MANAGEMENT REPORT 2017
RISK, OUTLOOK AND OPPORTUNITIES REPORT

RISK REPORT

The ability to monitor and keep risks under control at all times is essential for the successful management of business development at MünchenerHyp. For this reason, risk management plays a very important role in the overall management of the Bank.

The business and risk strategy defines the parameters of the Bank's business activities. MünchenerHyp's entire Board of Management is responsible for this strategy, which is regularly reviewed regarding the attainment of goals and updated as necessary and then submitted to the Supervisory Board no less than once a year.

As part of its supervisory duties, the Supervisory Board is advised about the Bank's risk profile no less than on a quarterly basis and additionally as required. This takes place using the reports concerning the Bank's risk-taking capabilities and lending risks, the OpRisk reports, as well as the risk report prepared in accordance with the "Minimum Requirements for Risk Management" (MaRisk).

The basis of risk management consists of, on the one hand, the analysis and presentation of existing risks, and, on the other, comparing these risks with the risk cover potential (ability to bear risk). Furthermore, a series of additional relevant analyses are in place and only when they are viewed as a whole do they permit the Bank to be managed appropriately. This objective is achieved by employing appropriate monitoring processes involving internal process-dependent supervision measures. Our internal audit department, as a process-independent unit, plays an additional monitoring role within the Bank.

The analysis and presentation of existing risks primarily distinguishes between counterparty, market price, credit spread, liquidity, investment, modelling and operational risks. Additional risks such as placement risks, reputational risk, business risk etc., are viewed as parts of the abovementioned risks and are taken into consideration at the appropriate place in the individual calculations.

COUNTERPARTY RISK

Counterparty risk (credit risk) is of major importance for MünchenerHyp. Counterparty risk refers to the danger that counterparties may delay their payment obligations to the Bank; only make partial payments or even default.

The Credit Handbook presents the competencies and procedural requirements of the units involved in lending, as well as the approved credit products. The business and risk strategy contains additional explanations pertaining to sub-strategies regarding target customers and target markets, as well as definitions for measuring and controlling credit risks at the individual deal and portfolio levels. A procedure based on the credit value-at-risk (Credit-VaR) is used to determine lending limits. The individual contribution of every borrower (aggregate debtor or limit group as appropriate) – the Marginal Credit-VaR – to the Bank's total credit risk is limited. Furthermore, limits are also set for each country to ensure adequate regional diversification.

We take care to ensure that the vast majority of our mortgage business activities consist of top tier loans with moderate loan-to-value ratios. The current breakdown based on loan-to-value ratios is as follows:

TOTAL PORTFOLIO OF MORTGAGE AND OTHER LOANS (INCLUDING OPEN COMMITMENTS)				
MORTGAGE LENDING VALUE RATIO	31 Dec. 2017		31 Dec. 2016	
	€	relative	€	relative
Up to 60 %	14,296,965,287.66	45.6%	13,728,296,351.62	46.2%
60.01 % to 70 %	6,280,906,478.52	20.0%	5,677,718,196.80	19.1%
70.01 % to 80 %	6,682,115,544.81	21.3%	6.311,223,356.12	21.2%
80.01 % to 90 %	2,272,306,838.37	7.2%	2,154,390,691.97	7.3%
90.01 % to 100 %	1,053,463,631.24	3.4%	1,106,925,787.91	3.7%
over 100 %	755,022,711.92	2.4%	711,366,203.19	2.4%
without	15,847,972.98	0.1%	25,419,250.26	0.1%
Total	**31,356,628,465.50**	**100.0%**	**29,715,339,837.87**	**100.0%**

The regional breakdowns within Germany and abroad are as follows:

