Disclosure Report as at 31 December 2012

Pursuant to Part 5 of the Solvency Ordinance (SolvV)
Facts. Figures.

Contents

Preliminary remarks

Pillar III of the Basel Framework (Basel II), supplemented by the Capital Requirements Directive (CRD) II and CRD III, defines the requirements for the regular disclosure of qualitative and quantitative information. The goal is to create transparency with regard to the risks entered into by institutions.

With the publication of the Solvency Ordinance (SolvV) on the capital adequacy of institutions, groups of institutions and financial holding groups as well as Section 26a of the German Banking Act (KWG), the disclosure requirements were transposed into national law. Compliance with these disclosure requirements is a prerequisite for the use of certain procedures to determine capital requirements.

On 1 January 2007 Bayerische Landesbank (BayernLB) obtained regulatory approval to use the Internal Ratings-Based (IRB) approach to measure capital requirements for credit risks under the Foundation IRB approach.

The disclosure report is published as a separate report on the internet alongside BayernLB's own annual report as a single entity – prepared under HGB (German Commercial Code) accounting rules – and the BayernLB Group's annual report, prepared under International Financial Reporting Standards (IFRS). This report is based on HGB data, which are the basis for preparing the Solvency Ordinance reports in the BayernLB Group.

Under the waiver rule, individual banks may apply for exemption from organisational and procedural rules relating to capital adequacy and disclosure requirements at individual bank level. BayernLB has opted not to apply the waiver rule under Section 2a of the German Banking Act (KWG).

This report is subject to the processes and systems for testing used by the auditors. Quantitative information has not been audited.

Note:

The last unit in the tables may be rounded to the nearest digit.

Risk management objectives and principles (Section 322 SolvV)

Organisational and operational implementation of the management philosophy

Risk strategy

The Group risk strategy is set by the Board of Management and the Risk Committee of the Board of Administration based on the Group business strategy and is checked regularly. The general objectives and guidelines and the strategic requirements for the different types of risk are drawn up based on the business strategy.

The Group risk strategy sets the following objectives and guidelines:

Objectives:
- To sustainably preserve capital, both regulatory and economic
- To ensure solvency at all times

Guidelines:
- The BayernLB Group only takes on risks it is able to assess and manage
- In those areas where the strategy allows for portfolio growth, quality takes priority over quantity
- Sales and Risk units are jointly responsible for earnings after risk provisions
- The BayernLB Group applies high ethical principles in its business activities

Organisation/internal risk monitoring and reporting

BayernLB's Board of Management ("Group Board of Management") is responsible for providing the BayernLB Group with a proper business organisation, which, in addition to having suitable internal monitoring processes, is capable in particular of ensuring major risks are appropriately managed and monitored at Group level. To prevent conflicts of interest, Sales and Risk Office units and Trading and Settlement units are functionally segregated within the business organisation.

To manage risks across the Group, the Group Board of Management has created several Group Boards whose members are drawn from BayernLB's Board of Management and the boards of management of the Group subsidiaries Banque LBLux S.A., Luxembourg (LBLux), Deutsche Kreditbank AG, Berlin (DKB) and MKB Bank Zrt., Budapest (MKB).

The main tasks of the Group Boards are to prepare the recommendations on Group-wide standards for approval by the governing bodies and regularly exchange information on implementing and refining these standards.

Risk management issues are addressed using Group and bank-specific strategies. These are based on the Group Risk Management Principles and the Group Risk Guidelines and set out in detail in formal policies and manuals.

The duties of the organisational units in relation to risk management are discussed in further detail below.

Risk Office

The Group Chief Risk Officer (CRO) Board advises on the standards and guidelines which are approved by the Group Board of Management for managing the key risks at Group level. The Group CRO Board also serves as a forum for exchanging information on current market and risk trends, with the aim of drawing up targeted and timely measures to reduce risks.

The Risk Office of BayernLB, the parent company, comprises the Group Risk Control and Credit Analysis Divisions.

The Group Risk Control Division independently identifies, values, analyses, communicates, documents and monitors the risk types at aggregated level. For the purposes of operational risk management and risk-bearing capacity management, Group Risk Control provides the Board of Management and other governing bodies with independent and risk-relevant reports.

In addition to periodic and ad-hoc reporting on the Group's risk situation to internal decision-makers, communication also includes external risk reports filed in accordance with legal and supervisory requirements. Group Risk Control serves as a central registry for the Group's risk situation. It also creates and updates the methods and processes needed for management and operational monitoring.

Decisions regarding risk management are made in accordance with the business strategy and risk strategy, which are harmonised with each other. Risk management is a joint responsibility of the Sales units and Risk Office units. In this management process, the Credit Analysis Division is responsible for analysing, assessing and managing the risk-relevant exposures in the core business (the Risk Office role). It takes the lead in setting the credit risk strategy for individual customers, sectors, countries and special products such as leasing, project finance and acquisition finance, is responsible for ongoing credit and transaction analyses, and votes on behalf of the Risk Office in the credit approval process. The same applies to all Group companies.

Restructuring Unit

The Restructuring Unit manages non-core business activities at the parent company level with the aim of progressively winding them down. The Group Risk Control Division is responsible for independently identifying, valuing, analysing, communicating and monitoring the risk types in the Restructuring Unit (RU), just as it is for the risks in the core business. The Restructuring Unit also assists in implementing the measures to wind down the non-core portfolios in the subsidiaries. The overall winddown strategy set by the Board of Management lays down the objectives and general principles for planning the winddown and for the credit decisions in the RU. The winddown strategies for individual exposures are decided by the relevant competence holders.

The portfolios to be wound down include ABSs, portions of the loan portfolio with banks and the public sector outside Germany, as well as structured financing and commercial real estate financing in certain markets and regions.

The goal is to free up the capital and liquidity resources in the non-core business as efficiently as possible, while conserving capital. The RU's task of winding down assets is thus directly derived from the Bank's focus on its future business activities.

The RU performs the roles of both the Sales units and the Risk Office for the exposures and portfolios assigned to it for winding down. It also handles exposures in restructuring or liquidation regardless of whether they are allocated to the core business or the reduction portfolio.

Financial Office

The primary task of the Group Chief Financial Officer (CFO) Board is to introduce and implement standards and directives for ensuring uniform accounts are prepared across the Group. The Group CFO Board also serves as a forum for exchanging information on current legal and technical issues in the fields of accounting, supervisory law, regulatory reporting by banks, taxation, business planning, controlling, capital planning and allocation, and funding and safeguarding liquidity, so that the measures needed can be implemented quickly and effectively.

Operational implementation of Group-wide accounting standards is the responsibility of the Financial Office Central Area, which is responsible for ensuring that the accounts are properly prepared. It is also responsible for establishing the accounting process and making sure it is effective. Its key tasks include preparing the consolidated financial statements and the Group management report, drawing up accounting policies, initiating accounting projects, and monitoring national and international developments in accounting.

The Financial Office also implements the relevant accounting standards and legal requirements on accounting, which are detailed in the directives for preparing the accounts. An important component of the accounting-related internal monitoring system, these directives are summarised and documented in the Group Accounting Manual, and in the instructions for Group companies for preparing the annual accounts.

The consolidated financial statements and Group management report are compiled in accordance with the directives for preparing the accounts produced by directive of the Board of Management, checked by the auditors and submitted to the Board of Administration for approval. The Board of Administration has set up an Audit Committee whose duties include discussing the audit reports and preparing the resolution for the Board of Administration's approval of the consolidated financial statements and Group management report. The Audit Committee also monitors the IFRS accounting process and the efficacy of internal monitoring, auditing and risk management systems. The auditor is invited to take part in the discussions of the Audit Committee and Board of Administration on the consolidated financial statements and report on the key findings of its audit.

The Asset Liability Management Committee (ALCO) is the umbrella and principal entity where earnings targets and risk management objectives are brought together. As a committee of the Board of Management, the primary tasks of ALCO are managing and allocating the key resources of capital and liquidity, as well as managing total assets and the balance sheet structure. ALCO also manages the risk/reward profile of the Bank's portfolio of its invested capital. As well as initiating and voting on Group rules, ALCO takes suitable measures within the Group when a liquidity crisis arises.

ALCO is supported by the Capital Management Committee (CMC), which mainly comprises the CFO and senior management from the risk control, treasury and accounting units. The CMC's task is to recommend capital management actions for approval by ALCO taking account of framework conditions such as directives from the Bank's owners and regulatory or EU requirements. Capital management includes changes in target regulatory capital ratios, the type and amount of the capital base and the allocation of risk positions, including ongoing monitoring of changes. Hence it is an important source of input for ALCO and the Board of Management and prepares suitable recommendations for action on matters related to capital.

The main components of the risk and earnings reporting system, in addition to the risk report, are the ALCO report and the MIS (management information system) report.

The Group Risk Control Division ensures that the Board of Management and the Risk Committee of the Board of Administration receive independent, risk-adequate reports so that the risk types can be operationally managed and risk-bearing capacity maintained. Alongside periodic reports, ad-hoc reporting is also carried out.

Operating Office

The Operating Office Central Area is responsible for BayernLB's operating processes and supporting these in the Group IT, Operations & Services, Human Resources and Organisation Development Divisions.

The Group COO Board prepares recommendations for approval by the Group Board of Management and the governing bodies of the subsidiaries that are responsible for the management and use of information and communications technology in the BayernLB Group. The Group COO Board is particularly involved in the following areas of responsibility in the Group: organisation (structural and procedural organisation), IT and the procurement of goods and services.

Group Compliance

The Group Compliance Division monitors and ensures compliance with legal and supervisory requirements and reports directly to the Chief Risk Officer, who sits on the Board of Management. It also coordinates the compliance activities of the subsidiaries.

Internal audit

The Audit Division audits the Bank's business operations and reports directly to the CEO. Taking a risk-oriented auditing approach, its auditing activities embrace basically all activities and processes within BayernLB, even those that have been outsourced. It also examines the efficacy and adequacy of the internal control system and risk management.

It carries out the tasks assigned to it independently of the activities, processes and functions to be audited, in accordance with applicable legal and supervisory requirements such as the German Banking Act (KWG) and Minimum Requirements for Risk Management (MaRisk). As Group internal auditor, it also supplements the internal auditing units of subordinate companies.

Liquidity management

The strategic principles for dealing with liquidity risk within the BayernLB Group are set out in the Group risk strategy. The overriding priority of liquidity risk management and monitoring is to ensure that the BayernLB Group can meet its payment obligations and obtain funding at all times. In addition to stringently ensuring solvency, BayernLB's prime goal in liquidity management is to maintain suitable access to the market.

These strategic goals are detailed in the Group Treasury Principles and the Group Liquidity Guidelines in conjunction with the emergency plan for safeguarding liquidity for daily management. These define the processes, management tools and hedging instruments needed to avert or address potential or real acute crises. They also contain an escalation mechanism, which comes into operation when early warning signals are triggered.

During the reporting year, strategic and operational liquidity management in the BayernLB Group was the responsibility of the Group Treasury and Treasury Products divisions within the Markets Business Area. This is also where operational liquidity is managed on the market and ample liquidity reserves is ensured at all times. Liquidity overviews (e.g. capital flow accounts, limit utilisation ratios and Group-wide risk monitoring of liquidity risks) are produced in the Group Risk Control Division of the Risk Office Central Area.

Managing credit risks

In accordance with its business model as a corporates and real estate lender and partner to the savings banks with a regional focus on Bavaria and Germany, the largest risk for the BayernLB Group is credit risk. No significant changes have been made in the instruments and methods for measuring, controlling and monitoring credit risks from those described in the risk report in the 2011 consolidated financial statements. Detailed information is given in the risk report of the 2012 consolidated financial statements.

