



# Annual Report 2006



# Hypo Pfandbrief Bank International S.A.

## Annual report 2006

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# Management report

## 1. Economic setting

Showing a real growth rate of around 5 %, the world economy continued to be robust in 2006. Although China is the unchallenged frontrunner, the developed economies also succeeded in meeting or exceeding their expected growth rates in 2006. In spite of the suspension of the current trade-liberalisation negotiation round in the World Trade Organisation in summer 2006, global economic integration continued unabated. As a result, the volume of world trade grew almost twice as strongly as world value added. Equities markets reflected this good climate. Apart from in Japan, indexes rose in all industrialised countries by a two-digit figure – and worldwide by about 18 %.

Also in 2006 this stable growth has to be seen against the background of a rapid rise in commodities prices. On a US dollar basis, a price rise of 30 % was recorded. Massive current account balance disequilibria continue to be problematic; despite somewhat stricter budgetary discipline on the part of the US administration, the US current account deficit rose slightly yet again to reach 7 % of gross domestic product. In contrast, China recorded a surplus of about the same magnitude in percentage terms. However, after a respite in 2005, the depreciation of the US dollar resumed – above all against the euro, which increased by over 11 % against the dollar.

Although consumer price inflation worldwide increased slightly in comparison with 2005, it may still be regarded as moderate. The major central banks increased their key interest rates in 2006. However, as far as long-term interest rates are concerned, the effect remained within fairly tight limits.

In 2006 the economy in Luxembourg gathered further momentum to show a growth rate of over 5 %. The financial sector above all constituted the locomotive for this growth, contributing for the first time 30 % to value added. As a result of this boom, above-average growth rates were also attained in the management consultancy/services sectors. With a per capita purchasing power of € 57,000, Luxembourg continues to occupy the leading position in the European Union.

For 2007, a general slight cooling-off in the economy is expected. This applies both to the major regions of the world and to Luxembourg. In 2007 oil prices are estimated to reach between 60 and 65 US dollars per barrel, whilst the forward markets for other commodities tend to point to a decline in prices. Alongside geopolitical risks, which are hard to predict, high current account balance disequilibria continue to give rise to concern worldwide. The continuing high US deficit is dependent upon international investors' readiness to continue to alter their portfolios in favour of US assets. One condition for this is that the real estate boom does not come to an abrupt end in the USA.

## 2. Financial report

The Bank's seventh financial year began with its shareholder, Hypo Public Finance Bank, Dublin, issuing a guarantee for Hypo Pfandbrief Bank International on 4 January 2006, as a result of which the rating agency Standard & Poor's raised the Bank's counterparty rating to A- (outlook: stable) and the short term rating to A-2. Our lettres de gage continue to be rated AAA. Hypo Pfandbrief Bank International is the centre of competence for the (coverable) public finance business of the Hypo Real Estate Group.

On this basis, the Bank succeeded in recording the largest volume of new business in its history. The banks range of lending was prudently enlarged whilst, however, maintaining a conservative risk policy. At the same time, commitments in North America were strongly expanded in close cooperation with our colleagues of Hypo Public Finance USA, Inc.. As a result, it was possible to increase the new business acquired in spite of intensive competition without making any compromises in the margins sought. In this way, notwithstanding the rise in interest rates over the year, the positive trend in terms of results was successfully maintained.

In new issues trading, the Bank also succeeded in selling the largest volume ever achieved in its history. While extending the average maturity, we have increased the volume of public lettres de gage in circulation from just over € 4 billion at the end of the last financial year to currently markedly over € 6 billion. For the first time, we succeeded in placing a large-volume US dollar lettre de gage on the market and not least as a result of this transaction have been able to extend our investor base. In numerous talks with investors, we have used the opportunity to explain our business model and the new set-up within the Hypo Real Estate Group.

HPBI's Board of Directors held three meetings to discuss and decide on matters for which there is a reporting obligation under our Articles of Association and our rules of procedure. The closer intermeshing of Hypo Pfandbrief Bank International with Hypo Public Finance Bank has been continually pursued by the Board. As a result, the Bank's lending processes have been integrated with those of Hypo Public Finance Bank in order to make the necessary lending decisions in day-to-day business operations more transparent and efficient. In shaping those processes,

account was taken of legal requirements and it was ensured that the executive bodies of Hypo Pfandbrief Bank International are appropriately represented in the decision-making processes.

**2.1. Lending operations** In the year under review, we acquired securitized claims of € 3,238 m (previous year € 933 m) including € 2,968 m (previous year € 677 m) of securities issued by public-sector borrowers or guaranteed by public institutions. As against this accrual, there were disposals in the form of redemptions, maturities and sales of € 787 m (previous year € 987 m). Derivatives were used to hedge against risks arising out of market changes.

**2.2. Funding operations** Covered bearer and registered public-sector Pfandbriefe (lettres de gage publiques) were issued in a nominal value of € 3,549 m (previous year € 842 m). Bearer bonds not requiring cover were issued to the extent of € 30 m. As in the previous year, subordinated funds were not issued.

In addition to drawings in EUR, we issued in CHF and USD. The bearer issues were floated within the framework of our MTN programme (Programme for the Issuance of Debt Instruments).

Of our issues in circulation, nine were scheduled for repayment during the year under review, totalling € 1,033 m (previous year € 1,411 m). Two issues totalling € 15 m were redeemed or terminated before term.

The limit of our commercial paper programme was utilised at the year's end with € 110 m (previous year € 65 m). The average maturity of the commercial papers issued over the course of the year amounted to 151 days. New issues were denominated in EUR.

**2.3. Balance-sheet movements and earnings** The balance-sheet total amounts to € 9,295 m, which represents a 31.0 % increase as compared to the previous year (€ 7,093 m).

Loans and advances, including securities, amount to € 8,272 m. This represents an increase of 34.3 % as compared to the previous year (€ 6,160 m).

The refinancing capital amounts to € 8,901 m. This is 31.1 % up on the previous year (€ 6,787 m).

**2.4. Profit and loss account in tabular form** The higher trading volume enabled net interest income to be increased by 25.5 % as compared with the previous year. While pursuing a very conservative risk policy, the interest rate and spread trend was used to achieve additional income from the sale of securities from the Bank's investment holdings. As a result of the closure of the Luxembourg branch of Hypo Real Estate Bank International, which in the past shared the same staff, the corresponding commissioning and hence also the income from other operating income and expenses no longer apply.

