

BASIS OF THE GROUP

BUSINESS ACTIVITIES

Headquarters, regional focus and products

HSH Nordbank AG was established in June 2003 by the merger of Hamburgische Landesbank – Girozentrale – with Landesbank Schleswig-Holstein Girozentrale (LB Kiel) and is managed in the form of a German public limited company (Aktiengesellschaft – AG). The headquarters of the Bank are located in Hamburg and Kiel.

HSH Nordbank is one of the leading banking partners for upper medium-sized enterprises in the core region of Northern Germany. HSH Nordbank is also active throughout Germany primarily in the corporate and real estate clients business. The focus of the project financing business in the Corporate Clients division (Energy & Utilities as well as Logistics & Infrastructure business fields) additionally is on the rest of Europe. The Bank conducts business with shipping clients throughout the world. Based on classical loan financing HSH Nordbank offers a wide range of appropriate financing solutions tailored to the needs of its corporate clients, wealthy private clients, savings banks and institutional clients.

Segments, divisions and locations

The strategic divisions are combined in the Core Bank. At the beginning of 2015, HSH Nordbank revised the allocation of business areas to the segments of the Core Bank as part of changes made to Management Board responsibilities. Under this the Energy & Infrastructure division was allocated to the Corporates & Markets segment (previously Shipping, Project & Real Estate Financing segment). The Corporate Finance product division, which was previously part of the Corporates & Markets segment and supports the client divisions with special financing and advisory solutions, was at the same time allocated to the Shipping, Project & Real Estate Financing segment.

Furthermore, the Corporate Clients, Energy & Infrastructure as well as Wealth Management divisions were merged into the new Corporate Clients division as at 1 July 2015 in the segment Corporates & Markets in order to focus the business and streamline the organisational structure. Since then the strategic focus of the new Corporate Clients division has been primarily on the Logistics & Infrastructure, Energy & Utilities, Healthcare, Trade & Food and Industry & Services business fields. Another key area remains the advising of wealthy private clients, foundations and non-profit organisations with regard to asset management. Furthermore, capital market activities and the servicing of savings banks, banks and insurance companies were combined in the Capital Markets division. Business conducted with shipping clients has also been concentrated in a single division in the Shipping, Project & Real Estate Financing segment.

In addition to the segment changes the Bank also started to streamline the organisational structure and to optimise processes across divisions, for example in the field of lending and loan processing, in order to improve efficiency and processes.

As part of the focusing of its business activities HSH Nordbank has significantly reduced its international network of locations over the past years and closed a number of branches abroad. HSH Nordbank continues to be present in Singapore, Hong Kong, Athens and New York in line with its strategic orientation. The New York branch was reduced in size and converted into a representative office at the end of 2015 as part of the further reorganisation of HSH Nordbank. HSH Nordbank has converted the representative office in Athens into a branch in the year under review. The associated upgrading of the location, which plays an important role in the shipping industry, supports the further diversification of the shipping portfolio. The branch in Luxembourg primarily provides services for the Restructuring Unit. In Germany, HSH Nordbank is represented in Berlin, Hannover, Düsseldorf, Munich, Stuttgart and Frankfurt am Main.

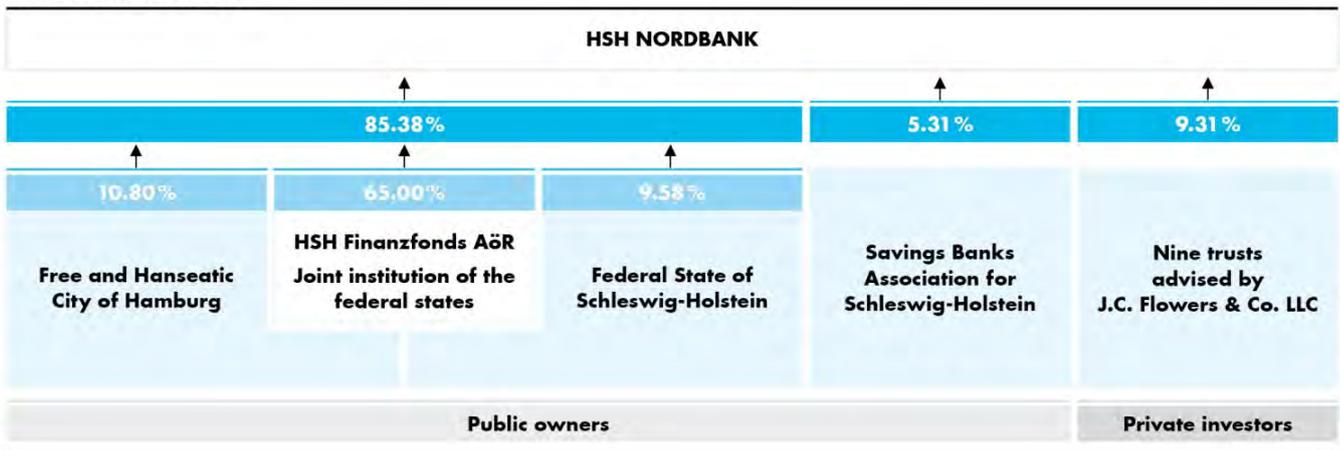
As an internal segment of the Bank, the Restructuring Unit has managed the winding-down of non-strategic credit and capital markets transactions since 2009 (legacy portfolio).