Definition

Counterparty risks arise if a transaction results in a claim against a borrower, issuer of securities or counterparty. If these fail to meet their obligations, the Bank suffers a loss equal to the unpaid amount less the value of any realised collateral plus the related settlement costs. This definition covers both lending and guarantee risks from the credit business, and issuer and counterparty risks from trading activities.

Risks from changes in the credit rating of securities are managed primarily through the management of interest rate risks. When managing interest rate risks, a distinction is made between market-related and credit rating-related interest rate risk; this is also reflected in the separate presentation of the risk capital requirements for counterparty risks and market risk, especially specific interest rate risk.

Country risks, which are another type of counterparty risk, are also measured, managed and monitored. Country risk is defined in the narrow sense as the risk of a country or business partner whose registered office is located in another country failing to meet its obligations on time or at all due to sovereign acts or economic or political problems (transfer and conversion risks). Country ratings are a key tool for measuring individual country risk. At BayernLB, both the country risk in the narrow sense and the sum of the assumed counterparty risks of individual customers in the respective countries (domicile principle) with the exception of Germany are considered when measuring and limiting risks.

Organisation

Credit risk management is carried out jointly by the Sales units and Risk Office units. In BayernLB, as the parent company, the Risk Office function is allocated in organisational terms to the Credit Analysis Division of the Risk Office Central Area. For the reduction portfolio the functions are performed by the Restructuring Unit.

Risk strategy

The credit risk strategy – which is part of the comprehensive risk strategy – is set by the Board of Management for BayernLB and the Group taking account of risk-bearing capacity considerations. A detailed credit policy is drawn up from the credit risk strategy and used as a basis for operational implementation. The general objectives and guidelines and the strategic requirements for the different types of risk are drawn up based on the business strategy.

Compliance with the EU conditions for transactions with borrowers based abroad is checked before executing these transactions. For Corporates, Mittelstand & Retail Customers the Investment Committee decides whether a client and/or transaction has a connection with Germany. The Investment Committee is moreover a standing body in Corporates, Mittelstand & Retail Customers and the highest decision-making body with authority to allocate capital and resources below the Board of Management member responsible for the business area. There is also a similar Investment Committee in the Real Estate & Savings Banks/Association Business Area for the Real Estate Division.

Management structure

The credit approval process consists of several stages. The Competence Regulations define the authority of the different competence holders based on the loan volume to be approved, the business area it is allocated to and the rating classification. Credit decisions that ultimately require approval by the Board of Management or Risk Committee of the Board of Administration must first go through the responsible subordinate credit committee which are themselves also competence holders. Since the Restructuring Unit was created, credit decisions on the portfolios to be wound down have been taken by a separate credit committee, the Restructuring Unit Committee. The Board of Administration monitors risk management through its Risk Committee. The latter decides on all credits that require the approval of the Board of Administration under the German Banking Act or the Competence Regulations.

New products and products for new markets are subjected to a stringent new product process.

The decision-making processes in the subsidiaries are similarly organised; at some subsidiaries, members of BayernLB's Board of Management are represented on the supervisory boards or the governing bodies.

Risk measurement and internal rating systems

Risk is measured at portfolio level using a version of CreditRisk+, an analytical software system for quantifying default risks. The impact of an unexpected loss by an individual business partner on the whole portfolio is also calculated for risk analysis purposes. A correlation model quantifies dependencies among borrowers in the portfolio. In addition, the effects of rating migrations and uncertainties in calculating loss ratios are also taken into account.

BayernLB uses several statistically based rating procedures in which borrowers are assigned to rating classes on a 25-tier master rating scale on the basis of default probabilities. There are 22 rating classes for solvent borrowers and three classes for those in default.

BayernLB obtained regulatory approval on 1 January 2007 to use the Internal Ratings-Based approach. To maintain and refine the rating procedures, BayernLB works mainly with RSU Rating Service Unit GmbH & Co. KG and Sparkassen Rating und Risikosysteme GmbH. All rating procedures are subject to an ongoing validation process to ensure they are able to correctly determine the default probabilities in each customer and financing segment. This process draws on quantitative and qualitative analyses. These assess the rating factors, the accuracy and calibration of the procedure, the data quality and the design of the model using statistical and qualitative analyses and user feedback.

BayernLB's main rating procedures are:

- Scorecard procedure
  The scorecard or scoring procedure is used to allocate points to certain major attributes of customers (quantitative and qualitative) based on mathematical/statistical analyses to calculate a total score for creditworthiness. The calculated scorecards are converted into rating scores using a calibration function. These risk ratings are supplemented by warning signals and cross-liability matrices

- Simulation procedure
  The simulation procedure is principally used to classify property financing risks. This rating procedure creates scenarios for future cash flow trends and calculates rating scores and default probabilities based on loan-to-value and debt service coverage ratios through the use of default tests that differentiate between performing and non-performing loans. The quantitative risk assessment is supplemented by qualitative factors and warning signals

The 16 rating modules approved for use in the IRB approach are:

1. Banks
2. Insurers
3. Corporates (corporate clients, including municipally owned companies)
4. Savings banks standard rating
5. International regional authorities
6. Country and transfer risk
7. Supranationals
8. Leveraged finance
9. Retail customer scoring (DKB)
10. Internal assessment approach for securitisations
11. Leasing (leasing companies and real estate leasing SPVs)
12. Aircraft financing
13. International commercial real estate
14. Savings banks real estate rating
15. Project financing
16. Ship financing

Rating procedures 1 – 9 are scorecard procedures that measure risks at customer level. Simulation-based procedures (12 – 16) that in some cases take account of information on creditworthiness and, in particular, transaction-related criteria are used for the "specialised financing". Rating procedures 10 and 11 employ both simulation and scorecard methods.

The "central governments" loan category mainly contains borrowers from the following rating procedures: international regional authorities (5), country and transfer risk (6) and supranationals (7). The "institutions" loan category comprises borrowers from the banks rating procedure (1). With the exception of securitisations (10) and retail (9), all other procedures are assigned to the "corporates" loan category.

The recession demonstrated that the rating procedures were for the most part robust and accurate. It became clear that taking account of market-induced factors significantly improved the depiction of the volatility of the financial markets during the crisis. These new findings have been and will continue to be integrated into the rating systems as much as possible.

The goal is to create sufficient leeway to implement risk avoidance/minimisation measures through the early detection of negative changes in the risk profile using suitable early warning indicators of risk. These indicators include prices (equities and credit default swaps), volatility, market capitalisation and other factors from peer group comparisons.

Risk limitation

In accordance with the Group Risk Management Principles, counterparty risks at borrower and borrower unit level are monitored daily by the Risk Office using a Bank-wide limitation system. The limitation process also takes account of the timing structure of default risks by sub-dividing limits into maturity bands. Comparable processes have been implemented in the subsidiaries.

To limit large credit risks, the maximum gross credit volume for each borrower unit is limited to EUR 500 million (gross loan amount) Group-wide in accordance with Section 19 para. 2 of the German Banking Act (Kreditwesengesetz (KWG)). Customer groups above this threshold are approved in accordance with the Competence Regulations, are managed separately and are made transparent on a regular basis.

To prevent risk concentrations in individual sub-portfolios, risk-based upper limits are set and monitored. Examples include sector-specific or country risk limits. Both qualitative and quantitative limits are set for sectors. In addition to the Group-wide sector limits, additional specific guidelines are set for each sector and issued by the Board of Management and the Risk Committee of the Board of Administration. Country limits at Group level are set by the Board of Management based on the country risk analysis and the vote by the Risk Office. Sector and country limits and guidelines are monitored by the Group Risk Control Division in the Risk Office Central Area. Sector and country strategies are reviewed annually. Irrespective of this, strategies can be changed as events arise.

Another key way in which risks are limited at the BayernLB Group level is by accepting the usual types of bank collateral and valuing them on an ongoing basis.

When deciding what collateral is needed, particular account is taken of the type of financing, the borrower’s available assets, their value and liquidity and whether the relative costs are reasonable (costs of acceptance and ongoing valuation).

Collateral is processed and valued in accordance with directives which also set out any discounts to be applied, along with the valuation intervals. Net risk positions are valued on the basis of the liquidation value of the collateral.

The German Federal Financial Supervisory Authority (BaFin) has granted BayernLB approval to lower its regulatory capital requirements through the use of real estate liens, ship mortgages, registered liens on aircraft, guarantees, financial collateral in the form of securities and cash deposits, and credit derivatives under its IRBA approval.

In derivatives trading, the usual practice is to conclude master agreements for the purposes of close-out netting. Collateral agreements exist with certain business partners restricting the default risk associated with certain trading partners to an agreed maximum and authorising a call for additional collateral should this limit be exceeded.

Credit derivative transactions are only carried out with counterparties rated as investment grade. Replacement risk is also reduced using appropriate credit hedging agreements.

Risk monitoring

A reporting system is used to constantly monitor all credit exposures in terms of their financial status and collateral, compliance with limits, fulfilment of the terms of agreements, and compliance with external and internal requirements. Monitoring is backed up by means of an escalation procedure. Exposures with elevated risk are identified promptly in the early risk detection process using defined early warning indicators. Early warning indicators are regularly tested for adequacy.

Problem exposures are classified in accordance with the standard international categories (“special mention”, “substandard”, “doubtful” and “loss”) in terms of their level of risk, and a special restructuring and risk monitoring process is implemented if warranted.

Restructuring problem loans to minimise default risk can require modification to the terms originally agreed on a loan, such as changes to the interest rate, term extensions, reductions in the amount to be repaid/interest accrued or deferral agreements.

By initiating suitable measures as part of an intensive support or problem loan handling process at an early stage, BayernLB aims to minimise or completely prevent defaults from occurring.

Proper account has been taken of all risks in the credit business through risk provisions. The principles governing loan loss provisioning for problem exposures establish how loans at risk of default are to be handled, valued and reported. Please see the accounting policies in the Notes of the consolidated financial statements of the BayernLB Group for details of how risk provisions are calculated and written off.

Managing investment risks

Definition

Investment risk (shareholding risk) comprises the BayernLB Group's counterparty (default) risk arising from its shareholdings.

This risk entails a potential loss in value arising from the following:
- The provision of equity or equity-type financing (e.g. silent partner contributions), or from suspension of dividends, partial writedowns, losses on disposals, or reductions in hidden reserves
- Liability risks (e.g. letters of comfort) and/or profit and loss transfer agreements (e.g. assumption of losses)
- Capital contribution commitments

Organisation

Group Risk Control is responsible for setting standards and reporting at portfolio level. BayernLB has an independent central unit with the authority to issue guidelines for all methods and processes relating to investment risk monitoring. Operational implementation of the risk management instruments is the responsibility of the business units concerned.

Risk strategy

BayernLB acquires investments to achieve its corporate goals. These are divided into a core and a non-core portfolio.

The core portfolio comprises investments which expand customer and market potential, support the business model or operating processes, and also miscellaneous investments.

As part of the resizing of BayernLB, however, the disposal of some non-core investments is being examined and, in some instances, a sale has already been agreed.

Where BayernLB provides both equity and debt capital, it examines any additional risks, particularly those arising from its status as a lender.

Investment risks are handled in accordance with the Group risk strategy, which is derived from the overall business strategy for the Group, and also the investment policy. These govern the investment process, the capital base of the investee companies and controlling and reporting. All investments are approved by the Board of Management. Decisions by the BoM to acquire an investment must be approved by the Board of Administration. Issues to be decided and mandatory consent for investments are governed by the Rules of Procedure of the Board of Management of BayernLB. The strategic conditions set by the European Commission must be complied with.