<b>Profit and loss account in tabular form</b>			
in thousand €		31.12.2006	Previous year
Net interest income		9,243	7,365
Net commission income		-380	-631
Net income from financial operations		-411	755
Staff costs	-1,852		-2,079
Other administrative expenses	-2,680		-2,238
Depreciation in respect of property, plant and equipment	-69		-36
Current expenses		-4,601	-4,353
Other operating income/expenses		556	3,758
Operating result before risk provisions		4,407	6,894
Capital gains/losses in respect of investment holdings		4,501	1,272
Risk provisions		-1,000	-1,250
Operating result after risk provisions		7,908	6,916
Taxes		-1,708	-1,366
<b>Net income for the year</b>		<b>6,200</b>	<b>5,550</b>

We intend to allocate the whole of the net income recorded for the year to the reserves in order to strengthen our capital base.

**2.5. Net income and profit appropriation** We achieved a net income after tax of € 6,200 k for the year under review (previous year € 5,550 k). This corresponds to an increase of 11.7 %.

We shall propose to the General Meeting that € 310 k be allocated to the legal reserve and € 5,890 k to the free reserves.

### 3. Risk report

**3.1. Organisation, responsibilities and tasks** As a member of the HRE Group, HPBI is integrated into the methods/processes of the Group's risk identification, measurement, limitation, control and management. In this context and that of local provisions, the Bank monitors risks independently. In that regard, major tasks lie with the risk control unit. This unit, which reports directly to a member of the management who is independent of portfolio and risk management, has kept pace with the Bank's growth and further developed the risk measurement and control systems accordingly in response to the constantly changing internal and external requirements. The main functions of this unit are:

- day-to-day risk measurement and monitoring of market, credit, counterparty, foreign exchange and liquidity risks, largely on the basis of the value-at-risk approach,
- daily determination of economic performance,
- independent monitoring of the parameters used to measure risk and performance,
- refinement and implementation of our risk control concepts.

The continual improvements made to our measurement and control systems and the integration into the risk control system of Hypo Public Finance Bank and the HRE Group mean that the Bank has high-performance risk control.

In order to monitor and control individual risks, we have set up appropriate reporting lines and control measures, as a result of which, not only the Bank's management and the Board of Directors are informed, but also all other levels within the HRE Group. As a result of the Bank's integration with the Group, it is also ensured that developments, such as the introduction of Basle II, are transposed in situ having regard to local provisions. An explanation follows of the major types of risk arising for the Bank.

### 3.2. Risk measurement, control and management with respect to major types of risk in HPBI

**3.2.1. Address risks** Address risks may be broken down into credit, counterparty, issuer and country risks and refer in each case to the potential loss of value which may arise in the event of the default or a decrease in creditworthiness of borrowers, issuers of loans evidenced by promissory notes and securities or counterparties to money-market, securities and derivatives transactions.

Our exposure to address and credit risks is restricted to public-sector borrowers and banks in OECD countries. The utilisation of all credit lines is available for each individual counterparty, and also in aggregated form, online on a market-value basis.

In the case of organisational measures and the functional separation of credit processes, not only is compliance with the legal conditions in Luxembourg ensured, but also the Bank, as a member of the HRE Group, acts in accordance with the German minimum

requirements for the conduct of credit transactions (MaK) and risk management (MaRisk).

Counterparty risks designate possible losses in value of interest-rate and foreign-currency based derivatives and futures. Such transactions are concluded predominantly in order to hedge positions in the context of assets/liabilities management. The yardstick for counterparty risks used throughout the Group is a value-at-risk approach based on a market-valuation method using potential future replacement costs. Address risks in derivatives, securities and money-market transactions exist with credit institutions, central banks and supranational institutions whose creditworthiness is to be regarded as above average according to the assessment of external rating agencies and in-house rating procedures. In order to reduce derivatives-based counterparty risks, the Bank uses framework contracts with its business partners which enable the contracts covered by the framework contract to be set against a net claim in the event that the counterparty does not fulfil its obligations (so-called close-out netting). In order to reduce the risk further, where appropriate, security agreements are concluded which may lead to the termination of transactions in the event that the counterparty does not comply with a request to provide security.

The HRE Group designates as country risk the risk of potential transfer and conversion problems with contracting parties based abroad. The address risk consists in the possibility that a debtor which is in principle solvent and willing to pay will not be able to fulfil its payment obligations because it is not in a position to procure foreign exchange or to transfer assets to non-residents on account of state measures. Country risks are constantly monitored by risk control. Management of country risks by credit-risk management is carried out on the basis of country limits.

Depending on the results of the in-house rating process of the HRE Group

(1) each individual country and  
 (2) groups of countries in specific rating corridors are assigned ceilings restricting business activities. All country ratings and country limits are checked at least once a year by the HRE Group's credit portfolio committee. In addition, in-house risk assessments are regularly checked against the assessments of the major rating agencies.

**3.2.2. Market risk** By market risk is meant the potential loss which may arise as a result of changing prices on financial markets. In this connection, as in the case of all banks belonging to the HRE Group, total lending business, all own issues, the securities making up the investment and liquidity provision holdings and all transactions in derivatives are taken into account. The ensuing market risks consist predominantly of risks of changes in interest rates.

In this context, a distinction is made between general and specific interest rate risks (spread risks). The former measure the possible changes in the present value of positions in the event of shifts in the risk-free interest curve (swap curve). The measurement of spread risks, which is to be refined still further in 2007 and introduced in the whole HRE Group, takes account of possible changes in present value in the event that the credit spreads factored in the prices of securities and foreign currencies alter.

At the Bank, as in all banks belonging to the HRE Group, currency risks are hedged as extensively as possible and therefore are present only to a slight extent.

For the purposes of the day-to-day quantification of market risk, HPBI uses a value-at-risk approach

which is uniform for the whole of the HRE Group. This determines a potential loss assuming a 10-day holding period and a 99 % level of confidence. The period of consideration of historical data is 250 trading days. The value-at-risk is determined daily by local risk control and reported to management, the Board of Directors and competent authorities of the HRE Group. With this system, the Bank is in a position at any time to manage the consequences of potential market fluctuations, such as, for example, interest-rate changes or currency rate movements, in a timely manner and efficiently. The average exposure to interest rate risks was € 1.3 m in 2006.