TOTAL PORTFOLIO OF MORTGAGE AND OTHER LOANS (INCLUDING OPEN COMMITMENTS)				
REGION	31 Dec. 2017		31 Dec. 2016	
	€	relative	€	relative
Baden-Wuerttemberg	2,794,684,631.11	8.9%	2,616,357,406.41	8.8%
Bavaria	5,849,474,855.94	18.7%	5,646,905,936.17	19.0%
Berlin	1,515,024,630.55	4.8%	1,621,952,619.85	5.5%
Brandenburg	549,477,361.59	1.8%	490,537,743.87	1.7%
Bremen	93,497,213.85	0.3%	72,477,010.74	0.2%
Hamburg	936,793,198.61	3.0%	714,905,017.62	2.4%
Hesse	1,742,536,130.56	5.6%	1,616,366,977.79	5.4%
Mecklenburg-Lower Pomerania	384,874,380.79	1.2%	338,336,073.85	1.1%
Lower Saxony	2,102,093,778.96	6.7%	1,947,571,402.44	6.6%
North Rhine-Westphalia	4,502,314,653.67	14.4%	4,175,437,802.38	14.1%
Rhineland-Palatinate	1,227,865,749.56	3.9%	1,090,638,755.50	3.7%
Saarland	276,568,563.00	0.9%	224,663,431.89	0.8%
Saxony	873,208,941.08	2.8%	830,836,929.91	2.8%
Saxony-Anhalt	479,890,424.73	1.5%	432,564,548.35	1.5%
Schleswig-Holstein	1,694,132,583.00	5.4%	1,675,695,390.58	5.6%
Thuringia	317,419,939.59	1.0%	235,292,855.09	0.8%
Total domestic	**25,339,857,036.59**	**80.8%**	**23,730,539,902.44**	**79.9%**

TOTAL PORTFOLIO OF MORTGAGE AND OTHER LOANS (INCLUDING OPEN COMMITMENTS)

SOVEREIGN STATE	31 Dec. 2017		31 Dec. 2016	
	€	relative	€	relative
Austria	117,228,434.45	0.4%	129,371,291.34	0.4%
France	334,128,112.01	1.1%	306,183,794.26	1.0%
Great Britain	457,267,526.70	1.5%	389,373,033.56	1.3%
Spain	241,773,685.93	0.8%	187,861,502.87	0.6%
Luxembourg	80,026,000.00	0.3%	48,626,000.00	0.2%
Switzerland	4,163,212,729.66	13.3%	4,321,626,705.80	14.5%
The Netherlands	392,584,077.07	1.3%	326,947,813.21	1.1%
Belgium	43,455,852.39	0.1%	49,976,456.52	0.2%
USA	187,095,010.70	0.6%	224,833,337.87	0.8%
Total foreign	**6,016,771,428.91**	**19.2%**	**5,984,799,935.43**	**20.1%**
Total domestic and foreign	**31,356,628,465.50**	**100.0%**	**29,715,339,837.87**	**100.0%**

The management of credit risks begins with the selection of the target business when drafting the terms of the loan, using risk cost functions that are regularly reviewed. A variety of rating or scoring procedures are used depending on the type and risk content of the transaction.

In addition, a computer-based early warning system is used to identify risks on a timely basis.

Property financing contains a broadly diversified portfolio of loans with emphasis on residential property financing and a credit approval process that has proven its value over many years as reflected in a portfolio with a low level of credit risk. Our lending business with public sector borrowers and banks is primarily focused on central and regional governments, regional and local authorities, and west European banks (only covered bonds). Regional emphasis is on Germany or Western Europe respectively. Our objective for this portfolio is to further reduce its volume due to reasons such as the introduction of the leverage ratio. Highly liquid sovereign bonds and other very creditworthy securities will, however, continue to be needed in order to meet the new liquidity requirements mandated by Basel III.

Depending on their ratings, mortgage loans are examined to determine any non-performance or other negative factors which could trigger an individual adjustment to value. Furthermore, an additional system to monitor individual adjustment to value is used by the Bank's work-out management department, especially for the non-retail market business.

The Bank has created a general adjustment-to-value reserve as a precautionary measure to cover latent lending risks. This general adjustment to value is calculated per the terms contained in a Federal Ministry of Finance notice dated January 10, 1994.

Individual adjustments to value taken remained at a low level for our residential property financing business due to the great stability of the residential property market. This also generally applies for our commercial property financing business.

Business relationships with financial institutions are primarily based on master agreements that permit settlement of claims and liabilities (netting) vis-a-vis the other institution. In general, we also enter into security agreements. We use a so-called Central Counterparty (CCP) as the preferred basis for settling derivative trades.