The Group's major investments are integrated into BayernLB's annual strategy and planning process.

Based on the risk assessment (risk inventory in accordance with MaRisk) and the requirements of the BayernLB's Group risk strategy, compatible risk management processes, strategies and procedures are implemented in the Bank's subsidiaries. These investments are closely integrated into the management and monitoring process of the BayernLB Group through the individual risk types.

Risk measurement, limitation and monitoring

For Solvency Ordinance reporting purposes, investment risks are measured using the simple risk-weighted method under SolvV where the grandfathering method under Section 338 para. 4 SolvV is not applied.

Risk capital requirements for investment risk in ICAAP are calculated using the regulatory PD/LGD method according to SolvV.

A classification procedure for assessing and monitoring risk with clear guidelines on the early detection of risks has been implemented for all investments. Key factors in this regard are the maximum loss potential and early warning indicators.

Risks from investments are reported to the Board of Management in the regular risk reporting process as well as in an annual investments report using the relevant procedures (classification, early warning). If early warning signals are triggered, the decision-makers are notified without delay. Significant critical investments are monitored in the intensive support or problem-loan processes and reported to the Board of Management on a quarterly basis. The investment report sets out in particular recommendations for action and the implementation status of measures already executed.

Managing market risks

Definition

Market risk is the risk of potential losses in value from changes in market prices (interest rates, credit spreads, exchange rates, equity and commodity prices) and other parameters (correlations, volatility) that affect prices. Accordingly, BayernLB breaks down its market risks into general and specific interest rate risk, currency risk, equity price risk, commodity risk and volatility risk.

Organisation

The Group Risk Control Division is responsible for monitoring market risks independently of Trading.

Risk strategy

The risk strategy sets out the strategic principles for handling market risks and prescribes the amount of risk capital to be made available for market risks from the available economic capital. Market risks may only be assumed within approved limits and are constantly measured and monitored.

The amount of risk capital provided for market risks is broken down by risk unit and individual market risk type and implemented in the form of value-at-risk (VaR) limits.

In accordance with current business and risk strategy, market risks are normally only assumed as a result of transactions on behalf of customers, including corresponding hedge transactions. Moreover, market risks may result from transactions for liquidity management, asset/liability management or the non-core businesses that are being wound down.

New products and products for new markets are subjected to a stringent new product process.

Risk measurement

Market risks are normally calculated for operating management and monitoring using a correlated VaR method based on a one-day holding period and confidence level of 99 percent. In the subsidiaries, besides the historical simulation approach mainly applied by BayernLB, methods such as the scenario matrix method (LBLux) and the variance-covariance approach (MKB) are also used. Risks in the banking book are also calculated on a monthly basis in certain cases. Customer deposits at DKB are modelled by moving average methods.

The methods used for measuring market risks are regularly assessed for the quality of their forecasting. In the backtesting process, the risk forecast is compared with actual outcomes (profit or loss). As of 31 December 2012, the forecasting quality of the market risk measurement methods was classified as good in accordance with the Basel traffic light approach.

The outcomes of value-at-risk based risk measurement must always be looked at in the context of the parameters used in the model (mainly the confidence level selected, a one-day holding period, and the use of historical data over a period of around one year to forecast future events). For this reason, the risk positions of each Group institution are exposed to extraordinary changes in market prices, with the potential risks undergoing an analysis, as part of a stress test. Additional individual stress tests are used at individual bank level. The stress tests take into account all relevant types of market risk, are regularly reviewed, and their parameters modified if necessary.

BayernLB and its subsidiaries currently employ the standardised approach to calculate regulatory capital backing for trading transactions.

Risk limitation

In the BayernLB Group, market risks are limited by allocating the economic capital available for them as determined in the risk-bearing capacity calculation. The VaR limits derived from this process are monitored at the individual entity and Group levels. VaR limits for different market risk factors and portfolio levels are calculated on the basis of the available economic capital that can be used to cover market risks. To create a reserve that can be drawn on in the event of an unforeseen market development, limit allocations to units in charge of risk are restricted.

Risk monitoring

In the BayernLB Group several tools are used to monitor and limit market risks including value-at-risk, risk sensitivity, stress tests and ratios for calculating risk-bearing capacity. The risk-controlling units at BayernLB and its subsidiaries are responsible for monitoring their own market risks internally. However, their market risks are included in BayernLB's daily risk reports.

Market risks in the trading book and in parts of the banking book are monitored and reported daily on a VaR basis independently of Trading. Supervisory requirements are implemented and risk transparency is assured by means of regular reporting to those responsible for positions in the divisions. In the event of VaR limits being exceeded appropriate measures are taken as part of an escalation procedure.

The interest rate risk in the banking books forms part of the regular risk calculation and monitoring processes of the risk-controlling units. Contractual or legal termination rights are modelled as options and incorporated into the risk calculation.

In addition, a supervisory interest rate shock scenario of +/–200 basis points is also calculated for interest rate risk in the banking book at individual entity level and Group-wide. As at the reporting date, the calculated change in present value relative to liable capital at both BayernLB and the BayernLB Group was well below the 20 percent limit set in BaFin's criterion for "institutions with elevated interest rate risk".

Through the Group risk report, the Chief Risk Officer was informed monthly, and the Board of Management and the Risk Committee of the Board of Administration at least quarterly, about the market risk situation.

Managing operational risks

Definition

In line with the regulatory definition in Section 269 of the Solvency Ordinance (SolvV), the BayernLB Group defines operational risk (OpRisk) as the risk of loss resulting from inadequate or failed internal processes, people or systems, or from external events. This includes legal risks.

Legal risks are the risks of loss resulting from non-compliance with laws or legal rulings due to ignorance of the law, insufficient diligence in applying the law or failure to respond to legal changes within a reasonable period of time. Legal risks do not include the risk of loss from changes in the legal framework that could make the future business activity of BayernLB more difficult.

Organisation

Operational risk is managed and monitored both centrally in the Group Risk Control Division and locally in the individual business areas and central areas. The Group Risk Control Division has the guideline competence for all methods, processes and systems. Responsibility for OpRisk management resides with the business areas and central areas. The subsidiaries manage their operational risk through their own risk-controlling units; relevant investments are included in the loss reporting procedure for the BayernLB Group.

Risk strategy

The treatment of operational risks is set out in the risk strategy, operating instructions and an OpRisk handbook. The strategic objective is to minimise or avoid risk in such a way that the costs of doing so do not exceed the risk of loss from operational risks.

This requires operational risks to be identified and assessed as completely as possible. The risk strategy limits the capital backing needed for operational risks in the risk-bearing capacity (ICAAP).

Risk measurement

For operational risks BayernLB uses the standardised approach (STA) set out in SolvV to calculate the capital requirements under SolvV/Basel II (Pillar I) and the risk capital requirement under the risk-bearing capacity assessment (ICAAP)/Basel II (Pillar II). In addition to quantifying capital backing, stress scenarios are employed under Pillar II. These, in turn, are an integral component of the cross-risk stress scenarios in ICAAP.

Risk management and monitoring

The risk management and monitoring process involves the use of further risk management instruments which go beyond straightforward quantification of capital backing and stress scenarios, such as risk inventories, which combine self-assessments with scenario analyses. Operational risk at BayernLB quantified in ICAAP is reported to the Board of Management every quarter as part of regular reporting on overall risk, but also on an ad-hoc basis as required. This ensures that operational risk management and monitoring is consistently integrated into risk-bearing capacity monitoring and the stress analyses, as well as into the overall risk management and strategy.

Scope of consolidation (Section 323 SolvV)

BayernLB is an institution under public law with a German banking licence and its registered office in Munich. This means that for supervisory purposes it is a parent bank that comes under SolvV. LBS Bayern was sold to the Association of Bavarian Savings Banks on 31 December 2012. It ceased to be a legally dependent institution of BayernLB on that date.

Consolidation matrix

The table below shows those companies directly included in the IFRS consolidated financial statements (either fully consolidated or stated at equity), and their supervisory treatment. A large number of smaller, subordinated companies are consolidated, but not shown because they are of little significance. A complete list of shareholdings pursuant to Section 285, sentence 1 no. 11 HGB and Section 313, para. 2 HGB is published separately in the electronic Federal Gazette.

Consolidation matrix

	Regulatory treatment				Consolidation under IFRS	
	Consolidation					
Name	Full	Proportional	Deduction method	Risk-weighted investments	Full	Valued at equity
Credit institutions						
• BayernLB, Munich (parent company)	x				x	
• Banque LBLux S.A., L - Luxembourg	x				x	
• Deutsche Kreditbank Aktiengesellschaft, Berlin	x				x	
• Landesbank Saar, Saarbrücken			x			x
• MKB Bank Zrt., H - Budapest	x				x	
Investment companies						
• BayernInvest Kapitalanlage-gesellschaft mbH, Munich	x				x	
Financial enterprises						
• BayernLB Capital LLC I, USA - Wilmington	x				x	
Other						
• BayernLB Capital Trust I, USA - Wilmington				x	x	
• GBW AG, Munich				x	x	
• KGAL GmbH & Co., Grünwald				x		x
• Real I.S. AG Gesellschaft für Immobilien Assetmanagement, Munich				x	x	

The scope of consolidation for supervisory purposes includes all subsidiaries where consolidation is mandatory, so that the carrying values of investments in subsidiaries are not deducted from capital (Section 323, para. 2 SolvV).

The BayernLB Group's investments in banks

The major banking subsidiaries shown below have an independent market presence. Forming part of a close-knit network with each other and BayernLB, they are able to offer customers a wide range of products while concentrating on their own core strengths. The banking subsidiaries are integrated into BayernLB's planning process.

No restrictions or significant impediments exist preventing the transfer of funds or equity within the BayernLB Group, provided no local banking supervisory rules are contravened.

No exemptions for group institutions under Section 2a KWG have been applied under the waiver rule to date.

Major banking subsidiaries of BayernLB:

- Deutsche Kreditbank AG, Berlin (100 percent holding) is BayernLB's internet-based retail bank and serves as the centre of expertise for residential sector exposures, particularly in the former East Germany
- Banque LBLux S.A., Luxembourg (100 percent holding) acts as service provider in the financial centre of Luxembourg. It is also responsible for BayernLB's Corporates and Real Estate divisions in the Benelux region and acts as IT service provider for several BayernLB entities
- MKB Bank Zrt., Budapest (98.1 percent holding) is BayernLB's principal presence in Eastern Europe and has its own banking subsidiaries in Bulgaria and Romania. It is a retail component, alongside DKB

Own funds (Sections 324 and 325 SolvV)

Regulatory capital adequacy (solvency)

To ensure the proper amount of regulatory capital, the objectives, methods and processes below have been defined:

The starting point for the allocation of regulatory capital is the BayernLB Group's own funds planning. Own funds consist of liable capital – the sum of core capital and supplementary capital – plus tier 3 capital. Core capital consists of subscribed capital plus reserves and other capital. Supplementary capital includes profit participation certificates and long-term subordinated liabilities.

Own funds planning is based largely on the internal target core capital ratio (ratio of core capital to risk positions) and an internally set target for the overall ratio (ratio of own funds to risk positions) of the BayernLB Group. It establishes for the planning period upper limits for risk assets, market risk positions and operational risks arising from the BayernLB Group's business activities. The effects of market fluctuations – simulated in stress tests – are taken into account by means of capital buffers to ensure solvency criteria are met at all times.

As part of Group planning, regulatory capital is distributed to each planning unit. The planning units (Group units) are the defined business segments of BayernLB, Bayerische Landesbodenkreditanstalt (BayernLabo) and the subsidiaries.