The day-to-day determination, limitation and reporting of the value-at-risk and of the present value changes which have actually occurred are supplemented by regular back testing and stress testing. By comparing the value-at-risk values with the daily changes in present value which have actually occurred, the quality of the procedure used is constantly checked and optimised. This has confirmed the statistical assumptions used in our models. Whilst the value-at-risk measures the market risk in the case of “normal” market fluctuations, simulation of stress scenarios is used to measure also potential present value changes in the event of very extreme and extraordinary market movements so as to guarantee that the undertaking can continue at any time also in such cases. Even in such circumstances, the measured market risk moved within the “normal limits”.

**3.2.3. Liquidity risk** The principal aim of controlling liquidity risks is to guarantee the Bank’s unrestricted solvency at any time. In accordance with the in-house limit system, foreseeable incoming and outgoing payment flows and any liquidity-procuring measures, the so-called liquidity position, must be at least in bal-

ance at all times over the following five days. This position is determined daily on the basis of conservative precautionary deductions (“haircuts”), monitored by risk control and reported to management and the group authorities responsible for risk supervision. In addition, every day a liquidity status is determined on the basis of a rolling thirty-day horizon and reported. This covers all future payment flows, together with the liquidity potential arising out of securities not used for cover, and enables precise liquidity control to be carried out. Furthermore, in order to be able to recognise short-term refinancing needs at an early stage, a liquidity preview extended to 90 days is produced independent of trading, which serves as the basis for active and foresighted liquidity policy.

We have connections with a number of well-performing banks in order to meet short-term liquidity requirements.

**3.2.4. Operational risk** Operational risk is increasingly gaining in importance with the increasing complexity of international transactions.

In the HRE Group, operational risk has been defined, in conformity with regulatory requirements, as an unexpected loss caused by erroneous in-house practices, human error, technological failure or external events. This definition includes legal risks. Strategic risks and reputation risks are not included.

In 2006, the HRE Group largely concluded the centrally managed design and implementation of the OpRisk Management System taking account of the requirements of “Sound Practices for the Management and Supervision of Operational Risk” in accordance with Basle II. The organisational framework, which is uniform for the Group, for the task and responsibility structure and the introduction of

technical support for recording and identifying operational risk is planned to be implemented in HPBI in 2007.

At present, HPBI manages these risks by means of control mechanisms using fixed procedures.

**3.3. Summary overview** The procedures used for the early risk detection, measurement and supervision of all types of risk will be subject to on-going further development also in 2007 taking account of the increasingly complex products and business processes. Comprehensive, independent reporting, together with the extension of risk/return analysis, support the aim of the risk-profile optimisation conducted by HPBI and the HRE Group.

A further central task for HPBI and the HRE Group in 2007 will be the supervisory examination of the comprehensive Basle II provisions.

#### 4. Other information

We are fully consolidated in the IFRS financial statements of Hypo Real Estate Holding through Hypo Real Estate Bank International AG and, since 1 January 2006, additionally through Hypo Public Finance Bank.

#### 5. Outlook

In 2006 Hypo Pfandbrief Bank International proved that it can grow successfully also under difficult market conditions. We intend to continue with this trend. Ever closer integration into Hypo Public Finance Bank and the resulting synergy effects will enable us to make a substantial contribution to the success of Hypo Public Finance Bank also in the future.

The development of business and earnings has continued as expected since 31 December 2006.

No events of particular significance as regards the assets, financial and earnings position for the past financial year have arisen since the end of the financial year.

14 February 2007

The Board of Directors





# Annual accounts

## Balance sheet as at 31 December 2006

<b>Assets</b>		<b>31.12.2006</b>	<b>Previous year</b>
in €			
Cash in hand, balances at central banks and postal check offices		318	707
Loans and advances to credit institutions		1,102,077,543	1,414,709,506
Municipal loans and loans guaranteed by public institutions	618,649,032		607,009,531
Other loans and advances	483,428,511		807,699,975
of which payable on demand	85,273,334		11,268,586
Loans and advances to customers		806,928,966	696,419,703
Municipal loans and loans guaranteed by public institutions	787,380,197		676,675,841
Other loans and advances	19,548,769		19,743,862
Bonds and other fixed-interest securities		6,363,052,446	4,048,861,918
Public sector issuers	2,416,774,330		2,130,846,652
Other issuers	3,824,679,784		1,781,148,166
Own bonds	121,598,331		136,867,100
Property, plant and equipment		268,007	90,420
Other assets		102,387	799,336
Prepayments and accrued income		1,022,568,460	932,522,576
<b>Total assets</b>		<b>9,294,998,126</b>	<b>7,093,404,166</b>

<b>Liabilities</b>				
in €			<b>31.12.2006</b>	<b>Previous year</b>
Amounts owed to credit institutions			1,786,906,110	1,848,038,637
Registered public sector Pfandbriefe issued		25,000,000		25,000,000
of which with agreed maturity dates or periods of notice		25,000,000		25,000,000
Other liabilities		1,761,906,110		1,823,038,637
of which payable on demand		1,104,918		1,696,688
of which with agreed maturity dates or periods of notice		1,760,801,191		1,821,341,949
Amounts owed to customers			1,236,453,234	1,081,407,702
Other liabilities		1,236,453,234		1,081,407,702
Registered public sector Pfandbriefe issued	1,236,453,234			1,081,407,702
of which with agreed maturity dates or periods of notice	1,236,453,234			1,081,407,702
Debts evidenced by certificates			5,877,348,827	3,857,416,026
Issued bonds		5,767,348,827		3,792,416,026
Public sector Pfandbriefe	5,737,348,827			3,792,416,026
Other bonds	30,000,000			–
Other		110,000,000		65,000,000
Other liabilities			263,847	319,074
Accruals and deferred income			248,169,543	166,942,242
Provisions			5,134,723	4,758,643
Provisions for taxation		3,985,021		3,211,992
Other provisions		1,149,702		1,546,651
Subordinated liabilities			34,000,000	34,000,000
Subscribed capital			66,000,000	66,000,000
Additional paid in capital			15,000,000	15,000,000
Reserves			19,521,842	13,971,842
Net income			6,200,000	5,550,000
<b>Total liabilities</b>			<b>9,294,998,126</b>	<b>7,093,404,166</b>

