

# ANNUAL REPORT 2007

DEXIA  
KOMMUNALBANK  
DEUTSCHLAND AG



*short term has no future*

**DEXIA**



# Annual Report 2007



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# Profile of Dexia Group

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Dexia is a European bank and the world leader in local public finance. Dexia is one of the top fifteen banking groups in the euro zone with a stock market capitalization of EUR 20.3 billion and more than 35,000 employees in 37 countries as of December 31, 2007.

## • A unique model in the banking sector

### Two pillars

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Dexia's future is built on two pillars: its Universal Banking business in Europe and its world leadership in Public/Project Finance.

Dexia intends to expand its Universal Banking business beyond its traditional markets of Belgium, Luxembourg, Slovakia, and Turkey to become a top-level European player while building upon its global leadership in Public/Project Finance through geographic expansion.

Dexia is confident that it can deliver exceptional operational and financial results, including a dividend per share increase of at least 10% per annum

– one of the Group's objectives announced in September 2006.

### Financial stability

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Dexia has vigorous yet prudent growth plans, which adhere to its core values for managing risk and maintaining financial stability. The Group maintains the highest standards for underwriting, risk management, operational discipline and product performance.

Dexia has one of the highest credit ratings in the banking industry. The Group's principal banking entities – Dexia Crédit Local, Dexia Bank and Dexia BIL – are all rated AA/Aaa/AA+; three of Dexia's European subsidiaries issue Triple-A rated secured bonds; and FSA, one of the world's three largest bond insurers, is a Triple-A rated company (recently affirmed).

### Long-term commitment to Group values

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Dexia has made a long-term commitment to the needs and well-being of its customers, the harmonious development of society, protection of the environment and sustainable growth. Dexia expresses

its unique corporate culture through its motto – short term has no future – which describes our approach to the conception and the management of our business lines.

Dexia's actions and goals are driven by:

- **Ambition** to constantly improve operational and financial performance while adhering to our social and environmental values.
- **Respect** for all, including customers, shareholders, employees, suppliers, and other stakeholders in our businesses.
- **Passion** for innovation that allows us to meet our goals while contributing to society.

## • Dexia's business lines

### Public/Project Finance and Credit Enhancement

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Over the last decade, Dexia has become the world leader in Public/Project Finance. Dexia operates in more than 30 countries including France, Belgium, Italy, North America, Mexico, Germany, Spain, the UK, Scandinavia, Switzerland, Austria, Slovakia, Poland, Romania,

the Czech Republic, Australia, Israel, Bulgaria, Hungary and Japan.

Dexia meets the financing needs of local public authorities and other public services through direct loans, signed commitments, liquidity guarantees and the purchase of their securities. Dexia offers its customers a full range of products that include structured loans and debt management.

Dexia deploys its know-how to project finance across the globe while adhering to highly selective policies in line with the Group's risk-management standards. Dexia focuses on transportation, environmental and other essential infrastructure as well as the renewable energy sector. The Group finances corporate borrowers in countries where it is active in Universal Banking, such as Belgium, Luxembourg, Turkey and Slovakia.

Through its U.S. subsidiary Financial Security Assurance (FSA), Dexia provides credit enhancement for municipal bonds, infrastructure projects and asset-backed securities. Today FSA occupies a dominant position in the U.S. municipal bond insurance market.

#### **Personal Financial Services**

Dexia is a leading European retail bank offering a wide range of banking and insurance services to more than six million customers – from individuals

to small and medium-sized companies – in Belgium, Luxembourg, Slovakia and Turkey.

Dexia is one of the top retail banks in Belgium and Luxembourg and has a local bank in Slovakia. Dexia's DenizBank is the sixth-largest privately owned bank in Turkey. Dexia Insurance Services supplies all the life and non-life insurance products sold in the retail networks of the Group in Belgium and Luxembourg, as well as in France. Dexia is also a major private banking services provider through various entities, including joint ventures, principally in Belgium, Luxembourg, France, Spain, Switzerland and Denmark.

#### **Treasury and Financial Markets**

Dexia's principal businesses give the Group a strong presence in the capital markets, where it funds and manages the Group's balance sheet and structures sophisticated products and solutions for clients of the various business lines. The Treasury and Financial Markets business segment generates substantial earnings in addition to providing support to the entire Group.

#### **Asset Management**

Dexia Asset Management is a top-tier

asset manager in Europe with a complete range of investment vehicles from traditional and alternative funds to socially responsible investments, an area in which Dexia is a leader in Western Europe. Dexia specializes in the management of mutual funds and institutional and private mandates. Dexia Asset Management operates through offices in Brussels, Luxembourg, Paris and Sydney, and via locally organized client relationship teams throughout Europe, the Middle East and Australia.

#### **Investor Services**

RBC Dexia Investor Services was created in 2006 as a joint venture with Royal Bank of Canada to offer its expertise in global custody, fund and pension administration and shareholder services to institutions around the world. The company ranks among the world's top 10 global custodians and does business in fifteen countries on four continents.

#### **Dexia's key figures at December 31, 2007**

Balance-sheet total	EUR 604.6 billion
Net income – Group share	EUR 2,533 million
Earnings per share	EUR 2.18
Tier 1 ratio	9.1%
Return on equity	17.8%
Cost-income ratio	55.6%

# Executive bodies of the bank

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## Supervisory Board

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François Duroillet  
*Deputy Executive Vice President Public Finance*  
*Head of Public Finance Network & FSA Department*  
Dexia SA  
*Chairman*

Claude Schon  
*Head of Group Treasury*  
*Member of the Treasury & Financial Markets Executive Committee*  
Dexia SA  
*Deputy Chairman*

Jean Le Naour  
*Member of the Management Board of Dexia Crédit Local*  
*Head of Finance, Operations and IT Department*  
Dexia Crédit Local

Xavier Rojo  
*Senior Vice President*  
*Innovation & Financial Engineering – Public Finance Department*  
Dexia SA

Karen Birgit Reinecke (until March 29, 2007)  
*Bank employee*

Stephan Schlege (until March 29, 2007)  
*Bank employee*

Hans Handschuh (since March 29, 2007)  
*Bank employee*

Sascha Riegenring (since March 29, 2007)  
*Bank employee*

## Management Board

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Giselbert Behr  
*Chairman*

Patrick Giacobbi

Wilfried Wouters

## Executive Vice Presidents

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Dr. Wolfgang Eickhoff  
*(since November 19, 2007)*

Frank P. Hahn  
*(since July 30, 2007)*

Ullrich Hetmank

## Trustees

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Josef Baiz

Dr. Bernhard Krewerth

# Report of the Supervisory Board

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The Supervisory Board fulfilled its duties according to statutory law and the articles of incorporation and monitored the Management Board of the bank on an ongoing basis. It obtained regular information from the Management Board on envisaged business policy, fundamental management questions, the position of the bank and business incidences of significance, and discussed these with the Management Board. Business transactions requiring the approval of the Supervisory Board were reviewed and discussed with the Management Board. There were frequent discussions as well as five meetings with wide-ranging reports presented in both verbal and written form.

The annual financial statements and the Status Report for the 2007 financial year were audited, on the basis of the bookkeeping system, by PricewaterhouseCoopers AG Wirtschaftsprüfungsgesellschaft, Berlin, and Mazars GmbH Wirtschaftsprüfungsgesellschaft, Frankfurt am Main. They had been appointed by the General Meeting of Shareholders to act as auditors. They stated in their unqualified audit certificate that the bookkeeping records and the annual financial statements give a true and fair view of the net assets, financial position and results of operations and that the Status Report is consistent with the annual financial statements. The Supervisory Board approved the result of the audit.

Based on the result of its final examination of the annual financial statements, the Status Report and the pro-

posal for the use of the net income, the Supervisory Board concluded that there were no objections to be raised. The Status Report and the annual financial statements as at December 31, 2007 submitted by the Management Board were approved by the Supervisory Board. Hence the annual financial statements have been established. The Supervisory Board approves the proposal of the Management Board for use of the net income.

The Management Board has submitted the report on relations to affiliated companies to the Supervisory Board pursuant to Section 312 of the German Stock Corporation Act (Aktengesetz). This report was audited by PricewaterhouseCoopers AG Wirtschaftsprüfungsgesellschaft, Berlin, and Mazars GmbH Wirtschaftsprüfungsgesellschaft, Frankfurt am Main and provided with the following auditor's certificate: "Following our due diligence and assessment, we confirm (1) that the facts contained in the report are correct, (2) that the charges of the company for the legal transactions shown in the report were not disproportionately high." The Supervisory Board approved the report of the Management Board and the result of the audit without any reservations.

DKD managed to further consolidate its position in the highly competitive market of financing local authorities, thereby further enhancing the market presence of Dexia Group in Germany.

Based on the expansion of the classic types of customers in the area of Public

Finance that took place in 2006 to include municipal utilities (KNU) operating under private law and providing public services as well as forfeiting of receivables from public-sector entities and project financing, the build-up of a project/structured financing team has been started in 2007. This team carried out its first transactions, including transactions as mandated lead arranger, in 2007.

Irrespective of the difficult market environment following the sub-prime crisis, DKD continued in 2007 to essentially refinance itself on a long-term basis via public Pfandbriefe.

DKD has at no time been either directly or indirectly committed in the sub-prime market through special purpose vehicles or structured investment vehicles.

The Supervisory Board would like to express its gratitude and appreciation to all members of staff and the Management Board for their good work in 2007.

Paris, March 2008  
Supervisory Board

François Duroillet  
*Chairman of the Supervisory Board*

# Report of the Management Board

## Status Report

### • General economic conditions in 2007–2008

The principal factor shaping general economic conditions in 2007 was the development in the US sub-prime segment, i.e. the segment that grants loans to borrowers in the American real estate market with a low credit rating. Looking back, 2007 can be divided into two parts: the first phase, in which the sub-prime crisis was seen as being no more than a problem specific to the American real estate market, and the second phase, in which the credit and liquidity crisis resulted in a revaluation of a large part of the financial assets of financial institutions operating in this market.

The ensuing flight of investors into low-risk and high-quality investments such as fixed interest federal bonds brought to an end the cycle of continuous increase in interest rates that had begun in 2006 and had been driven by the anticipated growth in the global economy.

The extent of the commitment in the sub-prime market and the consequences only became manifest when even banks themselves were no longer prepared to prolong lines of liquidity or extend new ones, and investors no longer provided short-term refinancing for structured products that were primarily third-party financed and asset backed (such as asset backed commercial paper (ABCP)). The additional problem of the market valuation of these products and the increase in balance sheet total when the off-balance sheet assets had to be disclosed and included in the annual financial statements, aggravated the situation of

(interbank) shortage of liquidity.

The European Central Bank (ECB) injected substantial liquidity into the money supply to prevent a further increase in money market rates and to ensure that banks could refinance themselves at the turn of the year (the 3-month Euribor was at a level of 4.95% on December 12, 2007 compared with 3.73% at the beginning of 2007). This policy was in contrast to the goals set at the beginning of the year, namely to reduce surplus liquidity by way of a more restrictive monetary policy. Surplus liquidity that had arisen from a low level of interest rates was the cause of the credit spread level at the beginning of 2007, leading investors in search of higher interest rates to pay insufficient attention to the underlying credit risks.

As a consequence of this credit and confidence crisis, the markets for securitized claims such as collateralized debt obligations (CDOs) or asset backed commercial papers (ABCPs) will probably remain illiquid in the near future and continue to be affected by a growing reluctance to take risks. Furthermore, regulators are expected to take radical steps in particular with a view to increasing the regulations on transparency and disclosure with regard to off-balance sheet liabilities.

### Development in the economic regions

The credit and liquidity crisis which has hit the banking sector has not (yet) had very detrimental effects on the global economy in 2007. The growth in the global economy (GDP) excepted for 2007

of 5.4% was approximately the same as the 5.5% for the previous year.

The US economy created 1.4 million new jobs in the past year; The US gross domestic product rose by 0.6% in the first quarter and by 4.9% in the third quarter. Capacity utilization remained constant at over 80%; industrial production was also at a high level.