Equity holdings and scope of consolidation

HSH Nordbank has sharply reduced its equity holding portfolio in the past years as part of the refocusing of its business activities. At the 2015 year end the scope of consolidation for the Group financial statements included, in addition to the parent company, HSH Nordbank AG, 61 fully consolidated subsidiaries compared to 64 fully consolidated subsidiaries as at 31 December 2014. Material changes in the scope of consolidation relate, on the one hand, to Immobilien-Objektgesellschaft GmbH Altstadt Grundstücksgesellschaft, Mainz, included for the first time on a fully consolidated basis in the scope of consolidation and, on the other, to the companies K/S Angered, Copenhagen, and LCG Finance, Luxembourg, that are no longer included in the scope of consolidation.

The impact of these changes to the scope of consolidation on the income statement is addressed in the Earnings section of this Group management report. Further details regarding the scope of consolidation are set out in Note 3 (Adjustments to previous year comparative figures) and Note 5 (Scope of consolidation).

OWNERSHIP STRUCTURE

**Ownership structure, guarantee and EU proceedings**

The principal owners of HSH Nordbank AG as at the 2015 year end with a combined shareholding of just over 85.4% are the Free and Hanseatic City of Hamburg and the Federal State of Schleswig-Holstein. 65.0% of this shareholding is held by HSH Finanzfonds AöR, an institution under public law that is managed jointly by Hamburg and Schleswig-Holstein. Other owners are the Savings Banks Association for Schleswig-Holstein (Sparkassen- und Giroverband) (5.3%) as well as private investors advised by J.C. Flowers & Co. LLC (9.3%).

The federal states of Hamburg and Schleswig-Holstein as the owners of the Bank have issued via HSH Finanzfonds AöR a guarantee in favour of HSH Nordbank that provides capital relief (second loss guarantee), under which defaults in a specified portfolio are hedged (mainly Restructuring Unit and ship financing recovery unit in the Core Bank). First piece losses incurred in this portfolio are to be borne by HSH Nordbank itself up to an amount of € 3.2 billion. Further details are set out in Note 2 in the Group financial statements. Details regarding the impact of the guarantee on the net assets, financial position and results of operations in 2015 are set out in the Economic report section.

In 2013, the guarantee facility provided by Hamburg and Schleswig-Holstein was replenished after a reduction in 2011 from € 7 billion to the original facility of € 10 billion in view of the changed underlying conditions. This measure was provisionally approved by the EU Commission in 2013. At the same time, the EU Commission instituted state aid proceedings to investigate whether the replenishment of the guarantee is consistent with state aid rules. In these state aid proceedings, the owners Hamburg and Schleswig-Holstein, the Fed-

eral Republic of Germany and the EU Commission reached an informal agreement on 19 October 2015 to provide significant relief to the Bank from the adverse impact of legacy portfolio items and guarantee fees. It is also envisaged that HSH Nordbank AG be privatised within a two-year period. The informal agreement was an essential basis for the formal decision of the EU Commission dated 2 May 2016 concerning the replenishment of the second loss guarantee granted by the federal states from € 7.0 billion to € 10.0 billion. The formal decision of the EU Commission is based on a catalogue of conditions and commitments provided by the Federal Republic of Germany to the EU Commission, which contains the grounds for the agreement and confirms the informal agreement in principle and sets it out in more concrete terms. The concrete terms relate primarily to the sale of HSH Nordbank AG by 28 February 2018, details relating to the operating relief provided to the Bank and obligations during the divestiture period.