Regulatory capital is allocated to Group units through a top-down distribution of limits on risk assets and market risk positions agreed by the Board of Management, with segment-specific targets and a supervisory minimum core capital ratio for the Group.

The limits on each Group unit's risk asset positions and market risk positions are constantly monitored for compliance by ALCO. The Board of Management receives monthly reports on current limit utilisations.

Capital structure (Section 324 SolvV)

BayernLB's regulatory capital consists of paid-in nominal capital and reserves plus various other capital instruments. The major characteristics of the main capital instruments (terms and conditions) are summarised below.

Core capital

Other capital – capital contributions from silent partners

Dated capital contributions from silent partners have original maturities of ten years or more. The annual dividend is dependent on capital market yields at the time of distribution plus a risk premium based on market conditions. The requirements for inclusion as core capital under the transitional provisions in Section 64m para. 1 KWG are met.

Undated capital contributions from silent partners have broadly similar terms and conditions but are perpetual and not cumulative (unpaid dividends are not carried forward). The capital-market based distribution is agreed for a ten-year time period. The requirements for inclusion as core capital according to the transitional provisions in Section 64m para. 1 KWG are met.

Other capital – hybrid capital

Hybrid capital that the BayernLB Group has included as core capital is generated by issuing trust preferred securities through a special-purpose entity. This structure is perpetual, but can be terminated by BayernLB once ten years have elapsed. The annual dividend is dependent on capital market yields at the time of distribution plus a risk premium based on market conditions. The requirements for inclusion as core capital according to the transitional provisions in Section 64m para. 1 KWG are met.

In preparation for the tighter future capital requirements under Basel III, BayernLB made a repurchase offer on 11 October 2012 to holders of the trust preferred securities of BayernLB Capital Trust I, Wilmington. The repurchase reduced hybrid capital by a nominal volume of USD 600 million.

Supplementary capital

Profit participation certificates

Profit participation rights have original maturities of at least five years, though most have maturities of ten years or more or are perpetual. The annual dividend is dependent on capital market yields at the time of distribution plus a risk premium based on market conditions. The requirements for inclusion as supplementary capital under Section 10 para. 5 KWG are met.

Longer-term subordinated liabilities

Long-term subordinated liabilities have original maturities of at least five years, though most have maturities of ten years or more. Interest rates are dependent on capital market yields at the time of distribution plus a risk premium based on market conditions. The requirements for inclusion as supplementary capital under Section 10 para. 5a KWG are met.

Short-term subordinated liabilities (tier 3 capital)

The BayernLB Group had no short-term liabilities (tier 3 capital) as at 31 December 2012.

Capital structure (based on balance sheet figures)

EUR million	**31 Dec 2012**
Subscribed capital	2,300
Other eligible reserves	6,644
Other capital under Section 10 para. 2a sentence 1 no. 8 KWG	3,000
Funds for general banking risks under Section 340g HGB	1,232
Other and country-specific core capital components	1,478
of which: other capital, limited and with repayment incentive	221
Deduction items under Section 10 para. 2a sentence 2 KWG	–809
of which: core capital deduction items under Section 10 para. 6 and 6a KWG	–616
Total core capital under Section 10 para. 2a KWG	**13,845**
Total of supplementary capital under Section 10 para. 2b KWG after deducting the deduction items under Section 10 para. 2b sentence 2 KWG and tier 3 capital under Section 10 para. 2c KWG	**4,171**
Total adjusted available capital under Section 10 para. 1d KWG and eligible tier 3 capital under Section 10 para. 2c KWG	**18,016**
Total deduction items under Section 10 para. 6 and 6a KWG	**–1,232**
of which: provision shortfall and expected losses under Section 10 para. 6a nos. 1 and 2 KWG	–514

Capital adequacy (Section 325 SolvV)

Internal Capital Adequacy Assessment Process (ICAAP)

Risk-bearing capacity is monitored using the Internal Capital Adequacy Assessment Process (ICAAP) at the BayernLB level, the subsidiaries DKB, MKB and LBLux, and at the Group level. The aim is to ensure there is sufficient economic capital available for the risks assumed and planned.

The methodology is based on a liquidation approach with the aim of ensuring the protection of senior creditors in the event of BayernLB's liquidation.

For an in-depth, forward-looking analysis of economic capital adequacy, the risk-bearing capacity calculation is based on planned business activity and is supplemented by stress tests. Both scenario and sensitivity analyses are carried out for this purpose. In addition to historical scenarios, the impact of adverse changes in risk factors both on specific risk types and across all risk types is also analysed using hypothetical scenarios. The latter in particular have a major role in the analysis of situational scenarios. Risk-bearing capacity analyses are supplemented by a going-concern perspective by means of the five-year loss scenario. This analyses capital adequacy with respect to the sustainability of the business model in the event of a loss that is statistically probable only once over a rolling five-year planning horizon.

Sensitivity analysis also plays a part in the comprehensive analysis of risk-bearing capacity by increasing awareness of the implications of potential changes in individual risk factors (such as the impact of changes in interest rates).

Risk-bearing capacity is quantified routinely and as required from liquidation perspectives and reported as part of the internal risk reporting, together with the results and key assumptions of the stress scenarios performed.

The risk strategy sets the proportion of available economic capital that can be allocated to risk types in the course of business activities. Currently, no more than 75 percent of available economic capital can be allocated. In 2012, as part of the revision of the Group risk strategy, the upper limit for the capital to be allocated to risk types was restricted further. The upper limit applies from 2013.

The available economic capital is calculated by deducting the items not available in the event of liquidation (e.g. intangible assets) from the sum of equity and subordinated capital, less a buffer for risk types which are not controlled at business unit level and/or have little controlling relevance for ICAAP. The planning of economic risks for the risk-bearing capacity calculation and the planning of the available economic capital are integral parts of the Group planning process described under "Regulatory capital adequacy".

The method for calculating risk-bearing capacity is assessed and refined on a regular basis to ensure it takes adequate account of external factors and internal strategic targets. The confidence level used in the ICAAP to calculate economic risk is 99.95 percent, which is equivalent to an external rating of A2 on the Moody's scale.

Capital requirements

In 2007, BayernLB obtained approval as an IRBA institution to use the Internal Ratings-Based approach (IRBA) at Bank and Group level. Since 2008, DKB has also been included in the IRB approach for the purposes of calculating capital requirements at BayernLB Group level. In 2012 DKB received IRBA approval for other rating procedures. 2009 saw the integration of LBLux into the IRB approach. All other BayernLB equity investments are included in the BayernLB Group using the credit risk approach (CRSA). Partial use is applied to calculate capital requirements at individual bank and at Group level.

Capital requirements for counterparty risk positions are calculated in the IRB approach on the basis of the rating procedure approved for BayernLB. External ratings under the standardised approach (CRSA) are used to determine capital requirements for all exposures that are not yet measured with an approved internal rating system.

Besides the ratings-based approach and the internal rating procedure, BayernLB uses the supervisory formula approach to calculate risk positions from securitisations.

In respect of equity exposures the simple risk-weighting method is employed where the grandfathering rule is not applicable. Capital requirements for investment units are mainly calculated using the look-through approach.

For market risks, BayernLB currently uses supervisory standardised methods instead of an in-house risk model. Operational risks are measured using the standardised approach.

Capital requirements for SolvV reporting

EUR million	31 Dec 2012
Credit risk	**6,177**
• **Standardised approach**	**801**
– Central governments	5
– Regional governments and local authorities	17
– Other public authorities	1
– Multilateral development banks	0
– International organisations	0
– Institutions	6
– Corporates	435
– Retail	118
– Exposures secured by real estate	111
– Past-due items	81
– Covered bonds issued by banks	0
– Investment units	0
– Other items	27
• **IRB approach**	**5,376**
– Central governments and central banks	63
– Institutions	726
– Corporates	4,169
– Retail	379
of which: secured by real estate charge	306
qualified revolving	15
qualified revolving other	58
– Other non-credit-obligation assets	39
Securitisations	**337**
• **Securitisations under the standardised approach**	**0**
• **Securitisations under the IRB approach**	**337**
Risks from investments	**153**
• **Grandfathered investments**	**103**
• **Investments under the IRB approach**	**50**
– Simple risk weighting approach	50
Listed investments	1
Unlisted but sufficiently diversified investments	0
Other investments	49
– Internal model approach	0
• **Investments under PD/LGD approaches**	**0**
Market risks in the trading book	**699**
• **Standardised approach**	**699**
– Net interest rate exposure	549
of which: general and specific price risk	466
specific price risk for securitisation exposures	0
specific price risk in correlation trading portfolio	0
– Net equity exposure	11
– Total currency exposure	51
– Commodities exposure	88
– Other market risk exposures	0
• **Internal model approach**	**0**
Operational risks	**664**
• **Basic indicator approach**	**0**
• **Standardised approach**	**664**
• **Advanced measurement approaches**	**0**
Capital requirements	**8,030**
Other or temporary capital requirements	**0**
Additional capital requirements under Section 339 para. 5a/b SolvV	0

Capital ratios (based on balance sheet figures)

in %	Total capital ratio	Core capital ratio
Consolidated banking groups		
• BayernLB Institutsgruppe, Munich	18.0	13.8
• BayernLB, Munich	24.2	18.4
Subsidiaries*		
• Banque LBLux S.A., L - Luxembourg	24.9	15.4
• Deutsche Kreditbank Aktiengesellschaft, Berlin	9.8	8.2
• MKB Bank Zrt., H - Budapest	9.0	6.2

** Calculated in accordance with SolvV or local reporting regulations, individual institution level only*

Requirements on risk types (Sections 326 to 336 SolvV)

Counterparty risks: general disclosure requirements for all institutions (Section 327 SolvV)

Total exposure by credit risk-bearing instrument

Total exposure is based on the individual exposure amount (before credit risk mitigation techniques and after credit conversion factors (CCF)). The credit equivalent amount is shown for derivative instruments.

Investment instruments and securitisations disclosed under Section 327 SolvV are not included in the breakdown as they have their own disclosure tables.

Exposures under SolvV arise from:
- Counterparty risks (Sections 9, 10, 11 and 13)
- Netting exposures (Section 12)
- Prepayment risks (Section 14)
- Settlement risks (Sections 15 and 16)

Total exposure by credit risk-bearing instrument

EUR million	Loans, commitments, other non-derivative off-balance sheet assets	Securities	Derivative instruments
Total	**203,815**	**29,746**	**12,689**

Total exposure by geographical region

EUR million	Loans, commitments, other non-derivative off-balance sheet assets	Securities	Derivative instruments
Africa	153	15	0
Asia	1,719	269	82
Caribbean	59	10	0
Latin America	807	0	0
Central and Eastern Europe/CIS	10,440	182	347
Middle East	2,292	0	253
North America	6,605	3,710	1,493
Western/Central Europe	180,902	25,504	10,485
Other	838	56	29
Total	**203,815**	**29,746**	**12,689**

Total exposure by sector

EUR million	Loans, commitments, other non-derivative off-balance sheet assets	Securities	Derivative instruments
Banks/financial service providers	36,402	18,124	5,503
Real estate	43,914	0	1,499
Sovereigns/public sector	30,683	10,642	1,078
Retail customers	18,732	0	1
Utilities	9,730	91	838
Renewable energy	8,536	24	120
Logistics	5,456	132	508
Automotive	4,207	25	422
Aviation	3,266	0	225
Food & beverages	3,208	33	213
Other	39,681	675	2,282
Total	**203,815**	**29,746**	**12,689**

Total exposure by residual maturity

EUR million	Loans, commitments, other non-derivative off-balance sheet assets	Securities	Derivative instruments
> 0 years to ≤ 1 year	36,801	1,953	4,353
> 1 year to ≤ 5 years	53,661	21,627	4,084
> 5 years, no maturity	113,353	6,166	4,252
Total	**203,815**	**29,746**	**12,689**

The amounts as at 31 December 2012 do not differ materially from the average amounts over that year (Section 327 para. 2 no. 1 SolvV).