These solid economic figures and high business profits gave rise to a positive development in prices on the US stock exchange. In the middle of the crisis the DOW JONES stood at 14,164.53 points on October 09, 2007 – a level that was higher than in 2000/2001. However, there was cause for concern about the situation in the US real estate market and its effects on consumer confidence. Borrowers on this market, whose loans as a rule were secured by the mortgaged property, found themselves in difficulties due to rising interest rates and falling real estate prices. The American consumer confidence index fell from 110.20 in January 2007 to 88.60 in December 2007. This in turn had negative effects on retail sales, with the automobile industry being particularly weak.

As far back as to the beginning of 2007, the Federal Reserve Bank (FED) had anticipated that a pause in the interest increase cycle would lead to a cooling off of the economy.

Forecasts of a decrease in economic growth in the euro zone – compared to the growth rate achieved in 2006 (2.9%) – were continuously revised upwards in the first half of the year. This trend was also reflected by the ZEW Index (senti-

ment index for the euro zone, Center for European Economic Research), which rose from -1.8 in January 2007 to +22.3 in May 2007. However, the first effects of the sub-prime crisis also began to influence eurozone consumer behavior significantly; the ZEW Index fell in December 2007 to -35.7. Real gross domestic product (GDP) in the year as a whole increased in the euro zone by 2.7%.

Apart from the falling growth in retail sales (drop of +2.7% in March to +0.2% in October), economic development was also shaped by the increase in the rate of exchange of the euro to the US dollar (US\$ 1.49 /EUR on November 26, 2007) and the negative effects the strong euro has on exports.

In addition, the German retail trade had no real opportunity to recover from the increase in VAT at the beginning of 2007; and retail sales fell in comparison to the previous year (-0.6%).

In contrast, the economic development of the emerging countries was remarkably robust despite the sub-prime crisis. Real gross domestic product rose from 7.9% in 2006 to 8.2% in 2007. When looking at the emerging countries excluding China, which saw a growth of 11.5% in 2007 following 10.5% in the previous year, average growth was still 6.7%.

### **ECB monetary policy** \_\_\_\_\_

At the beginning of the year the ECB indicated that, given the continuing economic growth that was anticipated, it would further increase interest rates to decrease the difference between the refi rate and FED funds. The ECB increased interest by 25 basis points in both the first and the second quarter of 2007 (14 March and 13 June), hence raising the refi rate from 3.5% to 4%.

In particular the liquidity crisis that arose out of the sub-prime crisis made the task of the ECB increasingly more difficult as the year progressed.

- While the FED lowered the base rate by 100 points, the ECB forwent an adjustment of the interest rate and instead made liquidity available by way of tender operations – also for terms beyond the end of the year.
- The ECB put off making further increases in interest rates until a clearer picture of the (global) economy emerged. However, given the smoldering fear of recession in the USA, interest rate reductions have already been anticipated by the markets as in the era of globalization it is not possible to de-couple the two economic areas (Europe/USA).
- The difference between the broad European CPI (Consumer Price Index) and core data of the HICP (Harmonized Index of Consumer Price) - in November 3.1% compared with 1.9% - increased continuously essentially due to rising energy and food prices. The markets are now asking themselves whether the ECB should keep to the principle of achieving the 2% price stability ceiling before it takes concrete action.
- Despite the temporary drying out of (interbank) liquidity in the course of the crisis, the M3 money supply rose in 2007 from 10.1% to 12.3%. The ECB is making efforts to prevent a further bubble.

The reactions of the central banks to the crisis were not uniform. While the FED focused on overnight money (lowering the discount rate and extending the types of assets eligible for repo), the Bank of England (BOE) chose to rely on the self-regulating force of the market and did not intervene. In contrast, the ECB made extensive liquidity available by means of low-price tenders for up

to three months in order to prevent a further rise in money market rates and to ensure a smooth transition from 2007 to 2008, in particular with the additional one month tender in December at a fixed interest rate (4.21%).

### **Development of the capital markets** \_\_\_\_\_

The euro swap curve has only risen by one half of a percent as per December 31, 2007 compared with its level at the end of 2006. The growing preference of investors for buying bonds with a low risk profile and the continuing uncertainty about the effects of the sub-prime crisis on the economy prevented any further increase. The euro swap curve has steepened only slightly by the end of 2007 in comparison with December 31, 2006. The two-year swap rate rose in 2007 by 43 basis points (BP), the 1-year swap rose by 52 BP. At 15 BP the 2-10-year interest curve remained very flat at the end of the year. The development of the US Treasury curve was in contrast to this: in 2007 it rose from -14 BP on 22 January, to +122 BP at the end of the year. This development also reflected the differing assessments of the effects of the sub-prime crisis in Europe and the USA.

The substantial changes in interest rates in Europe were reflected on the money market:

- the 3-month Euribor rose from 3.73 to over 4.95%
- the Eonia-Euribor spread increased from 5 BP to up to 95 BP
- the spread between 3-month and 6-month Euribor was inverse (-8 BP on December 06, 2007)

A clear sign that the development described above was due to fears about liquidity and refinancing in connection with the end of the year, was given by the

development of the 1-month Euribor. The 1-month Euribor was 4.17% on November 28, 2007; however when the term extended beyond the end of the year it rose to 4.81% on November 29 and reached its highest point on December 12 with 4.95%. The 1-month Euribor had fallen back to a level of 4.23% again on January 02, 2008.

By the end of 2007, the central banks had not succeeded in completely neutralizing the extremely low level of interest of the last few years, which had essentially been the driving force behind the boom in purchasing real estate using borrowed funds in the last few years, as fears of recession and stagflation accompanied the crisis.

#### **Covered bonds in 2007**

For a long time the assumption in the market for covered bonds was that of (risk) homogeneity of the products issued resulting in a corresponding leveling of the prices. However, this absence of differentiation came to an abrupt end in the middle of 2007.

The sub-prime crisis and the following scarcity of liquidity meant that investors returned to substantially more selective behavior with regard to covered bonds. Three criteria influenced investment decisions:

- the stability of local legal framework conditions underlying the covered bonds
- the quality of the cover pools, underlying the covered bonds issued
- the rating of the issuer.

This had negative effects on markets with structured covered bonds (USA) or weaker legal frameworks (UK) and led to an extreme widening of the spread. Markets with a large proportion of

mortgage loans with variable interest rates, Spain for example, saw themselves facing dwindling confidence and increasing spreads.

Although some (new) countries are working on legislation on covered bonds or on amending and tightening up existing legal frameworks, the volume of covered bonds issued worldwide fell in 2007 from a total of EUR 180 billion in 2006 to EUR 163 billion in 2007 in comparison with an expected volume of EUR 200 billion.

#### **The Pfandbrief market in 2007**

The Pfandbrief did particularly well in this difficult market environment and spreads only widened insignificantly, underpinning the status of the Pfandbrief as a premium product among the covered bonds. The high level of confidence on the part of Pfandbrief investors can be explained by a number of factors. Apart from an impeccable track record (no Pfandbrief has failed in over 100 years) it stands out due to the high quality standards set by German Pfandbrief legislation (PfandBVG), which makes investor protection a priority and the accompanying high quality of the covering pool. This is one of the reasons why the Pfandbrief is firmly established and has a long tradition with customers such as insurance companies, banks, pension and investment funds in the German market.

Against the background of the rating of the Pfandbrief recognized both at home and abroad, issuers have, in comparison with other covered bond products, been able to obtain liquidity at attractive rates in difficult times as well. The Pfandbrief Act provides investors in the Pfandbrief with a closely tied safety net. Only credit institutions that meet the stringent requirements for a Pfandbrief licen-

se may issue Pfandbriefe. Outstanding public Pfandbriefe must be covered by public receivables for at least the same amount. The receivables, known as cover assets, are listed in a separate register. In the case of insolvency of an issuer the claims of the Pfandbrief holders on the cover assets entered in the registers are preferential. The Pfandbrief is also subject to special supervision by the German Federal Financial Services Supervisory Authority (BaFin). The obligation to publish the main ratios of the cover pool assets quarterly makes its composition transparent and comparable over time. In the case of the public Pfandbrief stringent selection criteria ensure that the cover assets sustain their value. Claims against public sector debtors from the European Union, the EEA states, the USA, Canada, Japan and Switzerland can only be used as coverage provided that state liability is beyond any doubt.

Despite the by far the most stringent legal framework and the associated high quality of the Pfandbrief, the Pfandbrief market was at times negatively affected by uncertainty caused by the sub-prime exposure of some issuers and/or their exposures in SPVs and SIVs.

As a result the market for private-sector placements became increasingly difficult in the second half of the year and market making of the jumbo Pfandbrief market was suspended twice for a certain period or was available only for smaller minimum trading lots and with a substantially higher bid-offer spread.

The Pfandbrief banks raised EUR 50 billion on the market in the form of traditional bearer and registered Pfandbriefe between August and December 2007 alone – i.e. after the sub-prime crisis had started. Together with jumbo issues (issues with a volume in excess of EUR 1 billion) and increases in volume, the total was EUR 58 billion. It is striking

that the refinancing costs during this period were hardly any higher than in the first seven months of the year.

However, the total volume issued on the German jumbo Pfandbrief market in 2007 was only EUR 35.2 billion; maturities amounted to EUR 60 billion. This overall decreasing trend is expected to continue in 2008 as private placements remain more cost-effective than issues of jumbo Pfandbriefe; and the direct refinancing requirement (e.g. of new mortgage loans) will probably decline further.

#### **Executive bodies**

##### **Tasks and responsibilities**

The tasks and responsibilities of the Supervisory Board, consisting of four representatives of the Dexia Group and two representatives of DKD's employees as well as the tasks and responsibilities of the Management Board, are described and documented in full within the organizational rules and regulations (Articles of Incorporation, schedule of responsibilities of the Management Board, rules of procedure of the Supervisory Board and rules of procedure of the Management Board, organization instructions for the individual business segments). There is no overlapping of responsibilities.

##### **Management Board**

The Management Board of DKD develops the strategy of the bank and is responsible for organization of busi-

ness operations as well as due and proper steering and monitoring of risks. The framework required for this is set by targets, strategies and standards as well as by the authorization of limit structures and limits. The Management Board reports regularly and fully to the Supervisory Board to enable it to assess and monitor the bank.

##### **Supervisory Board**

The Supervisory Board meets quarterly and analyzes the strategy and development of the bank. The Audit Committee, the Human Resources Committee and the Credit Committee have specific areas of responsibility.

##### **▪ New lending and funding**

##### **Market position strengthened**

The commitments of classic municipal loans including short-term lending granted in the 2007 financial year was EUR 9,450.3 million (2006: EUR 7,226.6 million). Bonds to serve as cover for public Pfandbriefe were acquired for EUR 830.5 million (2006: 3,056.4 million).

After disbursements of EUR 10,366.9 million (2006: EUR 10,131.9 million) and divestures of EUR 6,564.6 million (2006: EUR 6,921.5 million), the volume suitable for the cover pool of public Pfandbriefe, excluding accrued interest,

increased by 10.2% to EUR 41,057.6 million (2006: EUR 37,255.3 million.)

Our branch office in Frankfurt am Main, which has its focus on granting and structuring municipal loans to towns, administrative districts, local authorities and local authority associations in Germany, committed itself to loans of EUR 8.3 billion in the year under review (2006: EUR 6.1 billion), thereby making a decisive contribution to strengthening our position in the highly competitive market of original financing of loans to local authorities and further enhancing the market presence of the Dexia Group in Germany. On the one hand, the volume of classic fixed-interest loans and short-term lending to administrative districts, municipalities and towns was increased; on the other hand the increasing demand for structured loans was also met.

When structuring its loan and securities portfolios the bank used the rating criteria it had obtained from internal and external analyses. Hence, in comparison with 2006 new business – including short-term lending – with the German Federal States (Laender), towns and municipalities was clearly stepped up in 2007. All in all, the gross volume of new municipal lending business (municipal loans including bonds to serve as cover for public Pfandbriefe) is divided up into the individual borrower categories as follows:

*Development of new lending in million euros*

	2006	2007
Federal German Government *	0	0
German Federal States (Laender)	2,097.7	2,196.0
Towns and municipalities	5,253.2	7,412.5
Banks	906.0	115.0
Other	607.5	319.2
Foreign borrowers	1,364.6	238.1
<b>Total</b>	<b>10,229.0</b>	<b>10,280.8</b>

\* including the Federal Government's special funds

In addition to the municipal lending business, loans amounting to EUR 476.1 million have been granted in the year under review in keeping with the policy that had been set up the previous year of expanding business activities to include financing of KNU (which provide public services, including ones without any municipal guarantee.) These loans also included mortgage loans to local authority housing associations.