Further information on the informal agreement as well as the formal decision can be found in the Business developments section under Major developments and events as well as in the Forecast, opportunities and risks report.

Membership in the German Savings Banks Finance Group

As a member of the German Savings Banks Association (DSGV) HSH Nordbank AG is a member of the guarantee scheme of the German Savings Bank Finance Group (SFG). The guarantee scheme protects deposits with savings banks, Landesbanks or a Landesbausparkasse. Furthermore, this system secures the continued existence of member institutions and guarantees the solvency of member institutions in the event of foreseeable or existing difficulties.

In the 2015 financial year, the German Savings Banks Finance Group amended its proven guarantee scheme to comply with the provisions of the new Deposit Guarantee Act (Einlagensicherungsgesetz), which came into force in Germany at the beginning of July 2015. The provisions of the guarantee scheme were supplemented by the strengthening of the governance rules for the institution guarantee and a stronger risk- and deposit-based orientation of the contribution regime. The funding of the deposit guarantee scheme of the German Savings Bank Finance Group is strengthened in accordance with the requirements by the contributions which were payable by member institutions for the first time in 2015, recalculated on this basis. Together with the institution guarantee the guarantee scheme of the German Savings Banks Finance Group continues to exceed the statutory minimum requirements.

External influencing factors and processes

Key external factors influencing the business of HSH Nordbank include economic and financial markets developments (such as movements in the EUR/USD exchange rates, interest rate), trends in the relevant industry sectors such as shipping (especially charter rates, second hand prices), regulatory requirements, external ratings as well as assessments made by capital market participants and other stakeholders.

Within its business organisation HSH Nordbank has defined processes that form the basis for operating and managing the Bank as well as for its internal control system. The main processes include strategy and planning, corporate management, customer management, financing, capital markets as well as support processes.

OBJECTIVES AND STRATEGY

The overriding objective of HSH Nordbank is to support the Northern German economy and to provide the upper end of medium-sized enterprises with an appropriate product portfolio with regard to all aspects of loan financing. This is in line with its mission statement as a Bank for Entrepreneurs and is in accordance with its importance for the core region of Northern Germany and beyond.

The objectives and strategies of HSH Nordbank are aimed at ensuring the sustainable development of the institution. This is also the subject of the ECB's integrated analysis conducted as part of the supervisory review and evaluation process (SREP), based on which banks are monitored taking into account the business model, capital and liquidity position and governance structures. Further information on the ECB's SREP process can be found in the Economic report section.

Informal agreement reached with EU Commission

Due to the informal agreement reached with the EU Commission on 19 October 2015 and the formal EU decision taken on 2 May 2016 the basis for a viable business model of HSH Nordbank was improved. The structural measures planned as part of the informal agreement with the EU Commission, which were in principle confirmed and defined in more detail within the framework of the formal decision, are currently being prepared in collaboration with the federal state owners. The implementation of these measures is intended to improve HSH Nordbank's financial and risk situation and, in combination with additional strategic and operating optimisation measures, create a sound basis for a successful privatisation process of HSH Nordbank.

Further details on the EU proceedings and the implementation of the agreed structural measures can be found in the section Business developments – Significant developments and events.

Strengthening of the Bank for Entrepreneurs and systematic winding down of the legacy portfolios

In order to implement the business model with a sustainable focus as a Bank for Entrepreneurs HSH Nordbank is continuing to concentrate on strengthening the strategic business areas of the Core Bank and, at the same time, on winding down the high-risk legacy portfolios which are bundled in the Restructuring Unit.

The aim of HSH Nordbank in the planning period up to 2018 is to increase new business with risk-commensurate margins in accordance with the business and risk strategy. On the one hand, business is to be promoted further in the core region of Northern Germany, where the Bank has long-standing client relationships and a high level of market penetration already and, on the other hand, business activities outside Northern Germany are to be expanded further in order to achieve the planned new business objectives and to ensure a balanced portfolio structure.

Furthermore, the sale of the entire range of services over and above traditional lending transactions (cross-selling) will continue to be driven forward to strengthen sustainable client relationships and exploit the business potential in the product division.

Strategic targets of the Core Bank's business fields

The strategic divisions will be continuously developed further and their business portfolios and positioning adjusted to the changing underlying conditions in the market and competitive environment.

The Real Estate Clients division will continue to make a risk-conscious contribution to the Bank's balanced portfolio mix taking account of the sector trends in the German real estate markets and with the objective of achieving an adequate level of profitability on business transactions entered into.

