks as part of risk identification and risk monitoring. This involves determining the relation of loss events expected from individual risks and the reported incidents of the corresponding loss events. Based on the results from back-testing, adjustments are made to the controlling instruments used to manage operational risks.

### Regulatory assessment

As a rule, we calculate the Group's operational risks according to the so-called "standardised approach" pursuant to sections 272 et seq. of the SolvV.

We make use of the transitional provision according to section 277 of the SolvV only for Aareal Bank France S.A. We have agreed with the regulatory authority to apply the so-called Basic Indicator Approach in accordance with section 270 of the SolvV for this subsidiary.

As an international property specialist, we limit our operations to trading, corporate clients, retail clients, plus payments and settlement businesses provided within the scope of the standard approach.[19)]

The results that are taken into consideration are based on the segment reporting at the end of the financial year and the quarterly results in accordance with the HGB. The details as at 31 December 2009 are therefore based on Q3/2007 up to and including Q3/2009.

Section 273 (4) of the SolvV defines regulatory risk weights (so-called "beta factors") for the individual business lines. We use these defined weightings rather than exercising the option to apply proprietary beta factors.

The "Corporates" business segment accounts for more than 82 % of gross income.

As segment reporting is not in line with the breakdown of business lines pursuant to Basel II or the Solvency Regulation, the individual items of the segment report are re-allocated on the basis of factually logical arguments. Statistical figures are partially used as further supporting data (such as relation of private vs. commercial loans).

[19)] Due to the fact that the SolvV does not provide for a separate adequate business area for the operating segment "Consulting/Services", the relevant income of that segment are weighted using the highest beta factor (18 %, corresponding to the beta factor for the trading business, amongst other things).

On average, the grouped and quantified positions of the last three years that are weighted by the respective beta factor result in regulatory capital requirements totalling € 72 million for operational risks.

## Liquidity Risks

Liquidity risk describes the risk that it might not be possible to meet current and future payment obligations in full or in good time.

The aim of liquidity risk management, which is the responsibility of the Treasury division, is to hold, at any time, liquid funds sufficient to meet future payment obligations. The risk management and monitoring processes have been designed to cover refinancing and market liquidity risks in addition to liquidity risk in the narrower sense.

### Liquidity risk strategy

In general, Aareal Bank has a low risk tolerance, ensuring the ability to generate liquidity in the short term in a considerable amount, even in a tight market environment or a crisis scenario, and to prevent liquidity squeezes. For this purpose, we hold a large amount of liquid and high-quality securities.

Within the framework of the refinancing strategy [20], various money and capital market instruments are used to achieve a broadly-diversified range of funding vehicles. We can rely mainly on three sources: firstly, the German Pfandbrief, secondly unsecured funding and thirdly deposits of institutional clients and housing sector clients.

### Instruments of liquidity controlling and management

Liquidity management (intraday and in the short and medium term) is assigned to Treasury and conducted based on the concepts of liquidity balance sheets and cash flow analyses, which are constantly developed. To analyse both the maturity structure and the quality of the individual money market and capital market products, the cash flows from the various refinancing sources are divided into different liquidity classes which are incorporated differently into the assessment of liquidity risk. The various properties, such as rollover probability, collateralisation, or ability to liquidate, are thus accounted for, thereby allowing the possible liquidity risks to be selectively quantified. The overall liquidity situation is broken down into several maturity ranges, taking into account possible stress scenarios. We generally consider the full withdrawal of customers‘ current account balances as the most significant scenario. Even in this stress scenario, liquidity is sufficient to cover the expected liquidity needs under stress conditions.

Managing and monitoring risk concentrations in the area of liquidity risks focuses on liquidity providers (composition of the liquidity reserve), the instruments used to raise liquidity, as well as on any concentrations of liquidity needs which may arise over time.

Risks are communicated by means of daily reporting to Treasury and to the members of the Management Board responsible for Treasury and monitoring. As part of monthly reporting, the entire Management Board is also briefed on the situation as regards liquidity risks. In addition, we notify further units if required.

[20] More information on refinancing, please refer also to chapter “Financial position” in the Group Management Report of the Aareal Bank Group 2009 Annual Report.

North America

Europe

Asia / Pacific

- Structured Property Financing
- Consulting / Services

**Aareal Bank, Real Estate Structured Finance:** Amsterdam, Berlin, Brussels, Copenhagen, Dublin, Hamburg, Helsinki, Istanbul, London, Madrid, Milan, Moscow, Munich, New York, Paris, Prague, Rome, Shanghai, Singapore, Stockholm, Warsaw, Wiesbaden, Zurich | **Aareal Valuation GmbH:** Wiesbaden | **Aareal Estate AG:** Berlin, Wiesbaden

**Aareal Bank, Institutional Housing Unit:** Berlin, Essen, Hamburg, Leipzig, Munich, Stuttgart, Wiesbaden | **Aareon AG:** Berlin, Coventry, Dortmund, Dresden, Erfurt, Hamburg, Hanover, Hückelhoven, Leipzig, Lyon, Mainz, Meudon La Foret, Milan, Munich, Nantes, Oberhausen, Orléans, Paris, Rostock, Rome, Stuttgart, Swansea, Toulouse | **Deutsche Bau- und Grundstücks-AG:** Berlin, Bonn, Moscow, Munich | **Aareal First Financial Solutions:** Wiesbaden | **Innovative Banking Solutions AG:** Wiesbaden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Aareal Bank
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