In addition, project financing with a volume of EUR 128.9 million was provided in the year under review for the first time. This included two lead mandates in the transport and power plant sectors in the case of which DKD was entrusted with structuring and arranging financing in the capacity of mandated lead arranger (MLA). In addition, the bank plans financing projects in further selected lines of business such as social infrastructure, utilities, electricity and gas grids, renewable forms of energy, equipment leasing, public sector real estate and telecommunications. The catalogue of products ranges from pure project financing (PF), public private partnerships (PPP) and leveraged

buyouts (LBO) to asset based lendings (ABL).

Following the move to provide financing for KNU as well as project financing and public-private partnership (PPP) transactions, the necessary operational structures were created in front and back office. The process of setting up the required teams was started in 2007 and carried out as a matter of priority.

**Pfandbriefe and other funding**

For the purpose of long-term refinancing of the lending business, the bank newly issued a total volume of EUR 6,114.6 million (2006: EUR 9,987.2 million) in the year under review. The difficult market conditions created by the sub-prime crisis had far less impact on covered refinancing by means of Pfandbriefe than on obtaining short-term (interbank) liquidity. Apart from the initial placement, call options amounting to EUR 3,591.3 were not exercised in the 2007 financial year and hence the residual terms to maturity of existing funds was extended. DKD was even able to realize its funding

budget successfully without having to replace two Jumbo Pfandbriefe maturities (February and September 2007) by new Jumbo Pfandbrief issues.

The primary refinancing instrument remained the public Pfandbrief with a share of 98%. Uncollateralized loans accounted for 1%. The newly placed refinancing funds consisted to approx. 85% of classic, fixed-interest instruments or floaters and up to 15% of structured issues. There was increased demand for private placements of up to EUR 50 million that satisfied the requirements of investors for tailor made and safe forms of investment. Given its funding structure described above, which is essentially based on long-term refinancing through public Pfandbriefe, DKD required only slight short-term liquidity, which in view of the increased rates of interest in the money market and the (interbank) liquidity scarcity in the wake of the sub-prime crisis had tended to become more expensive.

All in all, the portfolio of public Pfandbriefe additionally the uncovered other bonds and borrower's note loans

*Development of initial placement (bearer and registered instruments) in million*

	2003	2004	2005	2006	2007
Public Pfandbriefe	10,180.4	12,386.9	12,752.8	9,811.5	6,039.6
Other bonds*	30.0	18.0	27.0	0.0	20.0
Borrowing*	324.7	137.1	94.6	139.8	55.0
<b>Total</b>	<b>10,535.1</b>	<b>12,542.0</b>	<b>12,874.4</b>	<b>9,951.3</b>	<b>6,114.6</b>

\*including subordination agreements

amounted to EUR 37,777.0 million at the end of the year and corresponded to the previous year's level (2006: EUR 37,976.9 million). The last mortgage Pfandbriefe matured in the year under review. Our own debt securities acquired due to market-regulating operations had a nominal value of EUR 13.2 million on December 31, 2007 (2006: EUR 11.0 million).

We launched 38 issues (2006: 95) on the Berlin Stock Exchange, where Dexia Kommunalbank Deutschland AG is one of the largest issuers, with a total volume of EUR 2,633.4 million (EUR 2006: 7,277.7 million); all issues were placed on the regulated market.

The triple A rating for public Pfandbriefe awarded by Standard & Poor's in 1998 for the first time was, as in the previous years, reconfirmed in February 2008.

#### **Mortgage loans**

The remaining portfolio of classic mortgage loans was further reduced by EUR 3.7 million to net EUR 15.3 million.

#### **Compulsory measures**

There were four forced sales in the year

under review; three of which had not been completed by the end of the year. This is not of any further relevance for an assessment of the exposures in question.

#### **Development of assets, financial position and profit situation**

The balance sheet total increased slightly by EUR 0.5 billion (1.1%) in comparison with December 31, 2006 to EUR 46.2 billion. The portfolio of municipal loans rose due to the increased business activities in the financial year in public sector lendings including short-term lendings to the German Federal Government, the Federal States (Laender), and towns and municipalities, by EUR 3.3 billion to EUR 21.1 billion. In contrast, the overnight and time deposits due from other banks decreased by EUR 1.2 billion in comparison with the figures at the end of 2006.

Sales and maturities of securities led to a decrease in value shown in balance sheet by EUR 0.7 billion in comparison with December 31, 2006. In 2007 the bank transformed securities amounting to nominal EUR 1.3 billion from the portfolio of liquidity reserve to the fixed

assets; amounting to 99,7% the transformed portfolio shows an A-rating or better, calculated internally according to the Basel-II regulations to be used as of 2008.

The ratings of the bonds and debt securities issued by other credit institutions in the bank's portfolio as at December 31, 2007 amounting to a nominal EUR 9.5 billion are as follows: (see table "Internal rating according to Basel II (AIRBA\*)", page 14)

DKD has at no time been either directly or indirectly committed in the sub-prime market through special purpose vehicles or structured investment vehicles.

Funding showed in 2007 a shift away from public bearer Pfandbriefe towards registered Pfandbriefe placed with institutional investors.

Notwithstanding the difficult market conditions in the second half of the year resulting from the sub-prime crisis, the partial operating result approximated that of the preceding year. All in all, the targeted earnings were not achieved in full and the result of the previous year not equaled due to the increased provisioning against risks resulting from the widening of rating-linked credit spreads.

	Anteil in %
AAA	33.5
AA+ to AA-	37.7
A+ to A-	24.5
BBB+ to BBB-	4.1
BB+ to BB-	0.2
<b>Total</b>	<b>100</b>

\* Advanced Internal Rating Based Approach

### **Net interest income and commission income**

Despite the squeeze on spreads in the highly competitive market of local authority financing and the continuing flatness of the yield curves and the ensuing decrease in chances of additional earnings from maturity transformations, it was possible to maintain net interest income at the level of the previous year.

Net commission income increased to EUR -2.6 million (2006: EUR -4.3 million), as, following the lower level of issues in the financial year there was a reduction in the placement fees granted.

### **Administrative expenses**

General operating expenses rose in total by EUR 1.5 million or 9.0% to EUR 18.0 million. Of this amount, EUR 1.0 million was accounted for by personnel expenses; the increase was primarily due to recruitment of new staff in front and back office as a consequence of the expansion of strategic investments (KNU

business/project financing). The other administrative expenses including depreciation of tangible and intangible assets increased by EUR 0.4 million or 4.9% to EUR 9.6 million. This increase is primarily attributable to consulting and project costs that were incurred in connection with implementation of requirements of statutory law or regulators. Even so, DKD continues to have a low cost-income ratio. The percentage of administrative expenses to interest and commission income was, in a comparison with competitors, still a good 27.5% after 26.5% in the previous year.

### **Level and development of risk provisioning**

Risk provisioning comprises all recognizable and latent risks in the lending business and the securities of the liquidity reserve as well as the results from cross compensation pursuant to Section 340 f para. 3 of the German Commercial Code (HGB). Net risk provisioning amounts to EUR 33.4 million (2006: EUR 23.6 million). Essentially it includes provisions made for bonds issued by banks according to the lower of cost or market

principle in the securities business, which were affected by narrowing spreads. This also affected the portfolios of underlyings which are micro hedged against interest rate risks via interest swaps. The depreciations do not represent defaults but are due to circumstances that are indirectly attributable to the market development resulting from the sub-prime crisis. Capital gains on sales and realised gains from the buy-back of own bonds, which had declined significantly compared to the previous year, were the main items that were posted against the charges of risk provisioning through cross compensation.

### **Result of financial investments**

As in the previous year, the result of financial investments amounting to EUR 2.7 million includes the profits and losses arising from a small number of sales of securities treated as fixed assets that took place due to developments in ratings seen as favorable. No write-downs had to be made due to a permanent diminution in value.

### Profit before tax and net income

Profit before tax was essentially reduced due to a substantial 45.4% increase in risk provisions to EUR 17.0 million (2006: EUR 31.1 million). Hence the profit for 2007 decreased by 46% and was EUR 10.2 million in comparison with EUR 19.0 million to the previous year.

### Equity capital

The bank's own funds increased by a total of EUR 10.7 million in the financial year. They added up to EUR 546.9 million as at December 31, 2007 (2006: 536.2 million). The amount of EUR 7.6 million was transferred to retained earnings in 2007. The item to be deduc-

ted pursuant to Section 10 (2a) of the German Banking Act (KWG) increased by EUR 2.7 million. New profit participation capital of EUR 41.4 million was raised. Redemptions and the partial loss of eligibility due to residual terms having fallen below two years decreased own funds by EUR 35.6 million. Also in 2007 the bank again reported own funds substantially above legal requirements. The bank's capital backing of risk-weighted assets (the solvency ratio) was 15.1% on the balance sheet date (2006: 14.5%), significantly above minimum requirement pursuant to Principle I of the German Banking Act (KWG).

### Liquidity

The liquidity ratio in 2007 was calculated according to Principle II. This

principle states that the ratio of the means of payment available in the first time bucket (daily up to 1 month) to the callable payment obligations during the same period may not be below 1. In its liquidity planning DKD takes both the extent of the flow of incoming and outgoing payments into consideration as well as an adequate liquidity supply in the form of highly liquid assets.

As in the preceding year, the liquidity ratio pursuant to Principle II was above the required minimum of 1 throughout 2007.

### Relations to affiliated companies

The Management Board's report on relations to affiliated companies pur-

### Development of the bank's own funds in million euros

	2003	2004	2005	2006	2007
Subscribed capital	162.5	162.5	162.5	162.5	162.5
Reserves	96.9	108.7	111.4	114.8	122.4
Deduction item acc. to §10 (2a) KWG	0.0	-3.0	-2.0	-2.6	-5.3
Profit participation capital	126.9	126.1	126.1	125.5	140.6
Subordinated liabilities	123.4	134.1	135.3	136.0	126.7
Tier 3 capital	0.0	0.5	0.0	0.0	0.0
<b>Total</b>	<b>509.7</b>	<b>528.9</b>	<b>533.2</b>	<b>536.2</b>	<b>546.9</b>

### Principle II

	Minimum	Maximum	Average
Principle II	1.24 (August 2007)	2.29 (September 2007)	1.86

suant to Section 312 of the German Stock Corporation Act (AktG) ends with the following statement:

“In each of the legal transactions listed in the Board’s report on relations to affiliated companies, our company received appropriate consideration and was not placed at any disadvantage by the measures listed in the report taken or omitted. This assessment is based on the conditions known to us at the time of the events subject to a reporting requirement.”

### Derivatives

The bank uses derivatives as auxiliary transactions, as defined in and in accordance with the German Pfandbrief Act (PfandBG), to hedge against interest rate and foreign exchange risks, and to improve margins and earnings.

At year-end, the volume of interest rate and cross-currency swaps and the options were in a comparison with the preceding year as follows: (see table below)

The credit equivalent amounts of the interest rate and currency swaps in accordance with the market valuation method pursuant to Section 13 of the German Banking Act (KWG) was EUR 535.1 million as at the balance sheet date (2006: EUR 535.8 million).

### Subsequent events

There were no occurrences of special significance after the end of the financial year.

### Staff members

The bank had 99 employees at the end of 2007 (2006: 80). Of these, 23 work at the Frankfurt/Main Office (2006:13).

Business activities in the 2007 financial year posed great challenges for our employees, not least due to the market conditions described, numerous internal projects and the expansion of our business segments beyond the classic areas of public financing. We extend our special thanks to all of our employees for their extraordinary efforts and commitment, with which they made a very significant contribution to the bank’s success.

### ▪ Risk Report

#### Risk environment

Handling financial risks is an integral part of entrepreneurship. Effective risk management means, on the one hand, identifying and controlling risks to be

taken or that have been taken and, on the other hand, making full use of the associated profit opportunities they present in order to achieve the targeted return on capital investment.