## Profit and loss account

for the period from 1 January to 31 December 2006

<b>Expenses</b>				
in €			<b>31.12.2006</b>	<b>Previous year</b>
Interest paid and similar expenses			617,813,862	492,541,640
Commissions payable			676,515	631,447
Result from financial operations			410,716	–
General administrative expenses			4,531,751	4,316,825
Staff costs		1,851,776		2,078,989
of which wages and salaries	1,599,631			1,076,150
of which social security	195,615			328,292
of which relating to pensions	150,584			260,431
Other staff expenses	56,530			674,547
Other administrative expenses		2,679,975		2,237,836
Depreciation and value adjustment in respect of intangible assets and property, plant and equipment			69,344	36,352
Other operating expenses			327	57,962
Depreciation and value adjustment in respect of loans and advances and provision for contingent liabilities and credit risks			1,000,000	1,250,000
Depreciation and value adjustment in respect of securities held as financial assets			202,500	1,052,556
Taxes on income from ordinary activity			1,708,329	1,365,801
Profit for the financial year			6,200,000	5,550,000
<b>Total expenses</b>			<b>632,613,344</b>	<b>506,802,583</b>

<b>Income</b>				
in €			<b>31.12.2006</b>	<b>Previous year</b>
Interest receivable and similar income			627,057,037	499,906,928
arising from fixed-interest securities		275,204,524		229,814,358
Commissions receivable			296,216	–
Result from financial operations			–	754,634
Other operating income			556,155	3,816,242
Income in respect of write-backs of value adjustments in respect of securities held as financial assets, in respect of participating interests and shares held in affiliated companies			4,703,936	2,324,779
of which profits from the sale of fixed-interest securities held as financial assets		4,703,936		2,324,779
<b>Total income</b>			<b>632,613,344</b>	<b>506,802,583</b>

## Auditor's report

**Report on the annual accounts** In accordance with the mandate given to us by the Board of Directors on 21 February 2006, we have audited the attached annual accounts of Hypo Pfandbrief Bank International S.A., which consist of the balance sheet as at 31 December 2006 and the profit and loss account for the financial year, 1 January to 31 December 2006, which ended on that date, as well as the notes thereto.

**Responsibility of the Board of Directors for the annual accounts** The preparation and fair presentation of these annual accounts in accordance with the legislation and regulations in force in Luxembourg on the preparation and presentation of the annual accounts fall within the responsibility of the Board of Directors. That responsibility covers the development, implementation and maintenance of the internal control system with regard to the preparation and fair presentation of the annual accounts so that these are free from material misstatements, irrespective as to whether these result from inaccuracies or infringements, the selection and application of appropriate accounting principles and methods and the determination of appropriate accounting estimates.

**Responsibility of the auditor** It is our responsibility to issue an attestation on the basis of our audit of these annual accounts. We carried out our audit in accordance with the International Standards on Auditing implemented by the Institut des Réviseurs d'Entreprises. These standards require us to comply with our professional obligations and principles and to plan and carry out the audit in such a way as to obtain reasonable assurance whether the annual accounts are free from material misstatements.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the annual accounts. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatements of the annual accounts, whether due to inaccuracies or infringements. In making those risk assessments, the auditor considers the internal control system relevant to the preparation and fair presentation of the annual accounts in order to determine audit procedures that are appropriate in the circumstances, but

not for the purpose of issuing an attestation as to the effectiveness of the internal control system.

An audit also includes assessing the appropriateness of the accounting principles and methods used and the reasonableness of accounting estimates made by the Board of Directors, as well as the overall presentation of the annual accounts. We believe that the audit evidence obtained is sufficient and appropriate for the issue of our attestation.

**Attestation** In our estimation, the attached annual accounts provide, in accordance with the legislation and regulations in force in Luxembourg on the preparation and presentation of annual accounts, a true and fair view corresponding to the actual circumstances of the assets and financial position of Hypo Pfandbrief Bank International S.A. as at 31 December 2006 and the earnings position for the financial year, 1 January to 31 December 2006, which ended on that date.

**Report on further legal and supervisory obligations** The Management Report, which falls within the responsibility of the Board of Directors, is in accordance with the annual accounts.

Luxembourg, 14 February  
KPMG Audit S.à r.l. – Réviseurs d'Entreprises

Thomas Feld  
Christian Brüne



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## 1 General notes

Hypo Pfandbrief Bank International S.A. (HPBI) was founded on 27 July 1999 in Luxembourg under its original name of Pfandbrief Bank International S.A. (PBI). On 14 September 1999, a licence to operate the bank as a mortgage credit bank (banque d'émission de lettres de gage) under Luxembourg law was issued by the Minister of Finance of the Grand Duchy of Luxembourg.

The entry in the commercial register was made on 16 August 1999 under number 71104 (Section B). The legal basis for the operation of a mortgage credit bank is laid down in Articles 12-1 to 12-9 of the Law of 5 April 1993 on the financial sector (in its version in force at that time).

The Bank was originally founded by Bayerische Hypo- und Vereinsbank AG (HVB) and its German mortgage bank subsidiaries, each with equal shares in the capital, under a holding scheme.

Within the framework of the reorganisation of the HVB Group in 2003, the commercial real estate busi-

ness was spun off and bundled with other mortgage bank activities into Hypo Real Estate Group. In this transformation process, all shares in HPBI were taken over by Hypo Real Estate Bank International, Dublin. In a restructuring operation, Hypo Real Estate Bank International, Dublin, was renamed Hypo Public Finance Bank, Dublin, as of 1 January 2006.

All shares in the Bank are held by Hypo Public Finance Bank, Dublin, with the exception of one share, which is held by a trustee. The Bank's subscribed capital is fully paid-up. The name of the Bank was changed with effect from 1 September 2004 to Hypo Pfandbrief Bank International S.A., in order to highlight the fact that it is part of the Hypo Real Estate Group.

Hypo Pfandbrief Bank International S.A. is integrated into the group accounts of Hypo Real Estate Holding AG as well as into the subgroup accounts of Hypo Public Finance Bank, Dublin. The financial statements are available at the registered offices of the respective companies in Munich, Stuttgart and Dublin.