Risk provision procedure

To calculate risk provisions, customer relationships in the BayernLB Group are analysed at quarterly intervals as a rule. Specific loan loss provisions are established for significant individual credit exposures if objective indications of impairment exist with an impact on future expected cash flows. Objective indications include, for instance, interest and capital repayment arrears greater than 30 days or a rating of 19 or worse on a scale of 1–25.

The size of the specific loan loss provision is the difference between the carrying amount of the receivable and the net present value of future expected incoming cash flows calculated on the basis of the original effective interest rate using the discounted cash flow method. Additions to or releases of risk provisions are made if expectations of cash flows change. Unwinding – a change in the net present value of future expected incoming cash flows over the period – is reported as interest income; the actual interest payments received are subsequently recognised as repayments, and not as interest income.

For portfolios composed of similar, immaterial receivables, flat-rate specific loan loss provisions are made on the basis of collective risk assessment. These are also reported under the specific loan loss provisions due to creditworthiness risks.

For material and immaterial receivables for which no indications of impairment have been detected on individual examination and no flat-rate specific loan loss provisions have been made, portfolio provisions based on creditworthiness factors are calculated on the basis of historical probabilities of default and loss rates. This uses a procedure based on parameters derived from the Basel II system that are regularly assessed.

Country risks (transfer risk and general political risk) are reflected by making a portfolio provision on the basis of country risk-specific probabilities of default and loss rates if these risks have not already been taken into account through specific loan loss provisions.

Non-recoverable receivables are derecognised; this is carried out by utilising specific loan loss provisions that have already been made. Bad debt losses for which no or insufficient loan loss provisions have been made are charged to existing portfolio provisions (utilisation). An addition of the same size is made to the portfolio provision, which is reported as a direct writedown in risk provisions in the credit business.

Definition of "in default" or "non-performing"

Default criteria are incorporated in the rating system within the rating process. Relevant default criteria are:

(1) The individual borrower is past due more than 90 days on a material liability to BayernLB.
(2) The Bank considers it unlikely that the individual borrower will pay its credit obligations to BayernLB in full, without recourse by the Bank to actions such as realising collateral (if held).
(3) The Bank consents to a mandatory restructuring/workout of the credit obligation, which will result in a diminished financial obligation of the individual borrower on the basis of material forgiveness or postponement of principal, interest or fees.
(4) The Bank makes a value adjustment or partial writedown due to a significant deterioration in credit quality subsequent to taking on the credit risk.
(5) The Bank makes a full writedown of irrecoverable receivables.

(6) The Bank sells part or all of the receivable of an individual borrower at a material, risk-related economic loss.
(7) The Bank has filed for the individual borrower's insolvency or made a similar application in respect of the individual borrower's credit obligations to BayernLB, or the individual borrower has sought or has been placed in bankruptcy or similar protection such that this avoids or delays repayment of a credit obligation to BayernLB.

These default criteria take account of the definitions in the Solvency Ordinance, under which "loans in default" fall within rating class 22 (criteria (1), (2), (3) or (4)) and "non-performing loans" within rating classes 23 (criteria (3) or (4)) and 24 (criteria (5), (6) and (7)).

BayernLB's individual borrowers are also classed as "in default" or "non-performing" if they meet any of the default criteria of any subsidiary belonging to the BayernLB Group.

Changes in risk provisions

The following three tables show risk provisions under HGB and therefore cannot be compared with the presentation of risk provisioning under IFRS for the BayernLB Group.

Changes in risk provisions

EUR million	Opening balance as at 1 Jan 2012	Additions	Releases	Utilisations	Exchange rate-related and other changes	Closing balance as at 31 Dec 2012
Specific loan loss provisions	2,550	988	–446	–479	44	2,657
Provisions in the credit business	145	160	–152	–1	5	157
General loan loss provisions*	396	125	–176	–66	–18	261

** Includes GLLPs on positions on and off the balance sheet*

Loans in default and non-performing loans by sector

EUR million	Receivables		Closing balance			Net of additions/releases				
	Non-performing	In default	SLLP	GLLP	Provisions	SLLP	GLLP	Provisions	Direct writedowns	Recoveries on written down receivables
Banks/financial service providers	844	2	653	–	46	–14	–	–15	–13	–
Real estate	2,868	95	733	–	7	162	–	–2	–7	–
Sovereigns/public sector	43	1	2	–	0	0	–	0	0	–
Retail customers	767	565	392	–	7	160	–	2	–21	–
Utilities	139	3	33	–	1	7	–	0	–4	–
Renewable energy	117	20	52	–	2	37	–	0	0	–
Logistics	613	27	133	–	10	49	–	4	0	–
Automotive	64	9	44	–	2	7	–	–3	0	–
Aviation	53	0	20	–	0	8	–	0	0	–
Food & beverages	228	25	86	–	7	20	–	–8	–4	–
Other	1,145	118	509	–	75	106	–	30	–17	–
Total	**6,881**	**866**	**2,657**	**261**	**157**	**542**	**–51**	**8**	**–66**	**109**

Loans in default and non-performing loans by geographical region

EUR million	Receivables		Closing balance			Net of additions/releases				
	Non-performing	In default	SLLP	GLLP	Provisions	SLLP	GLLP	Provisions	Direct writedowns	Recoveries on written down receivables
Africa	0	0	0	–	0	0	–	0	0	–
Asia	28	0	5	–	0	–6	–	0	0	–
Caribbean	0	0	0	–	0	0	–	0	0	–
Latin America	4	0	4	–	0	0	–	0	0	–
Central and Eastern Europe/ CIS	1,542	740	914	–	23	248	–	8	–6	–
Middle East	61	11	64	–	0	6	–	0	0	–
North America	594	0	113	–	220	–3	–	7	–1	–
Western/Central Europe	4,562	115	1,526	–	–86	282	–	–7	–59	–
Other	90	0	31	–	0	15	–	0	0	–
Total	**6,881**	**866**	**2,657**	**261**	**157**	**542**	**–51**	**8**	**–66**	**109**

All default and non-performing loans are shown in their gross credit volumes as they appear in the risk report.

CRSA loan categories (Section 328 SolvV)

CRSA loan categories framework

Only external ratings from rating agencies Moody’s and Standard & Poor’s are used to assess creditworthiness in the standardised approach. Both have been specified for all CRSA loan categories.

The external ratings comprise ratings for issuers, issues and countries. As both rating agencies produce a high proportion of country assessments, no account is taken of the country classifications for export credit insurance agencies.

Issuers’ credit ratings are used for unrated loans that are not ranked as subordinate.

Total exposure under CRSA before and after credit risk mitigation techniques and by risk weighting

	Total exposure before credit risk mitigation	Total exposure after credit risk mitigation	
Risk weighting	**CRSA**	**CRSA**	**IRBA (investments)**
in %	EUR million	EUR million	EUR million
0	42,190	50,758	0
10	0	0	0
20	1,391	1,151	0
35	3,499	3,499	0
50	572	674	0
75	5,815	1,902	0
100	11,163	7,302	0
150	550	515	0
Other risk weighting	61	61	170

This table shows CRSA exposures before and after credit risk mitigation techniques pursuant to Section 328 SolvV (after credit conversion factors). Substitution effects result in the replacement of exposures with originally higher risk weightings by those with lower risk weightings; this is especially evident in risk weighting class 0. IRBA exposures rated by regulatory risk weightings (under Section 329 SolvV) are also shown.

Disclosure of loan categories where the IRB approach is used (Section 335 SolvV)

IRBA loan categories framework

The BayernLB Group uses a uniform master rating system for all rating procedures and all loan categories. This enables comparisons of rating classes across all customer segments. There are 22 rating classes for solvent borrowers and three classes for those in default. The boundaries of each rating class are set by specific upper and lower PD limits.

The allocation of a borrower with an IRBA exposure to BayernLB's rating systems is governed by the scope of application defined in the rating process. Criteria-compliant application is ensured by the respective authorisation system of the rating systems.

Total exposure under the IRB approach by probability of default

	PD category 0% to <= 0.5%		PD category 0.5% to <= 5%		PD category 5% to < 100%		Default PD = 100%		Total (excluding defaults)	
	Exposure EUR million	**Avg. risk weighting** in %	**Exposure** EUR million	**Avg. risk weighting** in %	**Exposure** EUR million	**Avg. risk weighting** in %	**Exposure** EUR million	**Avg. risk weighting** in %	**Exposure** EUR million	**Avg. risk weighting** in %
Central governments	50,407	2	17	135	1	200	0	–	50,425	2
Institutions	18,374	26	4,948	84	114	157	758	–	23,436	39
Corporates	60,315	35	27,765	92	2,809	186	3,537	–	90,889	57
Total	**129,096**	**20**	**32,730**	**91**	**2,924**	**185**	**4,295**	–	**164,750**	**37**

The reported exposure amounts are IRBA exposures pursuant to Section 99 SolvV (after credit risk mitigation techniques and after conversion factors) provided they can be allocated to PD categories. No risk weighting is calculated for exposures with a PD of 100 percent (default); Sections 104ff SolvV apply instead.

Total exposure under the IRB approach by default category (retail, only DKB)

	PD category 0% to <= 0.5%			PD category 0.5% to <= 5%			PD category 5% to < 100%			Default PD = 100%			Total		
	Exposure EUR million	**Avg. LGD** in %	**Avg. risk weighting** in %	**Exposure** EUR million	**Avg. LGD** in %	**Avg. risk weighting** in %	**Exposure** EUR million	**Avg. LGD** in %	**Avg. risk weighting** in %	**Exposure** EUR million	**Avg. LGD** in %	**Avg. risk weighting** in %	**Exposure** EUR million	**Avg. LGD** in %	**Avg. risk weighting** in %
Construction financing	7,157	34	13	2,899	35	46	734	35	193	620	40	24	11,410	34	34
Qualifying revolving retail receivables	1,707	59	2	378	59	34	34	59	126	8	59	8	2,126	59	10
Other retail loans	885	58	22	597	58	62	100	58	130	116	58	0	1,699	58	41
Total	**9,749**	**40**	**12**	**3,874**	**41**	**48**	**868**	**39**	**183**	**744**	**43**	**20**	**15,235**	**40**	**31**

Pursuant to Section 335 para. 2 no. 3 SolvV, only institutions applying the IRB approach for retail portfolios are required to publish the above table. As these procedures are applied in the BayernLB Group only by DKB, the amounts shown relate only to DKB.

Use of internal estimates for purposes other than calculating risk-weighted exposure under the IRB approach

Internal estimates of the probability of default (PD) and loss given default (LGD) rates are important parameters in risk management and credit decisions. In carrying out advance calculations (pricing), the minimum margin is calculated. This takes account of the credit ratings from the internal rating procedures and loss given default estimates, which are important input parameters in calculating risk and capital costs.

In addition to regulatory risk limitation, the Bank manages its risk-bearing capacity from an economic perspective. Assessments of economic risk-bearing capacity take account of, among other things, findings from the internal rating systems. Risk-bearing capacity is ensured by limiting available economic capital by risk type, business area and central area. The Credit Committee and Board of Management are informed about the economic risk-bearing capacity in a monthly report. A risk-bearing capacity report at Group level is also produced.

Ratings also play an important role in credit approvals and credit processing. For example, the Competence Regulations are based (partly) on ratings. Each loan is classified according to its level of risk. Different types of support are given: normal support, intensive support or problem loan treatment. Loans allocated to the intensive support and problem loan handling processes are subdivided into the “special mention” (only intensive support), “substandard”, “doubtful” and “loss” categories.