For this purpose, the Management Board defines the bank’s risk policy, on the basis of legal and regulatory provisions. The risk profile entered into is always defensive and strictly geared towards the bank’s capacity to carry and sustain risk. The predominant focus of the risk policy is on a return on the capital invested that is commensurate with the risks taken, and on the enhancement of the company’s value. The objectives are set in the annual income and risk budgeting process.

Responsibility for setting risk strategy, which is derived from the business strategy of DKD, for due and proper organization and monitoring of the risk elements of all business associated with risk lies with the Management Board. Risk limiting systems have been put in place for the individual risk categories (counterparty risks, market price risks and liquidity risks) in close co-operation with the parent company, Dexia Crédit Local, Paris.

The risk guidelines and structures are set out in the Risk Handbook, which is available to all employees via the bank’s intranet. It forms the basis of uniform

#### Derivatives in million Euro

	December 31, 2006	December 31, 2007
Interest rate and cross-currency swaps	123,629.9	118,595.1
of which, EONIA	25,998.6	27,270.0
Options	826.9	756.3

handling of and internal communication on all significant types of risks, enabling goal-oriented handling of risks by DKD.

**Carrying and sustaining risks**

A top-down approach is used to properly take stock of and show all relevant, quantifiable risks and interpret them in terms of the bank's ability to carry and sustain risks. A loss ceiling is set by the Management Board for market price, counterparty, liquidity and operational risks to be entered into. These are based on the individual pre-risk results and the forecasted cost of risk. As a principle, spreading of the individual kinds of risks over the aggregate risk limit is a dispo-

sitive competence of the Management Board. Taking the loss ceiling as a limit, a split of 30%-70%-0% is applied for the counterparty, market price and liquidity risks. Operational risks are described in worst-case scenarios. The individual risk categories are based on the following quantification methods: (see table "Capacity to carry and sustain risks")

The average and year-end utilizations of the ability to carry and sustain risks under normal scenario were as follows: (see table "Utilization of overall limit")

If critical limit reserves arise the Management Board decides on steps to be taken. Taking into account the time-based probabilities of risks occurring into account, a decision is made on

whether to adjust the limit permanently or temporarily or whether measures are to be adopted to decrease risks immediately.

**Risk management system**

Dexia Kommunalbank Deutschland AG has an extensive risk control and risk management system (identifying, recording, measuring, analyzing and assessing risks and monitoring ongoing risks) that is developed continuously. It provides the decision-makers with the information they need for active management of risks. All matters relating to the regulatory requirements (MaRisk, Basel II) are managed, organized and coordinated for all categories of risk.

**Capacity to carry and sustain risks**

	Normal scenario	Extreme scenario
Market price risk	Essentially depreciation of securities forming part of current assets plus risk of overnight deterioration (95% confidence level)	Essentially depreciation of securities forming part of current assets plus risk of overnight deterioration. (2 x doubled max. swing of past 2 years)
Counterparty risk	Credit VaR (exposure x PD x LGD)	CreditVaR (Rating downgrade of entire portfolio by two notches)
Liquidity risk	Due to high quality of assets not included in ability to carry and sustain risk; but included daily in the separate liquidity limits	Normal scenario
Operational risk	Not included	Basis Indicator Approach pursuant to Basel II

**Utilization of overall limit in %**

Ø 2007	95.5
December 30, 2007	71.5

Centralization of the core functions of risk management and risk controlling ensures evidence of the risk exposure of DKD and an uniform appraisal of risks and their quantification. Risk control has responsibility for the individual methods of measuring, including (further) development of suitable models, and for reporting to the Management Board, the Supervisory Board and the group parent company. Support for reviewing the business processes and reviewing the efficiency and adequacy of risk management and control systems as defined by MaRisk is provided by the Internal Audit Department. Audit planning is carried out process and risk orientated, on the basis of a risk matrix. The Value at Risk (VaR) calculated serves as a basis for setting the audit intervals. The risk matrix is updated regularly. The auditors report their results and recommendations to the Management Board, the Audit Committee of the Supervisory Board and its plenary organ.

There is a clear organizational and functional separation between identifying, defining, analyzing and valuing risks on the one hand and active risk controlling on the part of asset-liability management on the other hand.

At the same time, the risks specific to the Pfandbrief business and its cover pool pursuant to Section 27 of the German Pfandbrief Act (PfandBVG) are shown separately. The bank carries out monthly accruals of both the cover pool and the

covered bonds outstanding in order to quantify interest rate, counterparty and liquidity risks.

#### Market price risks

The main focus of risk management and monitoring is on market price risk that is inherent in volatile markets. Of relevance for DKD here are essentially interest rate risks and credit spread risk. Foreign exchange risks are prevented by hedging.

Management uses two risk ratios based on market values – basis point value (BPV) and value at risk (VaR) – to manage interest rate risks. BPV describes the potential loss of Net Present Value of the overall portfolio in the event of a parallel shift of a 100 basis point of the interest rates curve and the PVO1 by one basis point per defined time bucket.

The value-at-risk method (VaR) provides the maximum anticipated loss which may occur in normal market conditions during a pre-defined holding period, based on a given probability. The bank calculates the VaR on a daily basis, in particular based on a 99% confidence interval and a ten-day holding period.

Depending on whether long-term trends are to be followed in terms of interest strategy or advantage is to be taken of short-term trends, DKD has set up different sub-portfolios with their own

limits. The interest sensitivity of the credit spreads is measured daily and reported to decision makers. No separate limiting takes place.

Based on the above assumptions, the position as at December 31, 2007 was as follows:

Responsibility for strategic management of risks lies with the ALM (Asset Liability Management) Committee of DKD on the basis of the so-called ALM long-term portfolio. The members of the Committee set the tactical asset allocation (utilization, terms etc.) at their monthly meetings. A separate ALM portfolio was closed in the middle of the year. As a result, the +100 BPV interest rate risk fell by approx. EUR -25 million. The limit was adjusted.

Using back testing DKD reviewed the prognosis quality of the VaR models for all sub-portfolios in the year under review. The changes in NPV that actually occurred are compared with the results of calculations based on the VaR model. The single outlier established (= 0.4% of cases) for the global portfolio is very close to the anticipated value and constitutes a very good result.

The methods used for back testing will be developed further in a Group project set up for this purpose.

Analysis of the effects of extraordinary market situations calls the employment of stress tests in addition to risk measu-

#### Sub-portfolios

	Limit +/- 100 BPV in million euros	Limit VAR 99/10 in million euros
ALM long term*	10	-
ALM short term*	8.3	1

\* short term relates to all terms of up to (and including) two years; long term to all terms in excess of two years

	ALM long term			ALM short term		
	VaR (99%, 10 days)	+100 BPV in million euros	-100 BPV in million euros	VaR (99%, 10 days)	+100 BPV in million euros	-100 BPV in million euros
Ø 2007	3.1	-10.8	11.5	0.3	-0.5	0.5
Min. 2007	0.1	-27.5	-4.0	0.0	-5.2	-6.4
Max. 2007	6.9	3.9	28.6	0.7	6.4	5.2
Dec. 31, 2007	0.8	-0.6	1.2	0.2	-0.7	0.7

#### Credit Spread sensitivities to interest rate movements

	+ 100 BPV in million euros	-100 BPV in million euros
Ø 2007	-17.4	19.8
Min. 2007	-18.6	18.8
Max. 2007	-16.5	21.3
December 31, 2007	-17.0	19.3

rement. The bank uses the following scenarios to carry out the stress tests:

- Parallel shift by +/- 250 BP
- September 11, 2001: change in curve by the percentage change in the interest level from September 11 to September 12, 2001
- Reversal of the market interest curve by -5.4 BP around the 5-year point

The active hedging of risks is carried out with derivative financial instruments. Interest swaps are used for both micro and macro hedge relationships. Options serve exclusively to hedge on-balance items.

Management is informed by a daily risk report on developments in the market risk, the limit utilization and the results of back testing as well as of the overall

bank performance.

While the credit spreads continued to globally narrow in the first half of 2007, there was a clear shift when the crisis on the financial markets occurred. On the one hand, the credit spreads for private borrowers (in particular banks) widened appreciably; on the other hand, the credit spreads for public sector borrowers remained almost unchanged. On the German market the “flight to quality”, driven by liquidity, led to a further narrowing of the credit spreads for public-sector borrowers, as well as for short-term Pfandbriefe. Considering all assets and liabilities, the net present value therefore dropped by a total of EUR -103 million due to the asymmetry of the evolution of the above credit spreads.

The valuation effects arising from changes in the credit spreads are measured by the bank regularly. The market data used for credit spreads is updated continuously.

#### Counterparty risks

In order to limit counterparty risks, clear credit lines and credit delegations are set for all contracting parties by the Management Board in agreement with the Dexia Group.

In the area of lending to the German public sector, DKD has a dynamic system for granting credit lines to public corporations and public law institutions. Per-capita debt of the population and the ratio of overall debt of the corporation

to average overall debt in the category in question are the decisive criteria for the maximum credit line to be accepted by the bank.

The comprehensive calculations required to establish utilization of credit lines are made by risk management/ controlling daily and monitored by the back office. The Management Board is notified immediately if a credit line is exceeded and a decision on necessary steps is made.

Following the move to provide financing for private municipal utilities (KNU), which provide public services, including ones without any municipal guarantee, and of public-private partnership (PPP) transactions, the necessary organizational structures have been set up. The most important aspect here is credit analyses and their subsequent implementation and processing. The basis of this activity is formed by the credit risk strategy, the principles for management of credit risks, the credit regulations and rating procedures for assessing the credit risk of counterparties.

Risk management in the case of KNU allows for differentiated procedure depending on sector. The system of management reporting ensures that the Management Board is regularly informed of the corresponding portfolio structure.

Project financing business was made an additional strategic business segment of the bank in 2007. In contrast to classic lending, loans are made dependent on the anticipated profitability of the project per se. In accordance with its credit regulations for what is known as structured finance business, DKD plans to finance projects in selected sectors such as transport, social infrastructure, utilities, power stations, electricity grids and gas networks, renewable energy, rolling

stocks, public-sector real estate and telecommunication. The product catalogue ranges from pure project financing (PF), public private partnerships (PPP) and leveraged buyouts (LBO) to asset based lendings (ABL).

Particularly in the area of credit risk management organizational structures and procedures were adapted qualitatively and quantitatively in terms of both credit analysis and credit processing to meet the needs of these new business segments. The documentation required by the Minimum Requirements of Risk Management (MaRisk) was updated.

With regard to counterparty risks procedures are in place to ensure functional and disciplinary separation of commercial activity (= front side) and credit analysis (= support side) at all levels.

The counterparty risks, which are quantified with the help of a CreditVaR in the normal as well as the exposure/extreme exposure cases, are credited against an upper loss limit which depends on the current profitability, the hidden reserves and the shareholder's equity.

In addition, the measurement of the direct counterparty risks (credit risks), the risk of non-performance in full or in part by a business partner is also assessed (replacement cost risk). Following definition of the risks of individual business, all default risks are consolidated and measured on a contracting party or borrower basis.

#### **Liquidity risks**

Liquidity risk is understood as the danger that the bank will be unable to fulfill its current and future payment obligations in full or on time.

In view of the liquidity crisis on international money markets triggered by the crisis on the US mortgage market,

the Dexia Group has stepped up internal liquidity management. DKD is fully integrated into this system. This concerted action, coupled with the fact that DKD always has a large volume of ECB-eligible securities owing to the quality of its assets, meant that there were no liquidity shortages at any time.

In order to guarantee liquidity at any time, a liquidity forecast is made daily that contains an overview of maximum money outflows in the next 90 days. Risk management/ controlling establishes the accumulated liquidity congruence daily for one day, two days and one week and compare it with defined limits. The Management Board is informed daily on the utilization of these utility limits in the form of a summarized risk report. In addition, liquidity gap analyzes provide a medium and long term view of the bank's liquidity. Special reporting procedure compares the medium-term liquidity congruence (up to one year) with the available liquidity reserves in the form of securities eligible to ECB. The ratio calculated in the year under review was well below 100%.