In the Shipping division the Bank still strives to selectively conclude additional new business based on its long-standing expertise and in accordance with strict margin and risk requirements with a maximum volume of up to € 1.2 billion per year. The focus is on a diversification of the portfolio through domestic and international commitments with counterparties with a good credit standing.

The intention is to intensify new business in the Corporate Clients division. The approach of expanding business throughout Germany in the existing locations will be consistently continued in order to achieve this in a highly competitive market environment. At the same time, the potential in the core region of Northern Germany as well as in the project financing business in the business fields of Energy & Utilities and Logistics & Infrastructure will be further exploited in the rest of Europe.

The client divisions will be supported by products and services provided by the Capital Markets, Corporate Finance and Transaction Banking divisions in order to ensure an integrated product range and exploit the cross-selling potential. Capital Markets will continue to provide the client divisions with a tailored range of capital market product solutions, for example instruments for hedging interest rate and currency risk. At the same time, Capital Markets will continue to serve the savings banks and institutional clients in the areas of issuance and deposits. The Corporate Finance product division supports the client division business by providing specific advisory and financing solutions and thereby also contributes to the strengthening of client relationships. Furthermore, the Corporate Finance division places the credit risk on larger financing structures with external third parties as part of its syndication activities. Transaction Banking continues to provide tailored solutions in the areas of payment transactions, account management and foreign trade.

Further significant reduction in the Restructuring Unit portfolios

The aim of the Restructuring Unit in the planning period up to 2018, in addition to the planned sale of non-performing loans under the informal agreement with the EU Commission as confirmed by the formal decision of the EU Commission, continues to be a further significant reduction in the non-strategic loan and capital markets portfolios through scheduled and early principal repayments, sales of loans and structured solutions whilst maximising value.

Sustainable cost reductions and efficiency increases

A high priority for HSH Nordbank is to continually improve the Bank's efficiency. HSH Nordbank will revise its cost and efficiency targets for the period to 2018 in view of the challenging environment with a sustained shipping crisis, intensive competition in the German corporates business and increasing regulatory requirements. The objective is to achieve a sustainable, competitive cost-income ratio. HSH Nordbank is therefore striving to achieve a cost-income ratio of less than 50% by the end of the 2018 planning period.

A comprehensive cost reduction programme, which is currently being implemented, was launched to reduce administrative expenses. Against the backdrop of the planned portfolio sale of € 8.2 billion and the agreed privatisation in 2018 the measures are continuously reviewed and adjusted as far as necessary.

One focus of the programme is targeted overarching initiatives. These include the further streamlining of the organisational structure, simplification and standardisation of key processes as well as adjustments to the Bank's IT systems. Attention is also being paid on optimising the product portfolio. Details regarding the programme measures currently being implemented are set out in the Business developments section.

Realignment of IT

In this connection, the Bank had already launched the realignment of its IT in 2014 with the objective of strengthening the division's position as a central management unit and service provider that supports the business strategy requirements in a targeted manner. One key element of the new IT strategy to be implemented by 2018 is the focused rendering of services at a lower cost. Investments are also being made in adjusting the IT architecture with a focus on the Bank-internal data platform, in IT security and in meeting the ever-increasing regulatory requirements. Details regarding the progress achieved in implementing the IT strategy in the 2015 reporting year are set out in the Business developments section.

MANAGEMENT SYSTEM

Key value drivers and key indicator and ratio system

The integrated management system of the Bank is aimed at the management of key value drivers – income, expense, capital, liquidity and risk – on a targeted basis. For this purpose the Bank uses a risk-adjusted key indicator and ratio system that ensures that the Overall Bank, Core Bank and Restructuring Unit are managed in a uniform and effective manner. The HSH Nordbank Group is managed mainly on the basis of figures for the Group prepared in accordance with the International Financial Reporting Standards (IFRS).

In addition, a multi-level contribution margin accounting system is also used to manage the individual business fields. Other components of the Overall Bank management system are the annual strategy and planning process, plan/actual comparisons and the targets agreement and assessment process. There are various steering committees within the Bank at top management level that manage the key value drivers. Further information regarding this is included in the Risk report under Risk management by central committee structure.

Defined management indicators of the IFRS Group

Within the framework of management reporting the Bank focuses on the most important management indicators for the individual value drivers of the IFRS Group. On the one hand, the focus is placed on the change in these key indicators over the past year compared to the previous year and previous year's forecast (Economic report section) and, on the other, on their expected development in 2016 (Forecast, opportunities and risks section).