Management and recognition of credit risk mitigation techniques

See the section “Credit risk mitigation techniques: disclosure for CRSA and IRBA (Section 336 SolvV)”.

Rating system control mechanisms

The rating systems have technical control mechanisms that examine both the completeness and, where possible, the plausibility of individual data and their combination with other data. As a further control, ratings are approved in line with the dual control principle. With the exception of non-risk relevant business within the meaning of MaRisk, only the Risk Office may approve ratings.

The Group Risk Control Division, which forms part of the Risk Office, is independent from the business areas. The counterparty risk monitoring unit, which is assigned to this area, is responsible for introducing, developing, maintaining and optimising rating systems worldwide.

All rating procedures are subject to ongoing validation. The validation process meets SolvV requirements. This process draws on quantitative and qualitative analyses.

Expected and actual losses in the credit business

The table below is only relevant for the IRB approach. Actual losses consist of utilisations of SLLPs and direct writedowns less recoveries on written down receivables (HGB basis).

The expected loss (EL) calculation includes loans that are performing or in default based on a one-year default probability. Loans in default are considered to have a 100 percent probability of default (PD). Based on the definition of default under SolvV (e.g. “90 days in arrears”), customers are classed as “in default” very early on, before the institution has experienced any actual losses (“recovery”). In the event of realisation, actual losses are not immediately shown, as average settlement times for exposures/customers may take several years.

The risk provision process is also a multi-year process in which several effects need to be taken into account (cyclicality, SLLP utilisation vs. writeback etc.).

The items construction financing, qualifying revolving retail receivables and other retail loans relate only to DKB.

Expected losses in the credit business

EUR million	2012		2011		2010	
	Expected loss	Actual loss	Expected loss	Actual loss	Expected loss	Actual loss
Central governments	1	0	87	0	34	8
Institutions	370	43	361	139	432	25
Corporates	1,838	274	1,595	149	1,680	174
Construction financing	358	1	26	3	28	3
Qualifying revolving retail receivables	10	0	1	0	1	1
Other retail loans	103	9	14	2	15	1
Total	**2,680**	**327**	**2,084**	**293**	**2,190**	**212**

Actual losses in the credit business

EUR million	Loss in 2012	Loss in 2011	Change
Central governments	0	0	0
Institutions	43	139	–96
Corporates	274	149	125
Construction financing	1	3	–2
Qualifying revolving retail receivables	0	0	0
Other retail loans	9	2	7
Total	**327**	**293**	**34**

Losses in the “institutions” loan category went down more than 50 percent in financial year 2012. The increase in losses in the “corporates” loan category stems mostly from non-core business activities. The forecast probability of default rose slightly to just above the three-year average, owing in part to the increase in the number of IRBA positions in 2012 (following the approval of further IRBA rating procedures at DKB).

Credit risk mitigation techniques: disclosure for CRSA and IRBA (Section 336 SolvV)

Qualitative framework for credit risk mitigation techniques

Sound collateral is requested for the purpose of hedging credit risk exposure. BayernLB follows the principle that real collateral (particularly charges on property) is preferable to debt undertakings.

Procedures for accepting collateral (formalities and requirements) are governed by the internal processing guidelines for each type of collateral.

BayernLB also uses regulatory credit risk mitigation techniques. The German Federal Financial Supervisory Authority (BaFin) has granted BayernLB approval to lower its regulatory capital requirements through the use of real estate liens, ship mortgages, registered liens on aircraft, guarantees, financial collateral in the form of securities and cash deposits, and credit derivatives under its IRBA approval.

Credit derivative transactions are only carried out with counterparties with investment-grade ratings. Collateral agreements exist with certain business partners restricting the default risk associated with certain trading partners to an agreed maximum and authorising a call for additional collateral should this limit be exceeded. Most counterparties in the credit derivatives business are banks.

Specialists are responsible for ensuring these agreements are properly documented, administered and monitored on an ongoing basis. Monitoring is computer-aided.

The collateral policy sets out the requirements for valuing and administering collateral. To manage collateral, a collateral management system has been put in place where valuation criteria are documented. To ensure constant legal enforceability, contracts are usually standardised and changes in the law – particularly foreign legal systems – are monitored on an ongoing basis in cooperation with other institutions.

The procedure used to calculate and determine the value of the collateral must be documented clearly and meaningfully in line with defined requirements. If expert opinions are available, it must be ensured that information on marketability and liquidity used to assess liquidation value is available. Expected pro-rata shares from insolvencies and liquidations are recognised only if there is a high probability that they will actually be paid or if the liquidator or insolvency administrator has clearly shown in writing and in figures that there is an expectation of such shares being paid, indicating the anticipated date of payment.

As part of the reporting, the key types and structures of eligible collateral are analysed and assessed for concentrations. Concentration risks exist in relation to collateral for real estate and guarantees. Major guarantors (guarantees and eligible sureties) are reported on a quarterly basis. Most are loan collateral guarantees and first-demand guarantees. Guarantors mainly comprise export credit insurers, public-sector customers and financial institutions (particularly guarantee banks). In the guarantees category, the most important guarantor for BayernLB are public-sector institutions in Germany, which account for around 80 percent of the total.

Total collateralised exposures (excluding securitisations)

EUR million	Financial collateral under Sec. 154 sent. 1 no. 1		Other eligible IRBA collateral under Sec. 154 sent. 1 no. 3		Eligible guarantees under Sec. 154 sent. 1 no. 2	
	CRSA	**IRBA**	**CRSA**	**IRBA**	**CRSA**	**IRBA**
Central governments	0	1	0	–	22	773
Regional governments and local authorities	1	–	0	–	23	–
Other public authorities	12	–	0	–	271	–
Multilateral development banks	0	–	0	–	0	–
International organisations	0	–	0	–	0	–
Institutions	0	104	0	4,111	2	3,025
Covered bonds issued by banks	0	–	0	–	0	–
Corporates	526	862	0	22,783	3,375	6,593
Retail	13	5	0	10,445	3,893	7
Exposures secured by real estate	2	–	3,818	–	0	–
Investment units	0	–	0	–	0	–
Investments (shareholdings)	0	–	0	–	0	–
Other items	2	–	0	–	0	–
Past-due items	0	–	0	–	10	–
Total	**556**	**972**	**3,818**	**37,339**	**7,596**	**10,398**

The first part of the table provides a breakdown of financial collateral, the second part shows other collateral eligible under IRBA and the third part shows guarantees. The other collateral eligible under IRBA in the CRSA is calculated from the loan category “exposures secured by real estate”.

There is a guarantee agreement with the Free State of Bavaria for the Bank’s securitisation portfolio. As this is a structural component of the originator exposure, it is not included in the table. For further information, see the section on securitisations.

Derivative counterparty risk exposures and netting exposures (Section 326 SolvV)

Capital allocation/allocation of upper limits for loans to counterparties

Within the BayernLB Group, derivative instruments are mostly employed by BayernLB. Banks and public-sector customers are the main counterparties in the derivatives business.

BayernLB does not allocate capital separately or limit default risks for counterparties with derivatives exposures. Both are conducted as part of the general process of limiting counterparty risk. In addition, the regulatory and internal management methods for large credit risks also apply.

See the section “Internal Capital Adequacy Assessment Process (ICAAP)” for information on capital allocation for risk types.

Measures to mitigate risks

In derivatives trading, the usual practice is to conclude master agreements for the purposes of close-out netting. Collateral agreements have been made with certain business partners restricting default risk to an agreed maximum and authorising a call for additional collateral should this limit be exceeded. Actual collateral needs are regularly determined using mark-to-market valuations. Collateral calls are normally met by cash or government bonds.

Current economic risk is thereby reduced to a contractually agreed threshold or a minimum transfer amount that has not yet been reached. All collateral accepted is systematically documented.

BayernLB uses derivative instruments to reduce market risks, especially counterparty risk. Derivative instruments are integrated into the management systems for the market risks and counterparty risks described above.

Correlation between market risk and counterparty risk

Borrower risks are a subset of counterparty risk and are calculated separately from market risk. The same applies to counterparty risk from derivatives transactions.

In risk-bearing capacity reporting at Group level, aggregation by risk type currently takes no account of the impact of diversification through correlations and is therefore conservative.

Collateral increases in the event of rating downgrades

A small number of derivative OTC transactions have been concluded that contractually require collateral to be provided or increased in the event that one of BayernLB’s external ratings is downgraded. The amount of collateral to be provided in such an event would not affect BayernLB’s risk-bearing capacity.

Derivative counterparty risk exposures and netting exposures

Positive replacement values

EUR million	Positive replacement values before netting and collateral	Netting options	Eligible collateral	Positive replacement values after netting and collateral
Interest rate-related contracts	36,564	–	–	–
Currency-related contracts	2,903	–	–	–
Equity/index-related contracts	303	–	–	–
Credit derivatives	23	–	–	–
Commodity-related contracts	513	–	–	–
Other contracts	0	–	–	–
Total	**40,306**	**13,577**	**860**	**25,869**

Counterparty risk

	Maturity method	Fair value method	Standardised method	Internal model
Counterparty risk exposure	2	4,397	53	0

Credit derivatives (a)

	Nominal value of hedging	
Credit derivatives (protection buyer)	0	

Credit derivatives (b)

	Used for own credit portfolio		
Nominal value	**Purchased**	**Sold**	**As intermediary**
Credit default swaps	457	426	0
Total return swaps	500	0	0
Credit options	0	0	0
Other	0	0	0

The first section of the table shows positive replacement values (defined as the positive fair value of the derivative before add-on) pursuant to SolvV disclosure requirements. The reductions in positive replacement values shown were due to netting agreements.

The second section (counterparty risk) shows risk-weighted assets (RWA) for derivatives under the mark-to-market method/standardised method.

The third section shows credit derivatives (a): hedging transactions with credit derivatives are treated as sureties and are therefore classed in regulatory terms as off-balance sheet items in Solvency Ordinance reports.

Trading positions in credit derivatives are shown in the fourth section, credit derivatives (b).

BayernLB acts as both protection seller and protection buyer in respect of credit default swaps (CDSs). CDS positions are measured and monitored daily at individual transaction level. Profit and loss positions are calculated every day on the basis of this valuation.

Total return swaps (TRSs) are used by BayernLB for a number of business purposes, primarily to free up liquidity. TRSs are shown at the nominal value (not at exposure at default (EAD)) to the counterparty, with each underlying transaction being hedged.

Investments in the banking book (Section 332 SolvV)

Objectives of the investment portfolios

Investments at BayernLB level are divided into two portfolios: core investments and non-core investments. Core investments include equity investments that are conducive to BayernLB's business activities. Investments that are being considered for sale are allocated to non-core investments.

Core investments:
- The Group's strategic subsidiaries: investments that form an integral part of BayernLB's business model to expand; BayernLB has managerial control
- Investments that are in line with the business model; investments that are conducive to BayernLB's business activities
- Investments that support operating processes; investments undertaken to meet banking-related and/or non-banking related operating requirements
- Other investments: investments that are specifically conducive to neither BayernLB's business model nor to its operating processes, e.g. investments made on behalf of the public sector

Non-core investments:
- Investments which BayernLB plans to sell as a resizing measure or which it wishes to shed irrespective of its restructuring endeavours

The EU Commission has yet to publish a version of its detailed list of conditions that protects commercial confidentiality, i.e. one in which certain names are omitted. Section 26a para. 2 KWG (disclosure by banks) is therefore being applied in such a way that BayernLB's investments are not allocated by name to the objectives of the investment portfolio described under Section 332 SolvV. In the interest of confidentiality, and to prevent any possible damage to BayernLB through the disclosure of any of the investments that need to be sold under the EU Commission's list of conditions, the investments cited below are only examples from the portfolios.