#### **Operational risks**

The bank defines operational risk as the risk of direct or indirect loss caused by human conduct, weakness in procedures or control systems, technical failure, disasters and external influences. These also include risks to reputation and legal risks. The latter can arise from an unexpected change in legislation, disadvantageous contractual structures and legal disputes (including potential ones) with a third party. Instruments such as integration of customer complaint management, implementation of an anti-corruption code and a special code of conduct for both internal and external relationships contribute to a significant reduction in risks to the bank's

reputation. Controls are also in place at different levels to limit operational risks. Technical and organizational measures have been put in place in the area of IT infrastructure and organizational procedures in particular to limit and avoid risks. Emergency plans and a catalogue of measures have been drawn up; they are set out in a manual for emergencies that is available on the intranet.

As part of contingency planning, the bank has also set up a recovery centre so that business operations can still be carried out in a crisis situation. This contingency planning primarily concentrates on areas that are not directly in the bank's sphere of influence and contains scenarios and possibilities for solutions in cases in which the bank building at Charlottenstrasse 82 in Berlin cannot be used at all or only to a very limited extent. The aim of this plan is to ensure that the core area of the bank's operations is essentially still able to function. The priority of individual emergency procedures depends on the risk situation in question.

Apart from this, the operational risk correspondent at DKD compiles monthly a record of losses that have occurred in the area of operational risks at departmental level. Where losses have occurred, the parties involved are asked to analyze the procedures in question, to put a figure on the loss and develop proposals for avoidance of such losses in future. The risks that have occurred are discussed with the Management Board at meetings of the Operational Incidents Committee that meets quarterly. These meetings are followed by a report to the group parent company for the purpose of setting up a loss database for operational risks.

In order to identify and assess operational risks, procedures were set in place at the end of 2007 to map operational

risks as part of the Risk & Control Self-Assessment Programs (RCSA) of the Dexia Group. The aim was to identify operating risks in the individual processes and to make it possible to make the necessary adjustments. This risk stock-taking will take place annually from 2008 on.

Using the Basis Indicator Approach of Basel II, operational risks have been included in the potential risk-bearing capacity under extreme exposure since the beginning of 2006.

A suitable human resources development plan has been drawn up to ensure that all employees in the various departments always have the qualifications they need for their work.

#### **Information management** \_\_\_\_\_

All risk-related information is recorded centrally in risk management/ controlling, processed systematically to provide special reporting and made available to the relevant decision makers once a day (if necessary more than once a day). Employees needing such information also have access to the results of the analyses through the IT system. A functioning flow of information that achieves its aims and reflects the needs of the recipients ensures that the employees of Dexia Kommunalbank Deutschland AG have a high level of risk awareness accompanied by the necessary sensitivity.

#### **Basel II** \_\_\_\_\_

DKD is fully integrated into the "Basel II" Project Group of the Dexia Group. The aim of the project is to develop a uniform procedure within the Group to quantify counterparty and operational risks on the basis of the Advanced Internal Rating Based Approach

(AIRBA) and/or the Standard Approach for operational risks.

Following extensive certification examinations in 2007, Dexia Group including DKD was licensed as an AIRBA institution by the Belgian regulatory authority CBFA (Commission bancaire financière et des assurances) with regard to the financing activity. In this connection the German Central Bank (Deutsche Bundesbank) carried out what is known as a Basel II use test at DKD in July 2007 that produced a positive result.

#### **• Trading book**

The bank has been a trading book institution since January 2004 and meets completely the requirements for trading book institutions. There has been no activity in 2007 due to uncertainties on the markets.

#### **• Forecast**

The decisive factor for economic growth in 2008 will be whether the crisis on the financial markets spills over onto the global economy (in real terms) and how central banks then react in the case of such a development. The reduction in interest by 75 BP by the FED at the beginning of January 2008 and by a further 50 BP at the end of that same month did not produce any clarity on how interest rates will move in the future. A further decrease in the Base Rate to cushion the effects of the crisis does not appear to be out of the question. The billions of dollars made available by the US government in a program designed to stimulate the economy supports the assumption that a recession is looming.

Nor is any easing of the situation on the US real estate market to be expected. Falling real estate prices will probably influence 2008 as well, as the volume of property on the market will increase further and, combined with the rising energy costs, could lead to a “negative income effect”. Oil prices of US \$100 per barrel are no longer ruled out.

A decisive factor in offsetting this effect will be the strength of the labor market. The reason being that negative developments on the labor market in the form of lay-offs would have a far more immediate impact on consumer spending than rising inflation or stagnating stock markets. Here too a factor arising from the current crisis may not be ignored: the lending policy of financial institutions will become increasingly restrictive. Should the sub-prime crisis also have a sustained effect on other markets such as, for example, credit card or automobile financing, this could result in a fall in American GDP of down to 1% in 2008.

The focus of all thinking on economic and financial policies will again be on consumer behavior in the USA in 2008. This is not least due to the view often widely held that any downturn in the USA will not be without consequences for other markets as it is not possible to decouple individual national economies from each other entirely in a globalized world. Fortunately, the US economy has a high profitability level so that the effects of any recession would initially be less dramatic. Partial compensation for the decline in domestic demand by increasing demand from abroad would be favored by the weaker US dollar: Peaks of over US\$ 1.50/EUR are conceivable at the beginning of 2008 if the bad news on the year-end results in the financial sector fuels speculation on further aggressive intervention by the Federal Open Market Committee

(FOMC). However, the exchange rate of the US dollar to the euro will probably return to US\$ 1.30/EUR if the interest rate policies of the FED and the ECB start to converge again.

A further obstacle to growth could be the redefinition of liquidity and the conditions on which it is made available. It is expected that lenders will no longer be willing to provide continuous credit or capital market funds for risky assets at either the consumer or the corporate level – at least not on such favorable terms as observed from 2004 to 2006. This will push the refinancing costs up continuously in 2008. New fixed-interest refinancing instruments will have to offer an attractive return to awaken investor interest – a risk/return ratio such as existed in June 2006 before the phase of interest rate increases began is therefore not to be expected in the immediate future. This development will, also in the case of new issues, probably lead to a widening of the spreads between covered and uncovered bonds.

The call for greater transparency in the financial sector that has come in the wake of the sub-prime crisis, will increase the demand for new capital and hence its costs in particular with regard to disclosure of off-balance sheet activities, the inclusion of such transactions in the balance sheet and their refinancing via the balance sheet.

A positive effect of a slowdown in economic growth could be the effect on inflation. Slower growth could reduce the risk of second-tier inflation. Even so central banks are uneasy: on the one hand, if the effects of the credit crisis become appreciably more apparent, further interest rates would have to be reduced to ease pressure; on the other hand, with an inflation rate in excess of 2% in both America and Europe the cycle of interest rate increases would

have to be restarted. In the ECB’s last quarterly survey in February 2008 of the anticipated development of core inflation, the growth of GDP and unemployment figures in the euro zone, experts forecast an increase in core inflation from 2% to 2.5% in 2008, a decrease in growth of GDP from the 2.1% originally forecast for 2008 to 1.8% and an increase in the unemployment rate forecast from 6.7% to 7.1%.

The growing expectations of inflation coupled with a lack of specialized workers in individual industries indicate an increasing risk in the form of future pay increases. The ECB is endeavoring to prevent such a wage-price spiral occurring and has therefore kept to its policy so far. However, as it is not possible to entirely decouple individual economies in a globalized world and they may just not be synchronized from time to time, the ECB could run the risk of following the path of measures and developments in the USA further down the line and adjust interest rates accordingly.

In addition to the factors outlined above, the various conceivable scenarios of monetary policy in 2008 will be influenced by the need for the central banks to dispel tension on the money market as quickly as possible. It is our opinion that this will only be possible by decreasing the interest rate level.

On the assumption of a reduction in the interest rate level in the euro zone, normalization of the money market rates and a repositioning of investors in favor of risk-compatible investments, DKD assumes that it will be possible to maintain its comparative advantage of favorable refinancing costs by means of its AAA Pfandbrief. The widening of the spreads of certain assets categories as a result of the sub-prime crisis could also create very interesting investment possibilities in addition. For this rea-

son, we will continue to optimize our loan portfolio in particular in Germany. The “flight to quality” and the resulting large spread between Bund and swap (over 40 BP) could therefore be used, to buy securities from issuers with a good rating (in particular bank shares) on attractive conditions.

We anticipate that there will be a drop in new business in the municipal lending segment in 2008 as increasing tax revenues on the part of local authorities and municipalities will lead to a decrease in the need to borrow. The flight of investors – fuelled by the sub-prime crisis – into assets with good ratings will further increase competition in municipal lending and limit the widening of spreads in the future as well.

The uncertainty on the international financial markets and the associated increasing reluctance to enter into higher risks will increase volatility on the stock markets as the year progresses. Stock exchanges in China and India, which so far have been seen as being largely decoupled from the current negative developments in the USA, are therefore not necessarily immune from the need to make major corrections. However, the emerging markets have so far been spared the more substantial effects of the credit and liquidity crises. This has kept the demand for raw materials up

and, along with speculative investing in raw materials futures by hedge funds, driven prices higher.

The sharp rise in oil prices has further fuelled the debate on alternative forms of energy. DKD sees a growing market in the area of renewable energy forms such as wind power, both on-shore and off-shore, and will follow it intensively in the context of its new project financing business segment. In addition, the plans of the Federal Government to further expand PPP financing will strengthen the interest of DKD in expanding its activities in this area. With the expansion of the classic public-sector lending business that has already begun to include lending to KNU, forfaiting and the areas named above, we intend to secure interest income and obtain an ongoing improvement in commission earnings. This will form part of the overall strategy of the Dexia Group in infrastructure financing, in which we rank third in the world.

Given this assessment of markets, we anticipate net interest and commission income in 2008 similar to that of 2007.

We will continue to support our flexible cost management by strict cost discipline and increasing the potential for synergies through cooperation with the Dexia Group. However, due to investments in the segments described above, we must assume an increase in costs, in

particular of those of an administrative nature.

We do not expect a widening of the credit spreads of bank shares in 2008 comparable to those in 2007 and, in consequence, the risk provision for the securities business should be lower than for 2007.

All in all, from the present point of view and bearing the positive effects of the Tax Reform Act (Steuerreformgesetz) in mind, it should be possible for net income in 2008 to surpass the level reached in 2007. However, given the situation in the international financial markets, a forecast of net income is subject to considerable uncertainty.

Depending on the course of economic developments in 2008, the extent to which the ongoing difficulties in the financial sector and their effects on the US real estate sector can be controlled (effects which may also have a negative influence on the British and Spanish real estate markets) and the outstanding question of the probability of defaults in the retail loans sector as well as in the corporate sector makes a forecast for 2009 will be extremely difficult.

Ever so, the positive development expected for 2008 is likely to be continued in 2009 with a further expansion of the new business segments and a moderate increase in net profit.