The individual and general adjustments to value developed as follows in 2017:

TOTAL LENDING BUSINESS						
in € millions	Opening balance	Addition	Reversals	Utilisation	Changes related to exchange rate shifts and other factors	Closing balance
Individual adjustments to value	66.0	6.0	-13.0	-8.5	-4.0	46.5
General adjustments to value	13.0	0.0	0.0	0.0	0.0	13.0

MARKET PRICE RISKS

Market price risks consist of the risks to the value of positions due to changes in market parameters including interest rates, volatility and exchange rates among others. These risks are quantified as potential losses of present value using a present value model that differentiates between risks related to interest rates, options and currency rates.

Interest rate risks are divided into two categories: general and specific interest rate risks. General interest rate risks refer to risks arising from changes in the market value of investments or liabilities that are dependent on the general level of interest rates, and which will react negatively if interest rates change.

Specific interest rate risks are also referred to as (credit) spread risks, and are included under market price risks. Credit Spread is the term used to describe the difference between the yield generated by a risk-less bond and a risky bond. Spread risks take into account the danger that this difference in interest rates can change although credit-worthiness ratings remain unchanged. The reasons for altered yield premiums are:

- varying opinions of market participants regarding positions,
- the creditworthiness of the issuer actually changes although the issuer's credit rating does not yet reflect this change,
- macro-economic factors that influence creditworthiness categories.

The Bank's portfolio of bonds issued by euro area countries more heavily affected by the sovereign debt crisis, or in bonds issued by banks domiciled in these countries, remained at a moderate level. The Bank has not made any new investments in countries located on the periphery of the euro area since 2011. We do not believe that our investments are in danger of default. We are of the opinion that measures taken by individual countries, as well as protective mechanisms enacted at EU levels, are sufficient to ensure the repayment of the affected liabilities. In the case of bank bonds issued by banks domiciled in these countries, all of these bonds are covered bonds so that in this instance we also anticipate that they will be repaid as contractually agreed.

Among other risks, options involve the following risks: volatility risk (Vega; risk that the value of a derivative instrument will change due to increasing or decreasing volatility), time risk (Theta; is understood to the risk that measures how the passage of time impacts on the value of a derivative instrument), Rho risk (risk associated with a change in the value of the option due to a change in a riskless rate of interest), and Gamma risk (risk of a change in the option's Delta due to a change in the price of the underlying security; the option's Delta thereby describes the change in the price of the option due to the change in the value of the underlying security). The volume of risks assumed is moderate as options are generally not employed in the capital market business for speculative purposes. Option positions are almost solely entered into on an implied basis due to debtors' option rights (for example the right to give legal notice of termination per Art. 489 of the German Civil Code – BGB) and are then hedged if needed. These risks are attentively monitored in the daily risk report and are limited.

Currency risk defines the risk arising from changes in the market value of investments or liabilities dependent on currency exchange rates and which will react negatively due to changes in currency exchange rates. MünchenerHyp's transactions outside Germany are hedged against currency risks to the greatest extent possible and only margins involved in payment of interest are not hedged.

Stock risks play a minor role for MünchenerHyp as our total investments in this asset class consist of investments in enterprises within the Cooperative Financial Network. The Bank additionally invested in a mixed fund (a special fund) in 2017. This fund can also invest in equities. The calculation of the risk figure is thus transferred to the company managing the investment fund. The results will be examined for their plausibility and then integrated into our own system.

Market price risks are managed by determining the present value of all of MünchenerHyp's transactions on a daily basis. The Bank uses the "Summit" IT programme for these calculations. The backbone of our interest rate risk management is the "bpV-vector", which is calculated on a daily basis. This figure is determined by the change in the present value incurred per range of maturities when the mid-swap curve is shifted by one basis point. Furthermore, sensitivities regarding the currency exchange rates, rotations of the interest rate curve, as well as changes in the basis spreads and volatility are also determined.

MünchenerHyp uses the value-at-risk (VaR) figure to identify and limit market risks. Linear as well as non-linear risks are taken into consideration using a historical simulation when calculating VaR. In addition, different stress scenarios are used here to measure the effect of extreme shifts in risk factors and the effects of other risk categories.