## 2 Balance-sheet and valuation methods

The Bank's balance-sheet and valuation methods are in compliance with the rules in force in the Grand Duchy of Luxembourg, in particular the Law of 17 June 1992 regarding the financial statements and the consolidated financial statements of credit institutions ("the Law"). The breakdown of the balance sheet differs from that provided for in the Law since it is based on the CSSF recommendation on the annual accounts of mortgage credit banks.

The capital currency is the euro (€).

**Provisions** The bank pursues a policy of making specific provisions in order to cover risks of loss and default in relation to existing claims.

In compliance with the tax provisions in force in Luxembourg, the option of a general provision has been used to secure against latent credit risks. The upper limit of 1.25 % of the risk-weighted address risks which must be observed in this respect is utilised in part.

### 2.1 Fixed assets

**Property, plant and equipment** Property, plant and equipment are stated in the balance sheet at acquisition cost or production cost, less accumulated value adjustment. Property, plant and equipment depreciate over time, which is taken into account by means of scheduled adjustments.

The adjustments are tailored according to normal operating life. In view of the planned replacement of PCs/servers throughout the Group at the beginning of 2007, the IT equipment (€ 27,901) was written off unscheduled during the year under review.

The adjustment rates applied as at the balance-sheet date are set out in the table below.

Assets acquired with acquisition/production costs of up to a maximum amount of € 870 or with a useful life of less than one year are written off in full in the year of acquisition.

	Adjustment rate	Method
Office and business equipment	20.00 %	linear
IT (hardware/software)	33.33 %	linear

**Financial assets** Holdings of bonds and other fixed-interest securities intended to serve the business in the long term and fulfilling supervisory requirements are valued at acquisition cost or, in the case of foreseeable long-term depreciation, at the lower of the stock market or market price in connection with the so-called Beibehaltungsprinzip (valuation principle retaining previously established value adjustments). All securities of the cover fund are valued at acquisition cost. Securities hedged by interest-rate swaps (asset swaps) are also valued at acquisition cost.

Other fixed-interest securities are valued at the lower of the stock market or market price.

Premiums and discounts are apportioned pro rata temporis in the income statement over the residual maturity of the securities.

## 2.2 Current assets

**Bonds and other fixed-interest securities** Bonds and other fixed-interest securities which are not considered as financial assets are entered at acquisition cost and allocated in full to liquid assets.

The securities are valued on the basis of the strict lowest value principle in accordance with the Beibehaltungsprinzip. The values are then shown at the lower of the stock-market price as at the balance-sheet date or, if this cannot be established, the probable sales value or at the price which best reflects the value of the securities.

Redeemed own bonds hedged by asset swaps are valued at acquisition cost.

**Loans and advances** Loans and advances are shown at their nominal values. Interest accrued, but which is not yet due, is entered under prepayments and accrued income on the asset side of the balance sheet. Premiums and discounts are apportioned according to their maturity.

## 2.3 Liabilities / provisions

Liabilities are entered at their nominal or repayment amount, provisions at the amount required on the basis of a reasonable commercial judgement

## 2.4 Acquisition or production costs of similar inventory items and all fungible assets, including securities

The Bank uses the weighted average price method to determine the acquisition cost.

## 2.5 Currency conversion

Assets and liabilities not denominated in euro are converted into the capital currency at the mid spot rate on the balance-sheet date.

Income and expenditure in foreign currency are converted into the capital currency at the relevant current rate.

The effects arising from these valuation principles are shown in the income statement.

Covered spot and forward items are valued without effect on the income statement. The imparity principle is applied to the valuation results arising out of uncovered items.

## 2.6 Valuation of financial derivatives

Financial derivatives are recorded on the date of the conclusion of the transaction as off-balance-sheet items. They are valued at market prices on the relevant trading date having regard to the imparity principle unless they are used to hedge the Bank's market risks.

## 3. Notes on the asset items

### 3.1 Presentation of assets as at 31 December 2006

Maturity schedule	Loans and advances to credit institution (including central bank balances)		Loans and advances to customers	
	31.12.2006	Previous year	31.12.2006	Previous year
in thousand €				
Payable on demand	85,273	11,269	13	13
Up to 3 months	283,578	816,883	25,564	–
Over 3 months and up to 1 year	33,518	87,367	–	30,678
Over 1 year and up to 5 years	292,361	222,025	501,781	453,577
Over 5 years	407,348	277,166	279,571	212,152
<b>Total</b>	<b>1,102,078</b>	<b>1,414,710</b>	<b>806,929</b>	<b>696,420</b>
of which subordinated claims	–	–	–	–

Loans and advances to credit institutions payable on demand include balances with the Central Bank of € 129.

Loans and advances to credit institutions include return claims arising from securities lent in the amount of € 150,587 k.

### 3.2 Presentation of loans and advances and/or bonds and other fixed-interest securities vis-à-vis affiliated companies

in thousand €	31.12.2006	Previous year
Loans and advances to credit institutions	291,220	225,000
Loans and advances to customers	–	–
Bonds and other fixed-interest securities	146,598	226,837
<b>Total</b>	<b>437,818</b>	<b>451,837</b>
of which own bonds	121,598	136,867
of which subordinated claims	–	–

### 3.3 Breakdown on the basis of standardised risk weightings

<b>Calculation of balance sheet risk volume</b> in thousand €	<b>Nominal Amount</b>	<b>Weighting</b>	<b>Risk equivalent</b>
Asset items covered by internal cash deposits	132,000	0 %	–
Secured by local/central administrations of Zone A (20 % weighting)	885,369	20 %	177,074
Loans and advances to central governments and central banks of Zone A	1,757,817	0 %	–
Loans and advances to regional and local governments (0 % weighting)	2,569,940	0 %	–
Loans and advances to regional and local governments (20 % weighting)	826,062	20 %	165,212
Loans and advances to credit institutions of Zone A ≤ 1 year	377,185	20 %	75,437
Loans and advances to credit institutions of Zone A > 1 year	852,801	20 %	170,560
Bonds of credit institutions pursuant to circular 2000/10 part VIII, point 10.2.	665,023	10 %	66,502
Loans and advances to multilateral development banks	201,064	20 %	40,213
Loans and advances to other customers	19,646	100 %	19,646
Collection items	103	20 %	21
Prepayments and accrued income	52,952	50 %	26,476
Property, plant and equipment	268	100 %	268
Other assets	–	100 %	–
<b>Total</b>	<b>8,340,230</b>		<b>741,409</b>