Berlin, March 13, 2008  
Dexia Kommunalbank Deutschland AG

Management Board



Behr



Giacobbi



Wouters

*Annual financial  
statements 2007*



# *Balance sheet*

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*as at December 31, 2007*

	Euro	Euro	Euro	Previous year in thousand euros
<b>Cash reserve</b>				
a) Cash on hand		4,110.62		2
b) Balances with central banks		139,968,219.46		34,381
including: with Deutsche Bundesbank	139,968,219.46			(34,381)
c) Postal bank balances		0.00	<b>139,972,330.08</b>	0
<b>Public debt issue and bills eligible for refinancing with central banks</b>				
a) Treasury bills and non-interest-bearing Treasury notes and similar public-sector debt instruments		0.00		0
including: refinancable with Deutsche Bundesbank	0.00			(0)
b) Bills of exchange		0.00	<b>0.00</b>	0
including: refinancable with Deutsche Bundesbank	0.00			(0)
<b>Due from banks</b>				
a) Mortgage loans		0.00		0
b) Loans to the public sector		3,429,676,725.12		3,534,899
c) Other claims		2,838,329,558.77	<b>6,268,006,283.89</b>	5,164,509
including: payable on demand	924,409,080.79			(2,012,232)
collateralized by securities	0.00			(0)
<b>Due from customers</b>				
a) Mortgage loans		134,851,435.12		34,824
b) Loans to the public sector		21,079,402,515.15		17,789,438
c) Other loans claims		280,659,097.34	<b>21,494,913,047.61</b>	176,466
including: collateralized by securities	0.00			(0)
<b>Bonds and other fixed-interest securities</b>				
a) Money market instruments				
aa) Public-sector issuers	0.00			0
including: refinancable with Deutsche Bundesbank	0.00			(0)
ab) Other issuers	0.00	0.00		0
including: refinancable with Deutsche Bundesbank	0.00			(0)
b) Bonds and notes				
ba) Public-sector issuers	7,707,003,905.69			7,432,943
including: eligible as collateral with Deutsche Bundesbank	6,830,869,315.64			(6,593,805)
bb) Other issuers	9,991,920,567.02	17,698,924,472.71		10,930,060
including: eligible as collateral with Deutsche Bundesbank	9,502,701,197.88			(10,060,820)
c) Own bonds		13,664,013.44	<b>17,712,588,486.15</b>	10,456
Nominal amount	13,204,000.00			(10,956)
<b>Shares and other variable interest-bearing securities</b>			<b>20,995,784.70</b>	20,891
<b>Investments</b>			<b>0.00</b>	0
including: investments in banks	0.00			(0)
<b>Investments in affiliates</b>			<b>0.00</b>	0
including: investments in banks	0.00			(0)
<b>Trust assets</b>			<b>0.00</b>	0
including: Trust loans	0.00			(0)
<b>Compensation receivables from public bodies including bonds arising from their exchange</b>			<b>0.00</b>	0
<b>Intangible assets</b>			<b>4,464,382.64</b>	1,963
<b>Tangible assets</b>			<b>11,239,968.90</b>	12,699
<b>Subscribed capital unpaid</b>			<b>0.00</b>	0
including: called-up	0.00			(0)
<b>Own shares or capital</b>			<b>0.00</b>	0
Nominal value	0.00			(0)
<b>Other assets</b>			<b>153,812,719.68</b>	106,132
<b>Tax accruals</b>			<b>6,133.81</b>	1,756
<b>Accruals and deferrals</b>				
a) From new issues and lending		348,259,863.35		417,108
b) Other		60,619,488.38	<b>408,879,351.73</b>	24,438
<b>Deficit not covered by equity</b>			<b>0.00</b>	0
<b>Total assets</b>			<b>46,214,878,489.19</b>	45,692,965

	Euro	Euro	Euro	Previous year in thousand euros
<b>Due to banks</b>				
a) Registered mortgage Pfandbriefe		0.00		0
b) Registered public Pfandbriefe		1,479,258,729.18		1,770,874
c) Other liabilities		7,259,372,744.10	<b>8,738,631,473.28</b>	6,711,340
including payable on demand	36,822,117.12			(20,727)
registered mortgage Pfandbriefe and registered public Pfandbriefe pledged to lenders for the collateralization of loans	0.00	0.00		(0)
	0.00			(0)
<b>Due to customers</b>				
a) Registered mortgage Pfandbriefe		0.00		2,676
b) Registered public Pfandbriefe		15,707,413,100.34		14,124,133
c) Savings deposits				
ca) terminable within three months	0.00			0
cb) not terminable within three months	0.00	0.00		0
d) Other liabilities		2,095,365,083.20	<b>17,802,778,183.54</b>	2,246,404
including: payable on demand	3,560,555.78			(924)
registered Pfandbriefe and public Pfandbriefe pledged to lenders for the collateralization of loans	0.00	0.00		(0)
	39.113.828,90			(39,114)
<b>Securitized liabilities</b>				
a) Issued bonds				
aa) mortgage Pfandbriefe		0.00		0
ab) public Pfandbriefe	18,802,530,855.77			19,978,348
ac) other	88,640,950.82	18,891,171,806.59		92,685
b) Other securitized liabilities		0.00	<b>18,891,171,806.59</b>	0
including: money market instruments	0.00			(0)
<b>Trust liabilities</b>			<b>0.00</b>	0
including: trust loans account	0.00			(0)
<b>Other liabilities</b>			<b>17,448,244.69</b>	13,884
<b>Accruals and deferrals</b>				
a) From new issues and lendings		18,616,876.12		23,775
b) Other		106,696,965.12	<b>125,313,841.24</b>	110,436
<b>Provisions for liabilities</b>				
a) Provisions for pensions and similar commitments		220,546.00		0
b) Tax provisions		2,084,307.49		1,411
c) Other provisions		4,248,545.49	<b>6,553,398.98</b>	8,752
<b>Special reserve item</b>			<b>0.00</b>	0
<b>Subordinated liabilities</b>			<b>131,499,999.97</b>	147,350
<b>Profit participation capital</b>			<b>206,413,188.14</b>	164,629
Including: maturing within two years	64,129,188.12			(36,302)
<b>Fund for general banking risks</b>			<b>0.00</b>	0
<b>Equity</b>				
a) Subscribed capital		162,500,000.00		162,500
b) Capital reserve		78,684,911.98		78,685
c) Retained earnings				
ca) statutory reserve	0.00			0
cb) reserve for own shares	0.00			0
cc) reserves required by Articles of Incorporation	0.00			0
cd) other retained earnings	43,683,440.78	43,683,440.78		36,083
d) Net income		10,200,000.00	<b>295,068,352.76</b>	19,000
<b>Total liabilities</b>			<b>46,214,878,489.19</b>	45,692,965
<b>Contingent liabilities</b>				
a) Contingent liabilities from discounted bills of exchange		0.00		0
b) Liabilities from guarantees and indemnity agreements		112,477,125.67		30,091
c) Liability from assets pledged as collateral for third-party obligations		0.00	<b>112,477,125.67</b>	0
<b>Other commitments</b>				
a) Repurchase obligations from reverse repurchase agreements		0.00		0
b) Placement and underwriting commitments		0.00		0
c) Irreversible loan commitments		1,115,533,357.41	<b>1,115,533,357.41</b>	900,623

# *Profit and loss account*

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*for the period from January 1 to December 31, 2007*

	Euro	Euro	Euro	Previous year in thousand euros
Interest expenses			<b>5,297,166,625.61</b>	4,485,328
Commission expenses			<b>3,672,428.07</b>	4,495
Net expenses from financial operations			<b>0.00</b>	0
General administrative expenses				
a) Personnel expenses				
aa) wages and salaries	7,132,084.34			6,416
ab) social security contributions and other employee benefits	<u>1,306,883.43</u>	8,438,967.77		986
including: pensions	408,934.44			(171)
b) Other administrative expenses		<u>8,042,853.25</u>	<b>16,481,821.02</b>	7,832
Depreciation and write-downs of intangible and tangible assets			<b>1,519,028.29</b>	1,284
Other operating expenses			<b>304,835.69</b>	483
Depreciation and write-downs of claims and certain securities, allocation to provisions for possible loan losses			<b>33,354,997.60</b>	23,559
Depreciation and write-downs of participations, interests in affiliates and securities treated as fixed assets			<b>0.00</b>	0
Expenses from underwriting losses			<b>0.00</b>	0
Transfer to special reserve item			<b>0.00</b>	0
Extraordinary expenses			<b>0.00</b>	0
Income taxes			<b>6,742,620.56</b>	12,044
Other taxes not reported under 'Other operating expenses'			<b>24,861.85</b>	46
Profits transferred on the basis of profit pooling under a profit and loss transfer agreement or an agreement to transfer a portion of the profit/loss			<b>0.00</b>	0
Net income			<b>10,200,000.00</b>	19,000
<b>Total expenditure</b>			<b>5,369,467,218.69</b>	4,561,473

Profit and loss account for the period from January 1 to December 31, 2007

Income

	Euro	Euro	Previous year in thousand euros
Interest income from			
a) Lending and money market transactions	4,552,885,529.05		3,929,579
b) Fixed-interest securities and Debt Register claims	<u>812,326,251.11</u>	<b>5,365,211,780.16</b>	616,386
Current income from			
a) Shares and other non-fixed income securities	0.00		6,000
b) Participations	0.00		0
c) Investment in affiliated enterprises	<u>0.00</u>	<b>0.00</b>	0
Profits transferred on the basis of profit pooling under a profit and loss transfer agreement or an agreement to transfer a portion of the profit/loss		<b>0.00</b>	0
Commission income		<b>1,065,364.72</b>	158
Net income from financial operations		<b>0.00</b>	0
Income from write-ups to claims and certain securities as well as from the release of provisions for possible loan losses		<b>0.00</b>	0
Income from write-ups to participations, investments in affiliates and securities treated as fixed assets		<b>2,732,473.84</b>	8,856
Other operating income		<b>457,599.97</b>	494
Income from retransfer of special reserve item		<b>0.00</b>	0
Extraordinary income		<b>0.00</b>	0
Income from underwriting of losses		<b>0.00</b>	0
Net loss for the year		<b>0.00</b>	0
<b>Total income</b>		<b>5,369,467,218.69</b>	4,561,473
Net income		<b>10,200,000.00</b>	19,000
Profit carried forward from the previous year		<b>0.00</b>	0
		<b>10,200,000.00</b>	19,000
Withdrawals from capital reserves		<b>0.00</b>	0
		<b>10,200,000.00</b>	19,000
Withdrawals from retained earnings		<b>0.00</b>	0
		<b>10,200,000.00</b>	19,000
Withdrawals from profit participation capital		<b>0.00</b>	0
		<b>10,200,000.00</b>	19,000
Transfers to retained earnings			
a) to the statutory reserve	0.00		0
b) to the reserve for treasury shares	0.00		0
c) to the reserves required by the Articles of Incorporation	0.00		0
d) to other retained earnings	<u>0.00</u>	<b>0.00</b>	0
		<b>10,200,000.00</b>	19,000
Replenishment of profit-participation certificates		<b>0.00</b>	0
<b>Net income</b>		<b>10,200,000.00</b>	19,000

## Notes to the accounts

### - Principles

#### Principles of accounting, valuation and translation

The annual financial statements have been drawn up in accordance with the pertinent provisions of the German Commercial Code (HGB), the German Stock Corporation Act (AktG) and the Pfandbrief Act (PfandBG) and the Accounting Regulations for Credit Institutions (RechKredV).

Receivables and other assets have been reported at their nominal values including accrued interest. The differences between amount advanced and nominal value are carried as accruals and deferrals. All recognizable individual risks have been provided for by the formation of individual value adjustments. In addition general provisions exist for mortgage lending area.

The securities allocated to the financial assets are valued according to the moderate lower of cost or market principle. Premiums and discounts are amortized over the maturity of the securities and offset against the interest income.

Taking the hedging instruments into consideration, the securities of the liquidity reserve are valued according to the strict lower of cost or market principle at the average value calculated continually or, if applicable, the lower current market price on the balance sheet date taking the requirement to reverse write-downs where the reasons for them no longer exist. If no liquid prices were available for securities via external suppliers of market data as at the balance sheet date, the market values of the securities were calculated using own valuation models. These valuation

models are standard market discounted cash flow models, and issuer and asset class specific interest curves and risk premiums (credit spreads) are explicit taken into consideration. In the cases of fixed interest instruments that constitute a micro-hedge relationship with an interest rate swap, the unhedged credit risk is also provided for according to strict lower of cost or market principle taking the requirement to reverse write-downs where the reasons for them no longer exist. Premiums and discounts are amortized in the interest income over the maturity of the securities in accordance with the outstanding capital.

Interest income and expenses of the hedging swap transactions are offset against the interest income and expenses of the underlying and hence the net interest income of the hedge is shown in the relevant item in the profit and loss account.

Intangible and tangible assets are in accordance with the useful life reported at acquisition costs decreased by planned straight-line depreciation. Apart from planned depreciation, the bank use the alternative treatment pursuant to Section 6 para. 2 of the German Income Tax Act (EStG) for low value assets.

In the case of deferred taxes, tax accruals and deferrals item is reported pursuant to Section 274 of the German Commercial Code (HGB).

Securities transferred in connection with repos (repurchase agreements), together with their financial return, are included in the assets side of the balance sheet and valued according to the category to which the securities originally belonged. At the same time, a liability in the amount of the agreed-

upon repurchase amount is recognized on the balance sheet. The difference between the repurchase amount and the amount received is shown in the "Deferred items" section and taken into account on a pro-rata basis for interest calculations. Securities pertaining to reverse repos are not shown on the balance sheet. The amount paid for the securities received is recognized in the balance sheet as a claim on the repo seller. The premiums on repo transactions are accounted for as accruals or deferrals on a pro rata basis over the maturity of the transaction.