The current daily stress scenarios (others are conducted less frequently) are:

- Legal supervisory requirements: The interest rate curve is completely parallel shifted up and down by 200 base points for every separate currency. The worst result of the two shifts is used for calculation purposes.
- Parallel shifts: The current interest rate curve is completely shifted up and down by 50 base points across all currencies. The worst result of the two shifts is used for calculation purposes.
- Steepening/flattening: The interest rate curve is rotated in both directions pursuant to Guideline BCBS 368.
- Historical simulations:
  - September 11, 2001 terror attack in New York: Changes seen in market prices between September 10, 2001 and September 24, 2001 – the immediate market reaction to the attack – are played out using current levels.
  - The 2008 crisis in the financial markets: Changes in interest rates seen between September 12, 2008 (last banking day before the collapse of Lehman Brothers) and October 10, 2008 are played out using current levels.
  - Euro-crisis: the scenario replicates changes in interest rates that took place during the Euro-crisis between 21 May 2012 and 4 June 2012. Interest rates fell sharply during this period.

The Value at Risk (VaR) of the banking book (interest, currencies and volatilities) at a confidence level of 99 percent at a ten-day holding period in 2017 amounted to a maximum of € 21 million. The average figure was about € 14 million.

Although MünchenerHyp is a trading book institution (only for futures), as in the past the Bank did not enter into any futures deals in 2017.

MünchenerHyp manages its credit spread risks by calculating the present value of its asset-side capital market transactions on a daily basis to determine credit spread risks. The Bank uses the Summit valuation system to calculate the credit spread VaR, credit spread sensitivities and various credit spread stress scenarios.

MünchenerHyp uses the VaR figure to identify and limit credit spread risks. The VaR figure is calculated based on historical simulation.

The current (daily) credit spread stress scenarios are:

- Parallel shifts: All credit spreads are shifted up and down by 100 base points. The worst result of the two shifts is used for calculation purposes.
- Historical simulation of the collapse of the investment bank Lehman Brothers: the scenario assumes an immediate change

in spreads based on the changes that occurred one working day before the collapse of the investment bank until four weeks after this date.

- Flight into government bonds: The scenario simulates a significantly visible aversion to risk that was previously seen in the markets. Spreads for riskier classes of paper widen while spreads for safer government bonds narrow.
- Euro-crisis: The scenario replicates the development of spreads during the Euro-crisis that took place from October 1, 2010 and November 8, 2011. During this period the spreads of less creditworthy government bonds, in particular, rose sharply.

The credit spread VaR for the entire portfolio using a 99.9 percent level of confidence and holding period of one year stood at a maximum of € 101 million in 2017, while the average figure was about € 92 million.

LIQUIDITY RISKS

Liquidity risks consist of the following risks:

- Inability to fulfil payment obligations when they come due (liquidity risk in the narrow sense),
- inability to procure sufficient liquidity when needed at anticipated conditions (refinancing risk),
- inability to terminate, extend or close out a transaction, or only be able to do so at a loss, due to insufficient market depth or market turbulence (market liquidity risk).

MünchenerHyp differentiates between short-term assurance of solvency and mid-term structural liquidity planning.

SHORT-TERM ASSURANCE OF SOLVENCY

The purpose of short-term assurance of solvency is to ensure that the Bank is fully able to meet its required payment obligations (payment willingness) as agreed on a daily basis, even during stress situations. All of the currently applicable legal supervisory requirements as defined by the terms of MaRisk and CRD IV, regarding liquidity reserves that must be held by banks, are being fully implemented.

In doing so, MünchenerHyp has categorised itself as a capital market oriented institution per the terms of MaRisk, and therefore also fulfils requirements pursuant to BTR 3.2.

MaRisk distinguishes between five different scenarios, which were implemented accordingly:

1) Base Case: corresponds to the bank's control case.
2) Bank stress: the reputation of the institution deteriorates, for example due to high balance sheet losses.
3) Market stress: Short-lived event that affects a segment of the financial markets. Examples of this are the September 11, 2001 terror attack, or the financial market/sovereign debt crisis.
4) Combined stress: Simultaneous occurrence of bank and market
5) Combined stress without counter-measures: Scenario 5 assumes that it is impossible to obtain any liquidity.

MaRisk demands that an institution must be able to meet its liquidity requirements arising from scenarios 1-4 for at least 30 days. Scenario 5 represents the worst case situation for internal management purposes.