<b>Derivatives</b> in thousand €	<b>Replacement value*</b>	<b>Weighting</b>	<b>Risk equivalent</b>
<b>Transactions without netting</b>			
Interest-rate transaction ≤ 1 year remaining maturity	–	20 %	–
Interest-rate transaction > 1 year ≤ 5 years remaining maturity	4,992	20 %	998
Interest-rate transaction > 5 years remaining maturity	2,944	20 %	589
Foreign exchange transactions ≤ 1 year remaining maturity	965	20 %	193
Foreign exchange transactions > 1 year ≤ 5 years remaining maturity	–	20 %	–
Foreign exchange transactions > 5 years remaining maturity	42,587	20 %	8,517
<b>Transactions with netting</b>	<b>70,372</b>	<b>20 %</b>	<b>14,074</b>
<b>Total</b>	<b>121,860</b>		<b>24,372</b>

\*) see explanation note under 5.

### 3.4 Information regarding the credit risk

Loans and advances and bonds and other fixed-interest securities (after deduction of value adjustments)

are made up as follows as at the balance-sheet date:

Remaining maturity in thousand €	≤ 1 year	> 1 year ≤ 5 years	> 5 years ≤ 10 years	> 10 years	Total
<b>Credit institutions</b>					
Europe	478,153	756,446	1,028,953	147,232	2,410,784
Japan		20,235	47,945		68,180
Canada	12,000				12,000
South Korea		18,641	18,907		37,548
USA	9,860	19,947			29,807
<b>Total</b>	<b>500,013</b>	<b>815,269</b>	<b>1,095,805</b>	<b>147,232</b>	<b>2,558,319</b>
<b>Öffentliche Kreditnehmer (ohne Kreditinstitute)</b>					
Europe	255,961	1,048,483	1,297,719	1,569,669	4,171,832
Japan	29,162	40,440	58,452		128,054
Canada	6,676	87,595	37,947	214,938	347,156
USA	4,713	10,637	19,554	1,012,245	1,047,149
<b>Total</b>	<b>296,512</b>	<b>1,187,155</b>	<b>1,413,672</b>	<b>2,796,852</b>	<b>5,694,191</b>
<b>Sonstige Kreditnehmer (ohne Kreditinstitute)</b>					
Europa	13	19,536			19,549
<b>Total</b>	<b>13</b>	<b>19,536</b>			<b>19,549</b>
<b>Overall total</b>	<b>796,538</b>	<b>2,021,960</b>	<b>2,509,477</b>	<b>2,944,084</b>	<b>8,272,059</b>

### 3.5 Bonds and other fixed-interest securities (after deduction of value adjustments)

in thousand €	31.12.2006	Previous year
Listed securities	5,976,827	3,950,552
Unlisted securities	386,225	98,310
<b>Total</b>	<b>6,363,052</b>	<b>4,048,862</b>

Bonds and other fixed-interest securities falling due in the following year stand at € 381,800 k.

Bonds of a Member State of the European Union participating in the euro which are eligible for refinancing at a Central Bank of the Eurozone stand at a nominal amount of € 3,673 m as at the balance-sheet date.

The “Bonds” holding breaks down as follows:

in thousand €	31.12.2006	Previous year
Financial assets	6,241,454	3,911,995
Liquid assets	121,598	136,867
<b>Total</b>	<b>6,363,052</b>	<b>4,048,862</b>

As at the balance-sheet date, the accumulated amount of apportioned premiums stands at € 4,389 k accumulated apportioned discounts are shown as € 3,957 k. Repurchase commitments under repurchase agreements stand at € 932,390 k.

No value adjustment to the lower price value has been effected for securities in the financial assets of a book value of € 3,053,486 k (market value € 3,021,180 k),

since these securities are hedged by asset swaps against the risks of changes in interest rates and those hedging relations are booked as a valuation unit. Consequently, corresponding undisclosed reserves are included in the relevant hedging transactions.

### 3.6 Other assets

Other assets (€ 102 k) mainly consist of the outstanding claim arising out of foreign withholding tax.

### 3.7 Prepayments and accrued income

Prepayments and accrued income mainly consist of interest-rate accruals and premium and discount depreciations arising from issuing and lending business. Discounts from the issue business stand at € 736,494 k.

## 4. Notes on the liability items

### 4.1 Presentation of liabilities as at 31 December 2006

#### Maturity schedule

in thousand €	Amounts owed to credit institutions		Amounts owed to customers	
	31.12.2006	Previous year	31.12.2006	Previous year
Payable on demand	1,105	29,719	–	–
Up to 3 months	1,402,202	1,793,320	–	10,000
Over 3 months and up to 1 year	358,599	–	–	–
Over 1 year and up to 5 years	5,000	5,000	100,700	95,700
Over 5 years	20,000	20,000	1,135,753	975,708
<b>Total</b>	<b>1,786,906</b>	<b>1,848,039</b>	<b>1,236,453</b>	<b>1,081,408</b>

Of the amounts owed to credit institutions, € 932,390 k arise out of repurchase agreements.

#### Debts evidenced by certificates as at 31.12.2006

in thousand €	Public sector Pfandbriefe	Other bonds	Other	Total
Payable on demand	–	–	–	–
Up to 3 months	140,000	–	60,000	200,000
Over 3 months and up to 1 year	777,868	30,000	50,000	857,868
Over 1 year and up to 5 years	3,855,632	–	–	3,855,632
Over 5 years	963,849	–	–	963,849
<b>Total</b>	<b>5,737,349</b>	<b>30,000</b>	<b>110,000</b>	<b>5,877,349</b>

Debts evidenced by certificates falling due in the next year amount to € 1,057,867 k.

#### 4.2 Presentation of amounts owed to affiliated companies or companies, in which a participating interest is held

Amounts owed to affiliated companies consist of short-term money-market transactions amounting to € 525 m.

#### 4.3 Other liabilities

Other liabilities (€ 264 k) as at the balance-sheet date predominantly consist of outstanding payments in respect of value added tax, income tax and social security contributions.

#### 4.4 Accruals and deferred income

Accruals and deferred income mainly consist of interest deferrals and premiums and discounts.

#### 4.5 Provisions

The other provisions shown were constituted to cover liabilities to staff existing as at the balance-sheet date together with liabilities to third parties applying to the financial year ended (audit costs, consultancy costs, etc.).