Liabilities are shown at the redemption amount including accrued interest. The difference between the nominal value and the amount advanced is recognized to the accruals and deferrals item. Provisions were formed for taxes, uncertain liabilities and anticipated losses from pending transactions amounting of expected availment.

Provisions for pensions are assessed in accordance with the partial value calculated pursuant to actuarial principles with the application of a discount rated of 6%. The Heubeck 2005 G Tables formed the basis of the calculation. Pension commitments are covered by reinsurance coverage of the equivalent amount.

Premiums received from commitments from options sales of swaptions will be reported as other liabilities and recognized at the maturity of the option. Premiums received and paid out of swaps and interest limitation agreements (cap/floor/collar) will be reported as prepaid expenses or income. They will be recognized on a pro rata basis for interest calculations.

Foreign currency transactions were translated into euros. Assets and debts

in foreign currencies are fully hedged individually by separate hedging transactions and were translated at the conversion rate on the balance sheet date.

Derivatives in a micro hedge relationship are not valuated item by item.

Derivative components of an underlying are also not valuated item by item because they are hedging instruments due to the aggregated portfolio management.

## • Notes on the balance sheet

### Breakdown according to maturities \_\_\_\_\_

#### Breakdown according to residual maturities in million euros

	Due from credit institutions	Due from customers
Up to three months	1,459.9	870.4
Between 3 months and 1 year	17.7	945.1
Between 1 year and 5 years	1,673.2	3,990.9
Over 5 years	1,640.0	15,388.2
Interest	1,477.2	300.3
<b>Total</b>	<b>6,268.0</b>	<b>21,494.9</b>

	Due to credit institutions	Due to customers	Other securitized liabilities
Up to three months	3,769.6	194.6	-
Between 3 months and 1 year	903.5	223.5	-
Between 1 year and 5 years	1,458.0	2,221.2	-
Over 5 years	1,184.5	14,768.0	-
Interest	1,423.0	395.5	-
<b>Total</b>	<b>8,738.6</b>	<b>17,802.8</b>	-

	Notes and other fixed interest securities	Notes issued
Due the following year	603.6	5,272.6

Liabilities due to credit institutions are collateralized by securities with a value of EUR 4,453.5 million in the context of open market operations and repurchase agreements.

*Due from/to affiliates/participations in million euros*

	Total	Including from/to affiliates	Including from/to associates
Due from credit institutions	6,268.0	677.2	-
Due from customers	21,494.9	-	-
Notes and other fixed interest bearing securities	17,712.6	479.4	-
Due to credit institutions	8,738.6	3,058.0	-
Due to customers	17,802.8	-	-
Securitized liabilities	18,891.2	1,023.5	-
Subordinated liabilities	131.5	74.4	-

**Negotiable Securities in million euros**

	Total	Negotiable	Listed	Not listed	Volume negotiable securities not valued at the lower of cost or market principle
Notes and other fixed interest bearing securities	17,712.6	17,712.6	17,539.6	173.0	2,131.1
Shares and other fixed interest securities	21.0	21.0	21.0	-	-

There was no write-down to the lower value in the case of securities forming part of the fixed assets with a book value of EUR 2,131.1 million and a current market value of EUR 2,035.7 million. No lasting decrease in value has occurred, as this is a question of price fluctuations that will in all probability have been evened out when the securities mature.

**Other assets**

Other assets essentially consist of untaken profits from special covered forward exchange transactions (EUR 147.4 million).

**Tangible assets**

Tangible assets consists of premises and buildings used in the context of our own activities with a value of EUR 9.7 million and fixtures, fittings and equipment with a value of EUR 1.6 million.

**Development of fixed assets in million euros**

	Intangible assets	Tangible assets	Securities forming part of the fixed assets
Acquisition/manufacture costs brought forward to Jan. 01, 2007	15.4	20.5	2,817.3
Additions in the financial year	3.4	0.5	1,442.0*
Disposals in the financial year	0.0	5.2	834.0
Depreciation, accumulated	14.3	4.6	36.8
Residual book value as at Dec. 31, 2007	4.5	11.2	3,388.5
Residual book value as at Dec. 31, 2006	2.0	12.7	2,811.4
Depreciation in the financial year	0.9	0.6	0.2

\* The additions relate to the transformation of EUR 1,329.9 million from current to fixed assets.

**Tax accruals and deferrals**

We have capitalized an item pursuant to Section 274 of the German Commercial

Code (HGB) for the anticipated tax relief arising from the differences in reporting requirements between commercial and tax balance sheets for premiums

from stand-ready obligations for swap options and securities forming part of the current assets.

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**Accruals and deferrals (assets)**

million euros

Issuing discount from bonds	186.7
Premium on claims	161.6
<b>Issuing and lending business total</b>	<b>348.3</b>

The assets include foreign currency items with an equivalent value of EUR 1,221.1 million and liabilities of EUR 883.4 million.

**Other liabilities**  
Other liabilities essentially consists of accrued interest from subordinated lia-

bilities (EUR 3.2 million) and the profit participation capital (EUR 12.0 million), and premiums received from swaptions (EUR 1.3 million)

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**Accruals and deferrals (liabilities)**

million Euro

Discount from claims	9.1
Premium on bonds	9.5
<b>Issuing and lending business total</b>	<b>18.6</b>

**Subordinated liabilities**

Subordinated liabilities are only refunded in the case of bankruptcy or liquidation of the bank after all preferential creditors have been satisfied. Interest exposure in the case of all subordinated liabilities amounts to EUR 7.6 million.

Of the subordinated liabilities totaling EUR 131.5 two issues with a nominal of EUR 18.0 and EUR 40.0 respectively exceed 10% of the total amount. Interest rates are 5.5% and 4.96% respectively; the issues will mature in 2010 and 2016 respectively.

**Profit participation capital**

The profit participation capital of EUR 206.4 million is with EUR 140.6 million stipulated as liable equity pur-

suant to Section 10 para 5 of the German Banking Act (KWG). Bearers of profit participation shares receive an annual preferential dividend, which takes its bearings from the interest rate settled out in the terms and conditions.

**Subscribed capital**

Subscribed capital remains at EUR 162.5 million. It is divided up into 162,500,000 registered shares of EUR 1.00 each; they have restricted transferability.

**Capital reserve and retained earnings**

The capital reserve was EUR 78.7 million as at December 31, 2007. The other retained earnings were EUR 43.7 at the end of the year after the addition of EUR 7.6 million.

**Other commitments**

The irreversible loan commitments relate entirely to other sureties in sub-item 1b) and in sub-item 2c) to municipal lending amounting to EUR 714.9 million, mortgage loans of EUR 39.5 million and loans to municipal corporations amounting to EUR 358.6 million.

**Repurchase operations**

The book value of the assets sold on the basis of a buy-back agreement amounted to EUR 3,172.0 million.

	Nominal amount in million euros	Interest rate in %	Repayment of capital
Year of issue 1997	1.0	6.95	2008
1997	1.0	6.89	2008
1997	5.1	6.89	2008
1997	2.6	6.86	2008
1997	2.6	6.86	2008
1997	8.2	6.83	2008
1997	2.6	6.80	2008
1997	2.6	6.65	2008
1997	2.6	6.65	2008
1997	7.7	6.65	2008
Year of issue 1998	0.5	6.54	2008
1998	10.2	6.63	2009
1998	4.6	6.63	2009
Year of issue 1999	13.0	variable	2009
Year of issue 2001	3.5	6.97	2012
2001	15.0	6.40	2011
Year of issue 2002	1.0	6.60	2013
2002	5.0	variable	2013
Year of issue 2003	10.0	6.45	2014
2003	10.0	6.52	2014
2003	20.0	6.25	2014
Year of issue 2006	10.0	5.08	2017
2006	4.0	5.08	2017
2006	22,0	4.875	2017
Year of issue 2007	10.0	5.57	2018
2007	10.0	5.57	2018
2007	21.8	5.625	2018

**- Notes on the profit and loss account**

**Personnel expenses**

The personnel expenses for the year under review amounted to EUR 8.4 million. These includes all remunerations to members of the Management Board amounting to EUR 0.9 million.

**Other income/expenses**

The other operating expenses essentially consist of claims arising from reinsurance coverage (EUR 0.2 million) and rental income from buildings owned by the bank that it does not use for its own purposes (EUR 0.1 million); the other operating expenses are essentially com-

prise the related operating costs (EUR 0.1 million) and the insurance premiums (EUR 0.3 million).

**Risk provisioning**

Provisions for possible loan losses have been represented using the possibility of cross-compensation of all income an expense positions according to Section 340 f para. 3 German Commercial Code (HGB). The balance shown is the net of offsetting expense items “Depreciation and write-downs of claims and certain securities, allocation to provisions for possible loan losses” with income items „Income from write-ups to claims and

certain securities as well as from the release of provisions for possible loan losses”.

**Income Taxes**

New deferred tax assets of EUR 0.3 million were formed and EUR 2.1 million retransferred in the year under review. The taxes on income relate to ordinary business activities in their entirety. Tax expenses unrelated to the accounting period were EUR 0.3 million in the period under review.

**Auditor fees**

**Fees in million euros**

The other administrative expenses include the following auditors fees:

	Mazars GmbH Wirtschaftsprüfungsgesellschaft	PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft
Audit of financial statements	0.2	0.2
Other conformations and valuations	0.1	-
Tax consulting	-	0.1
Other services	-	0.2
<b>Total</b>	<b>0.3</b>	<b>0.5</b>

**Other information** \_\_\_\_\_

**Total volume of Pfandbriefe in circulation in million euros**

	Nominal Dec. 31, 2006	Nominal Dec. 31, 2007	Present value Dec. 31, 2006	Present value Dec. 31, 2007	Risk adjusted present value Dec. 31, 2006	Risk adjusted present value Dec. 31, 2007
Mortgage Pfandbriefe	2.6	0.0	2.7	0.0	2.7	0,0
Cover pool	5.0	0.0	6.3	0.0	5.5	0,0
including: derivatives	0.0	0.0	0.0	0.0	0.0	0,0
<b>Surplus cover</b>	<b>2.4</b>		<b>3.6</b>		<b>2.8</b>	

**Maturity structure in million euros, December 31, 2007**

	Up to and including 1 year	From 1 year up to and including 5 years	From 5 years up to and including 10 years	Over 10 years
Mortgage Pfandbriefe	-	-	-	-
Cover pool	-	-	-	-

**Maturity structure in million euros, December 31, 2006**

	Up to and including 1 year	From 1 year up to and including 5 years	From 5 years up to and including 10 years	Over 10 years
Mortgage Pfandbriefe	2.6	-	-	-
Cover pool	-	-	-	5.0

**Total volume of Pfandbriefe in circulation in million euros**

	Nominal Dec. 31, 2006	Nominal Dec. 31, 2007	Present value 31.12.2006	Present value 31.12.2007	Risk adjusted present value 31.12.2006	Risk adjusted present value 31.12.2007
Public Pfandbriefe	33,615.9	32,624.7	33,406.5	31,668.2	31,487.1	30,220.8
Cover pool	35,328.3	34,380.0	37,317.6	35,244.8	35,014.0	33,731.4
including: derivatives	0.0	0.0	0.0	0.0	0.0	0.0
<b>Surplus cover</b>	<b>1,712.4</b>	<b>1,755.4</b>	<b>3,911.1</b>	<b>3,576.6</b>	<b>3,526.9</b>	<b>3,510.6</b>

**Maturity structure in million euros, December 31, 2007**

	Up to and including 1 year	From 1 year up to and including 5 years	From 5 years up to and including 10 years	More than 10 years
Mortgage Pfandbriefe	2,969.0	10,453.3	6,184.6	13,017.8
Cover pool	2,401.7	8,016.9	11,000.9	12,960.5

**Maturity structure in million euros, December 31, 2006**

	Up to and including 1 year	From 1 year up to and including 5 years	From 5 years up to and including 10 years	More than 10 years
Mortgage Pfandbriefe	5,31.6	10,750.7	5,768.5	11,965.1
Cover pool	3,267.7	6,561.5	12,390.4	13,108.7

*Claims used to cover public Pfandbriefe in million euros, December 31, 2007*

Country	Regional authorities	Local authorities	Other debtors	Total
Belgium	45.0	-	175.0	220.0
Denmark	-	-	65.0	65.0
Germany	152.3	9,813.1	9,711.3	8,325.1
Finland	-	-	20.0	20.0
France	-	-	12.7	288.1
Greece	317.0	-	-	-
Great Britain	-	-	-	195.00
International institutions	-	-	-	405.3
Ireland	-	-	-	200.0
Iceland	10.0	-	-	10.0
Italy	345.1	-	-	121.7
Japan	382.3	-	-	-
Canada	-	-	67.1	-
Lithuania	25.0	-	-	-
Luxembourg	-	-	-	30.0
Netherlands	-	-	-	126.4
Norway	-	-	-	100.0
Austria	58.8	1,008.9	-	799.6
Poland	143.0	-	-	-
Portugal	-	275.0	-	-
Switzerland	-	90.6	-	60.4
Spain	-	-	2.0	615.2
Czech Republic	35.0	-	-	-
Hungary	209.3	-	-	-
United States of America	-	61.1	18.6	20.0
Cyprus	40.0	-	-	-
<b>Total</b>				<b>34,380.0</b>

No payments on the cover pool of the public Pfandbriefe are overdue by at least 90 days.