Core investments:
- Deutsche Kreditbank AG is and will continue to be an integral part of the new BayernLB
- The subsidiary Real I.S. AG supports BayernLB's business activities as the funds service provider to the Bavarian S-Finanzgruppe
- Deutsche WertpapierService Bank AG (a transaction bank for securities processing) and Bayern-Facility Management GmbH support BayernLB's operational tasks

Non-core investments:
- BayernLB has already divested itself of such sizeable non-strategic investments as LB(Swiss) Privatbank AG and DekaBank. GBW AG, MKB Bank Zrt. and Banque LBLux S.A. are other investments being considered for sale

Measurement and accounting principles

BayernLB has a corporate valuation tool that fulfils all accounting requirements. Recognised valuation procedures are used to measure value:
- Market approach
- Income approach
- Cost approach

The income approach is normally applied when a company's value is not reflected by a stock market price. The cost approach is only applied in justified exceptional cases (e.g. companies in liquidation). The valuation is based on data supplied by the investee company. All factors used to value a company are documented in the valuation tool and disclosed to the auditor.

Under German commercial law (Section 340e para. 1 HGB), investments are valued according to the provisions applying to fixed assets (i.e. Section 253 para. 1 and 2 HGB) unless they are not intended for long-term use by the business. In this case, they are valued in accordance with the provisions applicable to current assets (i.e. Section 253 para. 1 and 3 HGB).

Investment instruments are valued in regulatory terms on the basis of the simple risk-weighted method as long as the investments do not fall under the grandfathering rule. Investment funds are calculated in part using the look-through approach.

Values of investment instruments

EUR million	Comparison		
	Carrying amount	**Fair value**	**Stock market value**
HGB investments • listed positions	802	1,248	1,248
HGB investments • unlisted	512	310	–
Non-HGB investments • listed positions (equities in the banking book)	9	9	9
Non-HGB investments • unlisted (investment units)	141	151	–
Non-HGB investments • other investment positions	1	1	–

The table includes all investment instruments in the BayernLB Group less consolidated Group investments. Fair value comprises the carrying amount and any unrealised gains or losses. Market capitalisation is calculated on the basis of the Xetra price as at 31 December 2012.

Realised and unrealised gains or losses on investment instruments

EUR million	Realised gains/ losses from sales/ restructurings	Unrealised gains/losses	
		Total	**Of which reported under supplementary capital**
Total	**62**	**255**	**0**

Market risks (Section 330 SolvV)

For information on market risks, see the section “Managing market risks” (Section 322 SolvV).

Interest rate risks in the banking book (Section 333 SolvV)

Positioning and management

Interest rate risks in the Group banking book mainly arise from refinancing activities as part of asset/liability management and from placing excess undated funds. Limiting and management are based on a VaR model based in turn on a historical time series. Interest rate risk is also limited as a percentage of liable equity by means of various stress tests simulating parallel shifts and pivots in the yield curve. The treasury units in the Group and the ALCOs are responsible for managing interest rate risk in the banking book; they take account of long-term strategic targets when placing undated funds and medium-term market expectations in their ongoing funding activities. In addition to VaR, which is used to set limits and serves as the basis for verifying risk-bearing capacity and capital requirements, sensitivity figures – especially price value per basis point – are also used for management purposes. Interest rate risk in the banking book is dominated by euro risks; those in US dollar are much smaller, and in other currencies almost negligible.

Assumptions

For calculation purposes, all rate-sensitive positions in the banking book are included in an interest rate gap analysis, either individually or on an aggregated basis. Undated deposits are mainly modelled using moving averages. Interest rate risks from termination rights are covered by special option pricing models. Undated capital is not taken into account, as specified in MaRisk. To this extent, there is no distinction between product modelling using VaR or stress simulation. The measure of risk used is the change in net present value.

Frequency of risk measurement

Interest rate risk is calculated at the BayernLB Group at least monthly independent of Trading; at BayernLB it is calculated daily. The most frequently used historical simulation takes a period of at least one year and calculates the change in net present value at a 99 percent confidence level for a one-day holding period. This calculation, adjusted for the time needed to close out interest positions, is used to calculate risk capital utilisation in terms of risk-bearing capacity.

Besides the daily (or in certain Group units monthly) VaR calculation, other stress tests such as parallel shifts and pivots in the yield curve are run monthly.

Interest rate shock scenario

For the interest rate risk in the banking book, an interest rate shock scenario of +200/–200 basis points is calculated at both Bank and Group level. As at the reporting date, the calculated change in net present value relative to liable capital at both BayernLB and the BayernLB Group was well below the 20 percent limit. If the net present value of a bank falls by more than 20 percent of capital under this interest rate shock scenario, the regulator assumes that interest rate risk is disproportionately high and is obliged to take countermeasures.

Interest rate risk in the banking book

EUR million	Change in net present value Interest-rate shock +200 basis points	Interest-rate shock −200 basis points
EUR	−312	−10
USD	−39	108
CHF	−4	36
GBP	11	27
JPY	11	1
Other	4	−21
Total	**−329**	**141**

Securitisations (Section 334 SolvV)

Objectives, type, scope and structure of the securitisation and resecuritisation exposures and the functions assumed by BayernLB

As at 31 December 2012 the BayernLB Group had securitisation exposures, acting as investor, sponsor or originator, of EUR 12 billion (2011: EUR 15.2 billion) in total. Of this amount, EUR 11.9 billion stemmed from BayernLB and EUR 0.1 billion from LBLux. BayernLB assigns securitisations to the banking book.

The portfolio of securitisation and resecuritisation exposures can be broken down into three segments:

Investor function:
- The amount in securitisations where the BayernLB Group acts as an investor is EUR 1.3 billion; this is being gradually reduced
- Most of these securitisation exposures have senior ranking with mainly residential or commercial real estate loans as underlying assets
- The securitisation exposure includes resecuritisation exposures of EUR 119 million. The lion's share of this, EUR 102 million, comprises a resecuritisation which is being gradually reduced under the terms of a repayment agreement and due to be fully paid off in 2013. The resecuritisation is senior in ranking. The securitisation exposures underlying the resecuritisation are asset-backed securities based mainly on residential and commercial real estate

Sponsor function:
- The amount in securitisations where the BayernLB Group acts as a sponsor is EUR 1.2 billion
- BayernLB sponsors this sub-portfolio via the ABCP programme Corelux S.A. In the asset-backed credit business, BayernLB structures receivables portfolios comprising receivables from core customers. The strategic goal of BayernLB here is to offer ABCP customer transactions to its core customers as funding

All of these securitisation exposures have senior ranking with predominantly trade receivables or accounts receivables as underlying assets
- There are also a few outstanding non-core customer transactions that are sponsored through the ABCP programme Giro Lion Funding Ltd. (set for closure) and due to be quickly wound down. These are mainly securitisations of receivables from real estate loans

Originator function:
- The amount in securitisations where the BayernLB Group acts as an originator is EUR 9.5 billion. BayernLB is striving to wind down this sub-portfolio systematically while keeping losses to a minimum and has therefore explicitly assigned it for winddown. As a result, it is to be reduced significantly and on a step-by-step basis. No new business is being acquired
- These securitisation exposures are hedged by the guarantee agreement with the Free State of Bavaria (see discussion on hedge transactions, below). The ABS portfolio is thus, from a supervisory perspective, basically a resecuritisation in which BayernLB holds the senior and junior tranches (with a first-loss piece of EUR 1.2 billion). It is a securitisation transaction with no transfer of receivables (i.e. a synthetic transaction; for details see the table “Total securitised originator receivables by portfolio and sponsor activity”, below)
- The assets underlying the hedged (primary) securitisation exposures are mainly prime and non-prime residential mortgage-backed securities, commercial mortgage-backed securities, corporate loans, ABSs, bonds, credit default swaps (collateralised debt obligations), receivables from consumers (ABS consumers) and business customers (ABS commercial)
- Detailed information is provided in the risk report of the 2012 consolidated financial statements of the BayernLB Group

Hedge transactions aimed at minimising risks

On 19 December 2008, a guarantee agreement was concluded between the Free State of Bavaria as the protection seller and BayernLB as the protection buyer.

The guarantee covers losses in the ABS portfolio above a first loss of EUR 1.2 billion. It covers a maximum amount of EUR 4.8 billion.

The ABS portfolio hedge covers insolvency, non-payment of capital and interest, capital write-downs and losses incurred from any sales before maturity. The risk umbrella for the ABS portfolio under the guarantee agreement with the Free State of Bavaria also makes a material contribution to significantly reducing BayernLB’s capital charge for the ABS portfolio and minimising the P&L implications from the ongoing measurement of the ABS portfolio.

The guarantee agreement with the Free State of Bavaria is the BayernLB Group’s main hedging instrument for minimising risks from the securitisation exposures. Detailed information is provided in the risk report of the 2012 consolidated financial statements of the BayernLB Group.

Processes for monitoring changes in counterparty and market risks in securitisation and resecuritisation exposures

In its ongoing assessment of the credit quality of a securitisation or resecuritisation, BayernLB focuses largely on the value and expected change in value of the underlying pool of securitised receivables and on the suitability of the collateralised structural elements available (credit enhancements). However, the impact of structural factors and the influence of the parties involved at individual transaction level are also factored in.

In addition, BayernLB applies certain procedures to ABSs, in particular cash-flow modelling, at regular intervals so as to identify and flag risks early on, classify impairments and estimate losses.

The cash-flow models are based on up-to-date investor reports and other credit-related information from such sources as market price indicators, rating agency publications or research houses. The model parameters and the models themselves are constantly checked for suitability and plausibility by BayernLB and its advisors by way of backtesting.

In the current market environment, BayernLB has relied primarily on indicative prices to value asset-backed securities. These are obtained from market data providers, counterparties, brokers and the portfolio advisors. For more details, please see the Notes in the consolidated financial statements of the BayernLB Group. Prices from different sources are adjusted for statistical outliers and the average then taken. If a security has a wide range of prices compared with similar securities, it is assessed separately and implausible prices are eliminated. After this quality assurance check, the price of the security for valuation purposes is calculated using an averaging procedure.

In addition to counterparty and market risks, securitisation exposures are subject to liquidity risks and operational risks. The Bank sponsors customer transactions by providing its conduits with overdraft and liquidity facilities which, when utilised, result in a cash outflow. These liquidity risks are fully integrated into the liquidity risk management. As with any type of transaction, securitisation activities can harbour operational risks that may arise from inadequate or failed internal processes, from people or systems, or from external events. Securitisation activities are also covered by operational risk management (see comments in this report under Section 322 SolvV).

Procedures for calculating risk-weighted exposures

BayernLB applies the IRBA securitisation rules for all its securitisation exposures. To this end, it makes use of the transition regulation under Section 339 para. 23 SolvV. The ratings-based approach (RBA) is applied when an external rating exists for the securitisation exposure. The rating agencies Moody’s and Standard & Poor’s are used for determining the capital requirements.

The internal assessment approach for securitisations (IAA) is applied in the case of customer receivables that are refinanced through ABCP programmes. IRBA suitability has been confirmed for the internal rating procedures for, among other things, the following types of receivables: trade receivables, residential mortgage-backed securities, retail auto loans, consumer finance, student loans and ground rent leases.

As at 31 December 2012, portfolios with receivables in the form of trade receivables, consumer finance and ground rent leases were measured using internal rating procedures.