#### 4.6 Subordinated liabilities

As at 28 December 2000, the Bank accepted a “silent participation” of € 9,000 k. The maturity was indefinite, with profit-related interest. For supervisory purposes, this had to be classified as first-tier supplementary capital. With effect from 1 January 2003, the silent participation was converted into a subordinate debt issue. The interest rate, the maturity and the supervisory classification remained unchanged. In the year under review, interest of € 881 k was charged to the income statement.

On 18 May 2001, the Bank issued subordinated funds of € 15,000 k. The subordinated funds were increased by € 10,000 k to € 25,000 k on 30 January 2002 on the same terms. The subordinated funds, which are to be repaid in instalments as from 18 May 2017, will be repaid for the last time on 18 May 2026; the interest rate is 6.8 % per annum. In the year under review, interest of € 1,700 k was charged to the income statement. For supervisory purposes, these subordinated funds qualify as second-tier supplementary capital.

#### 4.7 Equity capital

The subscribed capital amounts to € 66,000 k and is divided into 66,000 registered shares with no par value.

Under the Luxembourg Law of 10 August 1915 on commercial companies, the Bank must allocate every year a sum equivalent to at least 5 % of its annual net profit to a legal reserve until such time as the reserve reaches 10 % of the subscribed capital. No distribution may be made from the legal reserve. As at the balance-sheet date, there was a legal reserve of € 1,155 k and free reserves of € 18,367 k.

The Bank utilises the tax-credit option for the imputation of wealth tax against corporate tax. The free reserves contain € 9,900 k for imputation of the wealth tax. Another corresponding allocation to the reserves will be made for the year under review.

In accordance with the proposed allocation of profits, a sum of € 310 k is to be allocated to the legal reserve and € 5,890 k to the free reserves.

#### 4.8 Assets deposited as security for own liabilities

Assets of a nominal value of € 265,025 k have been deposited with the Central Bank as security.

## 5 Notes on the off-balance-sheet items

Transactions in derivatives on the OTC market are effected exclusively for hedging purposes as part of the Bank's assets/liabilities management. No trading operations involving derivatives were conducted. We have, in principle, entered into netting agreements with our trading partners in the derivatives business with a view to reducing risks.

During the year under review, we included into the cover-pool interest-rate and currency swaps amounting to € 40 m. We have entered into contractual agreements with the counterparties concerned to provide for the duties of information and other cooperation obligations. The procedure has been approved by the supervisory authority and the trustee.

At the end of 2006, the nominal volume of outstanding off-balance-sheet transactions was € 10,621 m, of which € 4,255 m involved affiliated companies. The

address risk arising from derivatives was determined, inter alia, on the basis of the gross replacement costs. These are calculated as the sum of all positive market values, not taking netting agreements into account. At the end of 2006, the address risk thus defined (maximum risk of default) was € 122 m, or 1.1 % of the outstanding nominal volume. After netting agreements are taken into account, the address risk is reduced to € 81 m.

If, in accordance with banking supervisory criteria, add-ons and also risk weightings are taken into account for potential future risk, there is an address risk on the basis of the market-value method of € 24 m at the end of 2006. We shall also in the future pay strict attention to ensuring that the counterparty risk is kept within tight confines through active management. Our counterparties in the derivative business are solely OECD banks.

in million €	Nominal amount RM* ≤ 1 year	Nominal amount RM* ≤ 5 years	Nominal amount RM* > 5 years	Total Nominal amount	Positive market values	Negative market values
<b>Interest-rate transactions</b>						
Interest rate swap (same currency)	961	2,969	5,011	8,941	64	394
Interest rate options – purchases	54	29	109	192	2	–
Other interest rate contracts	–	–	–	–	–	–
<b>Foreign exchange transactions</b>						
Currency swaps	713	–	–	713	5	6
Cross-Currency-Swaps	6	467	302	775	51	13
<b>Total</b>	<b>1,734</b>	<b>3,465</b>	<b>5,422</b>	<b>10,621</b>	<b>122</b>	<b>413</b>

\*) RM = remaining maturity

Derivatives were concluded only for hedging purposes. As against the high negative market values shown above, corresponding undisclosed reserves are present in the hedged underlying transactions.

## Notes

### 6 Notes on items of the profit and loss account

#### 6.1 Geographical origin of income

The Bank's income arose predominantly out of business with counterparties having their seat in Europe or North America.

#### 6.2 Result from financial operations

In addition to profits from sales of liquidity holdings, this item contains the valuation of foreign currency items and the results of currency transactions concluded for hedging purposes.

#### 6.3 Other operating income

Other operating income mainly involves the writing back of provisions for taxes and restructuring measures in respect of previous years.

#### 6.4 Auditor's fees

The fees for the auditor, KPMG Audit S.à r.l. Luxembourg, and member firms of the KPMG network, shown for the financial year under review under the item "other administrative expenses" are made up as follows:

Fees for in € excl. VAT	31.12.2006	Previous year
Audit of financial statements (annual accounts/group accounts)	101,786	98,214
Other audit services	–	16,547
Other services	646	4,958
<b>Total</b>	<b>102,432</b>	<b>119,720</b>

### 7 Other explanatory notes

#### 7.1 Staff

The average numbers of staff employed during the year under review were as follows:

Management, including heads of departments: 5.0

Other staff: 15.1

At the end of the year, the management was comprised of two persons. There were another 14 employees on the staff.

#### 7.2 Payments and loans to executive and supervisory bodies

No loans have been made to members of executive bodies (management and heads of departments) or to other members of the Board of Directors.

The members of the executive bodies were paid emoluments totalling € 863 k for the financial year.

#### 7.3 Deposit guarantee system

The Bank is a member of the Association pour la Garantie des Dépôts, Luxembourg (AGDL) and thus a member of the deposit-guarantee association of the banking sector in the Grand Duchy of Luxembourg. The creation of a reserve was not necessary.

#### 7.4 Items not denominated in the balance-sheet currency

The total amount of assets in foreign currency (not including euro currencies) is € 2,210 m. At the end of the year, liabilities in foreign currencies came to € 2,443 m. These items are almost all covered by currency and interest/currency swaps.