Varying model assumptions for all important cash flows were derived for each scenario; for example utilisation of our liquidity lines or guarantees (Aval), utilisation of previously made lending commitments, or the development of collateral. Beyond this, all securities were divided into different liquidity categories. Based on this, we determined the volume that would be sold, over which time period, or could be used for a repo transaction, to generate additional liquidity in each individual scenario. Legal restrictions, like the Pfandbrief Act's 180 day rule, were always observed in all cases. The result is a day-certain presentation of the available liquidity for a three year horizon in three currencies: euro, US dollar, and Swiss franc. Positions in other currencies are negligible. Limitation in the stress scenarios takes place using various horizons as early-warning indicators in each scenario.

In addition, the Liquidity Coverage Ratio (LCR), including a forecast, pursuant to CRD IV is calculated at least once a week for all currencies. Furthermore, it is also separately presented on a regular basis for all relevant currencies (currently, the euro and the Swiss franc). The ratio was notably higher than 100 percent at all times in 2017.

MID-TERM STRUCTURAL LIQUIDITY PLANNING

The purpose of structural liquidity planning is to ensure mid-term liquidity. The legal basis consists of the MaRisk BTR 3 and CRD IV for the Net Stable Funding Ratio (NSFR).

Mid-term liquidity management in accordance to the terms of MaRisk is based on short-term liquidity management pursuant to the terms of MaRisk, which means that both procedures use the same scenario definitions and modelling assumptions. However, due to the longer observation period, additional modelling assumptions are also taken into account which are not essential for managing short-term liquidity – for example, new business plans or current expenses such as salaries and taxes.

Mid-term liquidity planning involves the following key liquidity figures as components for determining results across all due dates:

- accumulated total cash flow requirements,
- available uncovered and covered potential funding including planned new business and prolongations in line with the surplus cover requirements set by the rating agency Moody's,
- additional detailed data for planning and control activities.

The limitation of liquidity risks takes place using the structured liquidity forecast and the stress scenarios based on the available liquidity within a year.

In addition, pursuant to CRD IV, the NSFR is calculated on a quarterly basis for all currencies. Furthermore, it is presented separately for all relevant currencies (currently the euro and the Swiss franc). As the supervisory authority has not yet issued any binding minimum amounts for complying with NSFR requirements, and the values are currently stable at just over 100 percent, this key figure is not being actively managed at this time.

In order to reduce refinancing risks, MünchenerHyp strives to refinance loans with matching maturities and continuously checks if its relevant refinancing sources (primarily those within the Cooperative Financial Network) still remain available. In order to limit market liquidity risks in its lending business with public-sector borrowers and banks, MünchenerHyp primarily acquires securities that are acceptable as collateral by the ECB, and which can be used for open market transactions at any time.

MünchenerHyp does not have any less-liquid bonds, like Mortgage Backed Securities (MBS) or similar securities, in its portfolio.

INVESTMENT RISK

Investment risk is understood to mean the danger of financial loss due to a decline in the value of a holding to less than its book value. This refers to long-term investments MünchenerHyp has made in companies within the Cooperative Financial Network due to strategic reasons.

OPERATIONAL RISKS

Operational risks refer to possible losses caused by personal misconduct, weaknesses in process or project management, technical failure or negative outside influences. Personal misconduct also includes unlawful actions, improper sales practices, unauthorised actions and transaction errors.

We minimise our operational risks by qualifying our employees, using transparent processes, automating standard procedures, and by having fixed working instructions in writing, comprehensive functional testing of the IT-systems, as well as appropriate emergency plans and preventive measures. Insurable risks are covered by insurance to the normal extent required by banks.

Within the framework of a risk analysis, the materiality in accordance with MaRisk standards of all of the services that MünchenerHyp outsources related to banking transactions, financial services or other services that are typical for an institution like MünchenerHyp, is examined. All of the outsourced services that are defined as being material are monitored pursuant to MaRisk requirements and are integrated within the risk management process.

ABILITY TO BEAR RISKS

The professional concepts and models used to calculate the Bank's ability to bear risks are continuously further developed in accordance with legal supervisory requirements. MünchenerHyp calculates its ability to bear risks based on the so-called Going-Concern, as well as the Insolvency Case. However, the so-called Going-Concern scenario is the relevant method used for control purposes, which determines if the bank would still have an adequate equity capital ratio exceeding legally required levels after the occurrence of risks contained in all of the risk categories.