Profitability and efficiency

HSH Nordbank's management system is systematically aimed at improving profitability and cost efficiency – in terms of the return on equity (RoE) and cost-income ratio (CIR). The key indicators are used for the Overall Bank as well as for the continuing operations in the Core Bank.

RoE is calculated as the ratio of income before taxes to average equity capital disclosed on the balance sheet and shows the return on capital. The risk-adjusted allocation of the average equity capital disclosed on the balance sheet is determined on the basis of the regulatory capital committed. The cost-income ratio represents the ratio of administrative expenses to total income plus Other operating income.

Income

For the purposes of ensuring that the income targets are met, the key indicators of total income and net income before taxes are defined as the most important ones for managing earnings. New business volume is another important driver of earnings. The Bank also uses other supporting key indicators such as new business profitability, new business margins and cross-selling income for the value-driven management of business fields. The focus is on cross-selling business over and above traditional loan financing particularly with regard to the sustainability of client relationships.

Costs

On the cost side the management of absolute cost targets is focused on administrative expenses as the most important key management indicator. These comprise personnel and operating expenses. The number of employees (FTE) is no longer used as a primary key non-financial indicator for cost management. A supporting management tool in this connection is the lean management approach implemented at the Bank to increase the efficiency of work processes.

Risk

The monitoring of key risk types, which are described in detail in the Risk report section, is important for risk management. HSH Nordbank has identified loan loss provisions as a key management indicator for trends in the lending business. Other supporting key indicators and ratios are used to monitor the portfolio hedged by the second loss guarantee. These are the loan loss provisions recognised in the guaranteed portfolio and the risk weight of the guarantee.

In addition, non-performing exposure (NPE, total of all positions of borrowers in default) will be implemented in the future as an important management indicator given the importance assigned to this key indicator by the banking supervisor and market participants. Further information regarding this can be found in the Risk report section.

Capital

The core Tier 1 capital ratio (common equity Tier 1 ratio or CET1 ratio) and risk-weighted assets (RWA) are used as key ratios for managing regulatory capital. The additional premium buffer previously disclosed in the presentation of the Tier 1 capital ratio is no longer included, as the existing obligations regarding this were released as part of the implementation of the informal agreement, thereby strengthening capital. Further information regarding this can be found in the Business developments section.

The CET1 ratio is determined in the same period calculation (i.e. taking the annual financial statements into account) in accordance with the transitional rules (phase-in) of the Capital Requirements Regulation (CRR). The key ratio used for internal management purposes is not exactly the same as that disclosed in the regulatory report due to the same period calculation. The CET1 ratio calculated under the assumption of full implementation of the CRR (fully loaded) is also defined as a supporting key management indicator in light of the introduction of a uniform supervisory review and evaluation process (SREP).

Another supporting key ratio included in the management system is the leverage ratio. The leverage ratio is a capital ratio that is not weighted and compares the Tier 1 capital to regulatory adjusted business volume. There were no regulatory threshold requirements for the leverage ratio in 2015. The threshold for the leverage ratio and final definition are to be determined by the supervisory authorities by 2017 and are likely to represent a regulatory minimum requirement from 2018.

RWA in the same period calculation are determined in accordance with the provisions of the CRR taking due account of the second loss guarantee. The key ratio used for internal management purposes is not exactly the same as that disclosed in the regulatory report due to the same period calculation.

Liquidity

An important regulatory management indicator for liquidity risk is the liquidity ratio defined by the German Liquidity Regulation (LiqV). The liquidity ratio as defined in LiqV describes the relationship between expected cash inflows and cash outflows over the next 30 days. Furthermore, the regulatory ratios liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) have been integrated in the internal management system as supporting tools. The mandatory disclosure of the LCR will take place gradually from the middle of 2016. The NSFR will need to be adhered to from 2018 at the earliest.

The liquidity development report (LDR) used in the Stress Case with its defined survival period was also identified during the year as a key management indicator. The LDR maps expected cash flows in a specific time period in a structured manner. An economic assessment over several years is performed based on the so-called LDR Expected Case.

Details on the liquidity ratios and liquidity management are set out in the section Liquidity risk in the Risk report.

Key management indicators in the Core Bank

The focus of the Core Bank is sustained business development. Accordingly, the most important key indicators for managing earnings are total income and new business.