## 8 Asset overview

in thousand €	Acquisition costs	Accruals financial year	Disposals financial year	Depreciation financial year	Accumulated depreciation	Residual cost 31.12.2006	Residual cost Previous year
Office and business equipment	185.4	253.4	-42.7	-69.3	-128.1	268.0	90.4
Of which: IT-equipment	62.2	249.0	-3.9	-50.7	-74.4	232.9	34.7
Investment securities	3,911,994.8	2,967,801.3	-638,342.0	–	–	6,241,454.1	3,911,994.8
<b>Total</b>	<b>3,912,180.2</b>	<b>2,968,054.7</b>	<b>-638,384.7</b>	<b>-69.3</b>	<b>-128.1</b>	<b>6,241,722.1</b>	<b>3,912,085.2</b>

## 9 Special information

**Statement of cover assets held in accordance with Articles 12-1 to 12-9 of the Law of 5 April 1993 on the financial sector** The information is confined to the presentation of public-sector lettres de gage. No mortgage-backed lettres de gage were issued. Derivative financial instruments with a total value of € 39,969 k were used for cover as at the balance-sheet date.

### 9.1 Statement of cover assets for public-sector Pfandbriefe

in €	31.12.2006
Cover assets	6,427,956,186
Substitute cover assets	
Securities	161,500,000
Bank balances	200,000,000
<b>Total cover</b>	<b>6,789,456,186</b>
In circulation	
Bearer securities	5,610,201,520
Registered securities	562,806,208
<b>Total circulation (requiring cover)</b>	<b>6,173,007,728</b>
<b>Excess cover</b>	<b>616,448,458</b>

### 9.2 Additional breakdown

#### 9.2.1 Cover assets

Standard cover in €	31.12.2006
Loans and advances to credit institutions Municipal loans or loans guaranteed by public institutions	638,423,194
Loans and advances to clients Municipal loans or loans guaranteed by public institutions	737,380,197
Bonds of public sector issuers or guaranteed by public institutions	4,605,146,664
Covered public sector lettres de gage	407,036,866
Derivatives	39,969,265
<b>Subtotal</b>	<b>6,427,956,186</b>
<b>Substitute cover assets</b>	
Other loans and advances to credit institutions	200,000,000
Bonds pursuant to article 42 (3) of the UCITS Act	161,500,000
Cash	-
<b>Total</b>	<b>6,789,456,186</b>

#### 9.2.2 Cover holding for municipal loans

Breakdown according to orders of magnitude		Number	in €
Up to	25 million €	60	754,674,241
Up to	50 million €	57	2,016,416,016
Up to	100 million €	34	2,103,537,797
Over	100 million €	11	1,914,828,132
<b>Total</b>			<b>6,789,456,186</b>

<b>Breakdown by country</b>	<b>in €</b>	<b>in %</b>
Germany	1,474,072,611	21.7
USA	897,438,135	13.2
Spain	856,024,373	12.6
Austria	661,148,343	9.7
Italy	524,170,477	7.7
Switzerland	426,286,639	6.3
Canada	418,525,448	6.2
International organisations	234,248,120	3.5
Ireland	200,000,000	2.9
Japan	195,499,694	2.9
Portugal	188,000,000	2.8
Belgium	167,082,654	2.5
Finland	145,982,000	2.2
France	105,000,000	1.5
Great Britain	77,199,347	1.1
Luxembourg	61,111,617	0.9
Slovenia	50,000,000	0.7
Sweden	40,100,987	0.6
South Korea	30,030,372	0.4
Slovakia	21,000,000	0.3
Czech Republic	11,389,521	0.2
Denmark	5,145,848	0.1
<b>Total</b>	<b>6,789,456,186</b>	<b>100.0</b>

### 9.2.3 Statement of cover assets in terms of present value

in million €	Public sector Pfandbriefe*			in %
	Cover fund	requiring cover	Excess cover	
Nominal value	6,789	6,173	616	10.0
Present value	7,094	6,214	880	14.2
Present value, in case of shift of the interest rate curve				
by + 100 bp	6,825	6,042	783	13.0
by - 100 bp	7,391	6,398	993	15.5

\*) Lettres de gage publiques

### 9.3 Accrued and deferred items

in €	31.12.2006
<b>Prepayments and accrued income</b>	
Interest accrued	234,873,599
From issuing and lending business	744,863,201
Other	42,831,660
<b>Total</b>	<b>1,022,568,460</b>
<b>Accruals and deferred income</b>	
Deferred interest	225,716,579
From issuing and lending business	714,179
Other	21,738,785
<b>Total</b>	<b>248,169,543</b>

### 9.4 Redemption of own public-sector lettres de gage

During the year under review, we redeemed a nominal amount of € 86.9 m of our own public-sector lettres de gage for price regulatory purposes. A volume of € 102.0 m was redeemed as scheduled. A holding with a book value of € 121.6 m is shown as at the balance-sheet date. Reinvestment in the market is planned in so far as this is deemed to be appropriate in view of the situation on the market.

### 9.5 Interest arrears

Interest due during the year under review from loans and advances and securities has been received in full.

There are no arrears; no write-offs or value adjustments have been made on interest.

## Executive Bodies

## Board of Directors

<b>Stephan Bub</b>	Member of the Board of Hypo Real Estate Holding AG, Munich CEO of Hypo Public Finance Bank, Dublin Chairman of the Board of Directors, NY-Westport
<b>James William Campbell</b>	Member of the Board of Hypo Public Finance Bank, Dublin
<b>Heather Eileen Nesbitt</b>	Member of the Board of Hypo Public Finance Bank, Dublin
<b>Orla Jane Maureen Catherine Nicholson</b>	Head of Treasury of Hypo Public Finance Bank, Dublin
<b>Martin Schulte</b>	Administrateur-Délégué (Managing Director), Trier
<b>Klaus Söllner</b>	Administrateur-Délégué (Managing Director), Trier

## Management

<b>Martin Schulte</b>	Administrateur-Délégué (Managing Director), Trier
<b>Klaus Söllner</b>	Administrateur-Délégué (Managing Director), Trier

## Réviser Spécial (Auditor of the cover fund)

<b>PricewaterhouseCoopers S.à.r.l.</b>	
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Pictures: Schwabengalerie at Stuttgart-Vaihingen  
Honoured within the scope of the award of architecture  
of Hypo Real Estate Trust, Photographer: Stefan Jarysch





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