*Claims used to cover public Pfandbriefe in million euros, December 31, 2006*

Country	Regional authorities	Local authorities	Other debtors	Total
Belgium	-	45.0	175.0	220.0
Denmark	-	-	65.0	65.0
Germany	356.8	7,995.0	10,499.0	27,393.8
Finland	-	-	20.0	20.0
France	-	12.7	269.0	281.7
Greece	914.0	-	-	914.0
Great Britain	-	-	205.0	205.0
International institutions	-	-	425.1	425.1
Ireland	-	-	290.0	290.0
Iceland	10.0	-	10.0	20.0
Italy	868.9	-	120.5	989.4
Japan	360.5	-	-	360.5
Canada	-	72.2	-	72.2
Lithuania	25.0	-	-	25.0
Luxembourg	-	-	20.0	20.0
Netherlands	-	-	156.4	156.4
Norway	-	-	80.0	80.0
Austria	58.8	999.4	763.1	1,821.3
Poland	143.0	-	-	143.0
Portugal	280.0	200.0	75.0	555.0
Switzerland	-	93.3	-	93.3
Spain	-	-	627.2	629.2
Czech Republic	175.0	-	-	175.0
Hungary	220.6	-	-	220.6
United States of America	-	92.8	20.0	112.8
Cyprus	40.0	-	-	40.0
<b>Total</b>				<b>35,328.3</b>

### Interest-induced forward transactions

The following interest-induced forward transactions had not been executed at the balance sheet date: forward transactions with borrower's note loans, interest rate swaps, interest currency swaps, commitments from option sales of interest rate swaptions, calls, interest rate cap agreements, borrower's note loans with call option, issue of Pfandbrief with call option. In all cases aforementioned transactions are OTC products.

The bank's swap partners belong without exception to first-class banking groups from OECD member states and are hence also suitable credit institutions within the meaning of Section 5 para. 3 No. 1 of the German Pfandbrief Act (PfandbG).

The net negative market values of the derivatives of EUR -1.3 billion (without accrued interest) are exceeded by positive hidden reserves over EUR 1.3 billion in the book values of the balance sheet items 'Due from banks', 'Due

from customers', 'Securities', 'Due to credit institutions', 'Due to customers' and 'Securitized liabilities'. The total book value of the derivatives (without accrued interest) amounts to EUR -83.4 million.

The Present value of the derivatives is calculated with the help of zero bond discount factors and the future cash flow on the basis of the market value method. The arbitrage-free zero bond discount factors are calculated each business day from the current swap mid interest curve. Highly structured derivatives for which no valuation model existed as at December 31, 2007 were valued with the floating leg. Trading activities in derivatives are not transacted.

### Loans to members of the Management Board or Supervisory Board

There were no loans or advances granted to any member of the Management Board or the Supervisory Board at balance sheet date.

### Number of employees

The bank had an annual average of 92 employees. Of these 52 were employees paid in line with the collective pay scale and 40 get individually agreed salaries.

### Group affiliation

Dexia Kommunalbank Deutschland AG is an associated company with Dexia Crédit Local SA, Paris, and Dexia SA, Brussels. Its annual financial statements are included in their consolidated financial statements. These are deposited with the Commercial Register kept in Paris and Brussels respectively.

### Volume in the derivatives business in million euros according to residual maturities

	Nominal volumes				Market values		
	Within 1 year	1-5 years	Over 5 years	Total	Positive	Negative	Total
Interest rate swaps	38,310.3	24,456.5	53,628.1	116,394.9	1,191.4	-2,529.9	-1,338.5
Cross-currency-swaps	74.4	485.3	1,640.5	2,200.2	196.8	-146.3	50.5
Options	193.2	417.0	146.1	756.3	0.0	-13.7	-13.7
<b>Total</b>	<b>38,577.9</b>	<b>25,358.8</b>	<b>55,414.7</b>	<b>119,351.4</b>	<b>1,388.2</b>	<b>-2,689.9</b>	<b>-1,301.7</b>

## **Supervisory Board**

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François Duroillet  
*Deputy Executive Vice President  
Public Finance  
Head of Public Finance Network & FSA  
Department  
Dexia SA  
Chairman*

Claude Schon  
*Head of Group Treasury  
Member of the Treasury & Financial  
Markets Executive Committee  
Dexia SA  
Deputy Chairman*

Jean Le Naour  
*Member of the Management Board  
of Dexia Crédit Local  
Head of Finance, Operations  
and IT Department  
Dexia Crédit Local*

Xavier Rojo  
*Senior Vice President  
Innovation & Financial Engineering -  
Public Finance Department  
Dexia SA*

Karen Birgit Reinecke  
*(until March 29, 2007)  
Bank employee*

Stephan Schlegel (until March 29, 2007)  
*Bank employee*

Hans Handschuh  
*(since March 29, 2007)  
Bank employee*

Sascha Riegenring  
*(since March 29, 2007)  
Bank employee*

## **Management Board**

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Giselbert Behr  
*Chairman*

Patrick Giacobbi

Wilfried Wouters

# Certificate of the legal representatives

We certify that to the best of our knowledge the annual financial statements were prepared in accordance with the principles of due and proper accounting and give a true and fair view of the assets, liabilities, financial position and income

of the company. We also certify that to the best of our knowledge the development and result of business activities are presented in the Status Report in such a way that a true and fair view is portrayed and that the significant opportunities


and risks according to Section 289 para. 1 sent. 4 of the German Commercial Code (HGB) are described.

Berlin, March 13, 2008  
Dexia Kommunalbank Deutschland AG

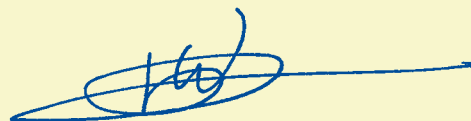
Management Board



Behr



Giacobbi



Wouters

# Statutory Auditors' Report

“We have audited the annual financial statements, comprising the balance sheet, the income statement and the notes to the financial statements, together with the bookkeeping system, and the management report of Dexia Kommunalbank Deutschland Aktiengesellschaft, Berlin, for the business year from January 1 to December 31, 2007. The maintenance of the books and records and the preparation of the annual financial statements and management report in accordance with German commercial law and supplementary provisions of the articles of incorporation are the responsibility of the Company’s Board of Managing Directors. Our responsibility is to express an opinion on the annual financial statements, together with the bookkeeping system, and the management report based on our audit. We conducted our audit of the annual financial statements in accordance with § 317 HGB (“Handelsgesetzbuch”: “German Commercial Code”) and German generally accepted standards for the audit of financial statements promulgated by the

Institut der Wirtschaftsprüfer (Institute of Public Auditors in Germany) (IDW). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the annual financial statements in accordance with German principles of proper accounting and in the management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Company and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the books and records, the annual financial statements and the management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the accounting principles used and significant estimates made

by the Company’s Board of Managing Directors, as well as evaluating the overall presentation of the annual financial statements and management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

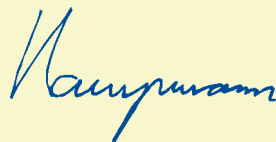
In our opinion, based on the findings of our audit, the annual financial statements comply with the legal requirements and supplementary provisions of the articles of incorporation and give a true and fair view of the net assets, financial position and results of operations of the Company in accordance with German principles of proper accounting. The management report is consistent with the annual financial statements and as a whole provides a suitable view of the Company’s position and suitably presents the opportunities and risks of future development.”

Frankfurt am Main, March 14, 2008

Mazars GmbH  
Wirtschaftsprüfungsgesellschaft



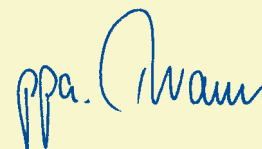
(Jürgen App)  
Auditor



(Oliver Kampmann)  
Auditor



(Roman Berninger)  
Auditor



(Mirko Braun)  
Auditor

Berlin, March 14, 2008

PricewaterhouseCoopers AG  
Wirtschaftsprüfungsgesellschaft

# Further explanatory remarks

## Development of structures - Assets in million euros

	2007	2007 in %	2006 in %
<b>Due from banks</b>			
b) Loans to the public sector	3,429.7	7.4	7.7
c) Other claims	2,838.3	6.1	11.3
<b>Due from customers</b>			
a) Mortgage loans	134.9	0.3	0.1
b) Loans to the public sector	21,079.4	45.6	38.9
c) Other claims	280.7	0.6	0.4
<b>Bonds and other fixed interest securities</b>			
b) Bonds and notes	17,698.9	38.3	40.2
c) Own bonds	13.7	0.0	0.0
Other assets	739.4	1.6	1.4
<b>Balance sheet total</b>	<b>46,214.9</b>	<b>100.0</b>	<b>100.0</b>

## Development of structures - Liabilities in million euros

	2007	2007 in %	2006 in %
<b>Due to banks</b>			
a), b) Registered Pfandbriefe	1,479.3	3.2	3.9
c) Other liabilities	7,259.4	15.7	14.7
<b>Due to customers</b>			
a), b) Registered Pfandbriefe	15,707.4	34.0	30.9
c) Other liabilities	2,095.4	4.5	4.9
<b>Securitized liabilities</b>			
aa) Public Pfandbriefe	18,802.5	40.7	43.7
ab) Other debt securities	88.6	0.2	0.2
Subordinated liabilities	131.5	0.3	0.3
Profit participation capital	206.4	0.4	0.4
<b>Equity</b>			
a) Subscribed capital	162.5	0.4	0.4
b), c) Reserves	122.4	0.3	0.3
d) Net income	10.2	0.0	0.0
Other liabilities	149.3	0.3	0.3
<b>Balance sheet total</b>	<b>46,214.9</b>	<b>100.0</b>	<b>100.0</b>

*Profit and loss account/ Statement of operating results in thousand euros*

	2007	2006	Veränderung	Change in %
Interest income	5,365,212	4,551,965		
Interest expenses	5,297,167	4,485,328		
Interest surplus	68,045	66,637	1,408	2.1
Commission income	-2,607	-4,337		
Interest and commission surplus	65,438	62,300	3,138	5.0
Net income from financial transactions	0	0		
Personnel expenses	8,439	7,402		
Other administrative expenses	8,043	7,832		
Depreciations of tangible assets	1,519	1,284		
Part operating result	47,437	45,782	1,655	3.6
Other operating income/ expenses	153	11		
Risk provisioning	-33,355	-23,560		
Securities income	2,732	8,856		
Operating result	16,968	31,089	-14,122	-45.4
Net income	10,200	19,000	-8,800	-46.3

*Development of the bank over a five-year period, in thousand euros*

	2003	2004	2005	2006	2007
Interest surplus	63,250	63,815	64,437	62,300	65,438
Part operating result	47,930	49,276	49,271	45,782	47,437
Operating result	18,157	22,720	23,816	31,089	16,968
Net income	11,800	12,700	17,000	19,000	10,200
<b>Balance sheet total in million euros</b>	<b>32,849</b>	<b>35,050</b>	<b>39,223</b>	<b>45,693</b>	<b>46,215</b>

*Publisher's details* \_\_\_\_\_

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