These procedures are based on quantitative, mathematical-statistical models drawn from the methodologies used by the external rating agencies (Moody's, Standard & Poor's and Fitch), with these models already having played a key role in the transactions' structuring.

The quantitative models show mostly the counterparty risks in the receivables portfolio and the transaction-specific credit enhancements used for hedging. To ensure that the same assets are measured using the same methodology, a specific rating agency model has been defined for each asset class relevant for BayernLB. Any necessary modifications must be documented.

To measure and mitigate the risks, the stress factors used in the respective rating agency model are applied. The quantitative models produce rating scores that are then used in the IAA rating procedure.

Besides these rating scores and the rating scores of the main parties to the transactions – the originator, the most relevant third party, and the servicer – the IAA rating procedure also involves measuring quantitative risk factors which cannot be assessed in the quantitative models (e.g. commingling, dilution or transaction cost risks – here the rating agencies' stress factors and/or the Bank's own modelling components are used instead) and qualitative (i.e. non-quantifiable) risk factors. Qualitative risk covers origination risk, operational risk, servicing risk, and legal and regulatory risk.

If there are additional risk factors that the model does not take sufficient or any account of, the rating result can be adjusted if needed (overwritten).

In addition to determining the capital requirements, the output of the internal rating procedures is used for internal management and incorporated into all stages of the credit process as a basis for decision.

The internal rating procedures are evaluated for suitability each year by the independent counterparty risk monitoring unit, as part of the validation process. Among the tools used for the validation are backtesting, rating distribution analyses and central tendency in accordance with the internal validation strategy for IRB approach rating methods. The procedures are modified where needed to ensure validity.

The supervisory formula approach is utilised for exposures to which neither the ratings-based approach nor internal rating procedures are applied.

Accounting and valuation methods for securitisations

Securitised financial instruments purchased by BayernLB are treated in accordance with generally accepted accounting principles.

Accounting under HGB

Securities in the trading portfolio: these are measured at fair value less a risk discount. Measurement results and current income and expenses are shown under “net income or net expenses from the trading portfolio”.

Securities in the liquidity reserve: these are valued on the basis of the strict principle of lower of cost or market value, taking account of the obligatory writeup. Measurement results are reported under “writedowns and valuation adjustments on receivables and certain securities and allocations to provisions in the credit business” and “income from reversals of writedowns on receivables and certain securities and from writebacks of provisions in the credit business”.

Securities valued as investments (investment portfolio): these are valued on the basis of the less strict principle of lower of cost or market value. Measurement results are reported under “writedowns and valuation adjustments on investments, shares in affiliated companies and securities treated as fixed assets” and “income from reversals of writedowns on investments, shares in affiliated companies and securities treated as fixed assets”. Securities allocated to the investment portfolio are regularly tested for indications of permanent impairment.

The receivables portfolio of securities is mostly allocated to the investment portfolio.

Receivables are reported at nominal value or at cost. Potential liabilities arising from guarantees, warranties, and letters of credit are reported under contingent liabilities. Committed facilities (overdraft/liquidity facilities) used for helping finance securitised receivables are reported as irrevocable credit commitments under “other commitments”.

Credit risks are taken into account by establishing appropriate risk provisions. General loan loss provisions have also been established for credit risks harboured by off-balance sheet transactions.

Current income is reported under net interest income.

The methods, basic assumptions, and data and parameter principles used for measuring securitisation exposures are unchanged on the previous year.

Accounting under IFRS

Held-for-trading financial instruments and financial instruments designated at fair value (fair value option): the fair value measurement attribute is used. Measurement results are reported under “gains or losses on fair value measurement”. Current income and expenses from financial instruments held for trading are reported under “gains or losses on fair value measurement” and financial instruments designated at fair value are reported under “net interest income”.

Financial instruments classed as available for sale: the fair value measurement attribute is used. Any difference between fair value and amortised cost is shown as a separate item in equity (in the revaluation surplus) and not recognised through profit or loss until the asset is either disposed of or permanently impaired. Gains or losses on their sale or permanent impairment are reported under “gains or losses on investments” and current income under “net interest income”.

Loans and receivables: these include non-derivative financial assets with fixed or determinable payments which are not quoted on an active market, are not designated at fair value through profit or loss (fair value option), and are not allocated to the available-for-sale category. They are measured at amortised cost. Impaired loans are carried through the income statement and reported under "risk provisions in the credit business", and securities under "gains or losses on investments".

The receivables portfolio of securities is mostly allocated to the loans and receivables category.

Current income is reported under interest income.

Liabilities from guarantees and indemnity agreements in particular are reported under contingent liabilities. Commitments (placement and underwriting commitments, overdraft/liquidity facilities) used for helping finance securitised receivables are reported under "other commitments" as irrevocable credit commitments. Provisions in the credit business are made for both single transactions and portfolios to meet contingent liabilities and other commitments where there is a risk of default.

The methods, basic assumptions, and data and parameter principles used for measuring securitisation exposures are unchanged on the previous year.

Total retained or acquired securitisation exposures (by type of securitised receivable)

	Banking book		Trading book
EUR million	CRSA	IRBA	
On-balance sheet exposures			
• Receivables from residential mortgage loans	0	910	0
• Receivables from commercial mortgage loans	0	321	0
• Receivables from corporate loans	0	434	0
• Receivables from other retail loans	0	297	0
• Other on-balance sheet items	0	2	0
• Securitisations	0	9,585	0
guarantee agreement with the Free State of Bavaria	0	4,800	0
Total on-balance sheet exposures	**0**	**11,549**	**0**
Off-balance sheet exposures			
• Liquidity facilities	0	310	0
• Derivatives	0	161	0
Total off-balance sheet exposures	**0**	**471**	**0**
Total	**0**	**12,020**	**0**

The fall in the value of securitisation exposures by EUR 3,173 million on the previous year was largely due to the repayments of the Bank's ABS portfolio hedging by the Free State of Bavaria.

As at the reporting date there was no concrete intention to securitise assets.

BayernLB has no net securitisation exposures in the trading book. To provide a better overview, the table gives a breakdown of trading book and banking book exposures.

Total retained or acquired securitisation exposures by securitisation risk weighting (before scaling factors)

	Banking book			
	Securitisations		Resecuritisations	
EUR million	Exposure	Capital requirements	Exposure	Capital requirements
Ratings-based approach				
> 0% ≤ **10%**	6	0	0	0
> 10% ≤ **20%**	994	10	0	0
> 20% ≤ **50%**	107	3	0	0
> 50% ≤ **100%**	0	0	0	0
> 100% ≤ **650%**	0	0	0	0
1250%/capital deduction	0	0	0	0
Supervisory formula approach				
> 0% ≤ **10%**	45	0	0	0
> 10% ≤ **20%**	18	0	0	0
> 20% ≤ **50%**	9	0	102	2
> 50% ≤ **100%**	0	0	3,953	254
> 100% ≤ **650%**	0	0	17	6
1250%/capital deduction	0	0	713	363
Guarantee agreement with the Free State of Bavaria	0	0	4,800	0
Internal rating procedure				
> 0% ≤ **10%**	359	3	0	0
> 10% ≤ **20%**	276	3	0	0
> 20% ≤ **50%**	253	8	0	0
> 50% ≤ **100%**	0	0	0	0
> 100% ≤ **650%**	229	49	0	0
1250%/capital deduction	139	111	0	0
Total	**2,435**	**187**	**9,585**	**625**

Capital requirements for originator exposures fell by EUR 423 million on the previous year, but capital requirements for investor and sponsor exposures were virtually unchanged.

For a breakdown of securitisation exposures by external rating class, see the IFRS risk report.

In the supervisory formula approach, the item “1250%/capital deduction” includes the outstanding first-loss piece (EUR 350 million) under the guarantee from the Free State of Bavaria. This first-loss piece has already been fully recognised as an expense in the financial statements of 2007 and 2008.

The item “1250%/capital deduction” in the internal rating procedure includes a reported SLLP of EUR 28 million.

Without the guarantee agreement, the tranche of the originator exposure guaranteed by the Free State of Bavaria would have had a risk weighting of 1,250 percent. To a lesser extent (exposure value EUR 21 million), hedges by monoliners (external rating of AA-) in the ABS portfolio ringfenced by the Free State of Bavaria are taken into account in the KIRB calculation.

Total securitised originator receivables by portfolio and sponsor activity (by type of securitised receivable)

	Banking book		
	Originator exposures		Sponsor exposures
EUR million	Classic securitisations	Synthetic securitisations	
On-balance sheet exposures			
• Receivables from residential mortgage loans	0	0	0
• Receivables from commercial mortgage loans	0	0	205
• Receivables from corporate loans	0	0	392
• Receivables from other retail loans	0	0	264
• Other on-balance sheet items	0	0	0
• Securitisations (hedging transaction with the Free State of Bavaria)	0	9,466	0
– of which RMBS non-prime	0	5,079	0
– of which RMBS prime	0	2,222	0
– of which CDO	0	1,021	0
– of which CMBS	0	884	0
– of which ABS consumer	0	131	0
– of which ABS commercial	0	129	0
Total on-balance sheet exposures	**0**	**9,466**	**861**

The BayernLB Group has no securitised exposures to which the special rules under Section 262 SolvV apply.

By 31 December 2012, losses on defaults and sales of ABSs in the ABS portfolio ringfenced by the guarantee from the Free State of Bavaria amounted to EUR 850 million, which was covered in full by the first-loss piece of BayernLB.

Losses on defaults and sales of ABSs (by asset class)

Asset class (EUR million)	Losses (including interest)	Outstanding notional of positions where losses have been realised
CDO	351	116
CMBS	3	0
RMBS – non-prime	440	615
RMBS – prime	56	564
Total	**850**	**1,295**

Operational risks (Section 331 SolvV)

For information on operational risks, see the section "Managing operational risks" (Section 322 SolvV).

List of tables

The layout of the tables is largely based on the examples used by the Bundesbank's Disclosure Expert Panel of November 2006.

List of abbreviations

ABCP	asset-backed commercial paper
ABS	asset-backed securities
ALCO	Asset Liability Management Committee
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (German Federal Financial Supervisory Authority)
BCM	Business Continuity Management
CDO	credit debt obligation
CDS	credit default swap
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CHF	Swiss franc
COO	Chief Operating Officer
CIS	Commonwealth of Independent States
CMBS	commercial mortgage-backed securities
CRO	Chief Risk Officer
CRSA	Credit Risk Standardised Approach
DakOR	OpRisk data consortium
EAD	exposure at default
EL	expected loss
EUR	euro
GBP	British pound sterling
GLLP	general loan loss provision
GmbHG	Gesetz betreffend die Gesellschaften mit beschränkter Haftung (German Limited Liability Companies Act)
HGB	Handelsgesetzbuch (German Commercial Code)
IAA	internal assessment approach
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IRBA	Internal Ratings-Based approach

JPY	Japanese yen
KStG	Körperschaftssteuergesetz (German Corporation Tax Act)
KWG	Kreditwesengesetz (German Banking Act)
LGD	loss given default
MaRisk	Mindestanforderungen an das Risikomanagement (Minimum Requirements for Risk Management)
ÖffSchOR	loss database run by the Association of German Public Banks
OpRisk	operational risk
OTC	over-the-counter
PD	probability of default
RBA	ratings-based approach
RMBS	residential mortgage-backed securities
RWA	risk-weighted assets
S&P	Standard & Poor's
SLLP	single loan loss provision
SolvV	Solvabilitätsverordnung (Solvency Ordinance)
SPV	special-purpose vehicle
STA	standardised approach
TRS	total return swap
USD	US dollar
VaR	value at risk
VÖB	Bundesverband Öffentlicher Banken Deutschlands (Association of German Public Banks)

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