Key management indicators in the Restructuring Unit

The focus in the Restructuring Unit is on the active winding down of non-strategic positions whilst protecting the key capital, balance sheet, liquidity and net income resources. The most important management indicators used in the Restructuring Unit are total assets and loan loss provisions.

Restructuring and early warning indicators

The recovery and early warning indicators defined in the German Recovery and Resolution Act (Sanierungs- und Abwicklungsgesetz (SAG)) and by the EBA (European Banking Authority) are regularly monitored and assessed as supporting key indicators in order to be able where necessary to implement targeted measures on a timely basis. HSH Nordbank updated its recovery/resolution plans in the 2015 reporting year in accordance with the statutory requirements.

Management Board remuneration

The remuneration of the Management Board of HSH Nordbank is limited to a fixed – and therefore not performance-based – monetary remuneration. Entitlements to variable remuneration are not granted due to a requirement imposed by the European Commission. The provisions recognised up to and including the 2011 financial year for variable performance-based remuneration are dependent, amongst other things, on when the Bank is able to pay dividends. Details are set out in the Remuneration system section below.

Enhancements to the internal management system

In the 2015 reporting year, HSH Nordbank developed a concept for the focused enhancement of the internal management system in 2016. The main focus of the enhancements in the area of the key indicator system was the alignment of the capital and liquidity ratios to the SREP requirements. The management of business fields was also supplemented by the value added after capital costs, the CIR and various adjustments for improving the disclosure of income and costs under the causation principle. The revised key indicator system will be gradually implemented in 2016. Liquidity and capital management as well as balance sheet management will be combined in 2016 into a newly created unit (Asset Liability Management).

REMUNERATION SYSTEM

The remuneration system for the Management Board of HSH Nordbank meets all of the relevant, regulatory requirements. In addition, particular attention was paid to ensure that the remuneration system complied with the guarantee agreement of the federal states as well as the conditions imposed by the EU in the initial EU proceedings for the approval of the granting of the second loss guarantee.

The limit on the fixed monetary remuneration of each board member of a maximum of € 500,000 per year as long as HSH Nordbank AG is not capable of making dividend distributions is implemented in the remuneration system.

The Supervisory Board decided on the basis of a communication of the European Commission dated 23 August 2012 to no longer grant any entitlement to variable remuneration for the 2012 financial year and subsequent years until the reorganisation phase is completed.

General agreements have not been concluded for the early termination of a Management Board member's contract without good cause. However, it is contractually agreed that – in accordance with Section 4.2.3 of the German Corporate Governance Code – any agreed payments to a departing member of the Management Board may not exceed the value of two years' fixed annual salary (including fringe benefits) and the total of the fixed salary for the remaining term of the employment period.

In the year under review no member of the Management Board received payments or promises of payment from a third party in respect of their activities as a Management Board member. The same also applies to payments or promises of payment from companies, with which HSH maintains significant business relationships.

Further information on Management Board remuneration is set out in Note 62 (Related parties).

The remuneration system for employees below the Management Board level is based on a total remuneration approach, counteracts any significant dependence on variable remuneration and thereby prevents employees from taking excessively high risks for the purposes of realising the variable remuneration potential. The amount of the total budget for the variable performance-related remuneration of employees is determined on the basis of the Bank's performance, which is calculated using parameters that reflect the success of the Bank. In addition to achieving key financial ratios these parameters are also based on the Bank's strategic objectives amongst other things. They take account of the concept of sustainability and are always tailored to the business model as well as the overall Bank strategy and risk strategy.

The budget for the Overall Bank for variable performance-related remuneration of the employees is distributed to the employees taking into account the performance of the divisions based on the achievement of individual objectives. Fixed upper limits for the ratio of variable to fixed remuneration were set for all employees of the Group in accordance with the German Ordinance on the Remuneration of Financial Institutions (Institutsvergütungsverordnung – InstitutsVergV) in order to avoid disproportionately high variable remuneration.

In accordance with the specific requirements of the InstitutsVergV HSH Nordbank defines a group of employees as so-called risk takers, who have a significant influence on the overall risk profile of the Bank by virtue of their function. In accordance with the InstitutsVergV parts of their variable remuneration are paid on a deferred basis and are dependent on the sustained performance of the Bank.

The required adjustments identified on the basis of the amended InstitutsVergV that came into force on 1 January 2014 were implemented. Due to the fact that these regulations are dependent upon the relevant collective bargaining agreements, they have been adapted in 2015.

In accordance with the ordinance further details are published in a separate remuneration report on the website of HSH Nordbank.