The scenario deducts market risks, counterparty risks, operational risks, spread and migration risks, investment risks, property risks, as well as modelling risks containing other non-explicitly defined risks. Risks on cover potential for risks are accounted for on a conservative basis and without taking diversification effects between the risk categories into consideration.

The Bank's ability to bear risks was given at all times during the year under review.

USE OF FINANCE INSTRUMENTS FOR HEDGING PURPOSES

We engage in hedging activities – interest rate and currency derivatives – in order to further reduce our risks and to hedge our business activities. Credit derivatives are not employed. We use asset swaps as micro-hedges at the level of individual transactions. Structured fundamental transactions such as callable securities are hedged accordingly with structured asset swaps. Matching currency funding is primarily sought to hedge foreign exchange risks arising from transactions involving foreign currencies; the remaining deals are hedged using (interest rate) currency swaps. The main hedging instruments we use at the portfolio level are interest rate swaps and swaptions. In addition to linear instruments, Bermudan options on interest swaps (swaptions) and interest options (caps and floors) are also used as hedges for embedded legal termination rights or arrangements to limit interest rates.

ACCOUNTING-BASED INTERNAL CONTROL AND RISK MANAGEMENT PROCEDURES

The accounting-based internal control system is documented in organisational guidelines, descriptions of work processes, financial reporting handbooks, and operating instructions. It contains organisational security measures, as well as ongoing automatic measures and controls that are integrated in the work processes. These are, in particular, separation of functions, the double-check principle, access limitations, payment guidelines, new product and new structure process and balance confirmations. Process-independent measures are, above all, carried out by the internal audit department.

The risk management methods described in the risk report provide continuous qualitative and quantitative statements regarding MünchenerHyp's economic situation, including, for example, the development of performance. This evaluation involves aspects of all risk categories.

A close coordination process exists between the risk controlling and accounting departments at MünchenerHyp. This coordination process is supervised by the entire Board of Management.

The results from the risk management system form the basis for the multi-year planning calculations, year-end projections, and agreement procedures for approving the key figures generated by the Bank's accounting process.

CORPORATE PLANNING

MünchenerHyp continues to pursue a growth strategy focused on its residential and commercial property financing activities built on a solid refinancing foundation primarily based on Pfandbriefe and other bonds. The Bank's overarching strategic goal will continue to be the further strengthening of its earning power and thus its ability to retain profits. The Bank's strategic planning is focused on measures to improve net interest income and net commission income, increase cost efficiency, and keep risks under control.

The annual adjustment of our business and risk strategy required by the MaRisk defines the formal planning framework for this. Our integrated annual planning process plays a key role in the planning and management of our operations. This process synchronises our sales goals, management of the decentral and central components of our administrative expenses – including our project portfolio – with the outlook for the profit and loss account as it develops over the course of the year. All of the income and expense elements, as well as our ability to bear risks, are continually monitored, or additionally planned on a rolling basis, thereby allowing the Bank to respond appropriately and in a timely manner to fluctuations in earnings or costs.

Planning also includes issues regarding appropriate levels of equity capital – especially in view of meeting supervisory requirements.

OUTLOOK – OPPORTUNITIES AND RISKS

ECONOMIC DEVELOPMENT AND FINANCIAL MARKETS

The outlook for the global economy is clearly optimistic. Forecasts anticipate that the broad-based upswing will continue with the IMF expecting global GDP to grow by 3.9 percent per year in 2018 and in 2019.

The upswing is mainly driven by strong growth in advanced economies where production is predicted to grow further. The ECB foresees the euro area growing by 2.3 percent as it did in the year under review. Growth is only anticipated to slow slightly to 2.0 percent in 2019 against a background of a possible diminishing monetary support.

The strong and wide growth of the German economy will continue in 2018. In line with this outlook the German Federal Government's latest Annual Economic Report predicts that the country's gross domestic product will expand by 2.4 percent. This growth is still supported by the domestic economy, especially by private consumer spending. A notable increase is also foreseen for investments in construction due primarily to unwavering attractive financing conditions. However, the construction industry is already operating at the upper limits of its capacities. This is increasingly leading to bottlenecks and higher prices. The good global economy is also benefiting the export sector, which will also contribute to the growing economy. It is estimated that the rate of inflation will remain at the level recorded in 2017 and therefore still to be moderate. The labour market will continue to develop favourably in light of the good economy as employment figures continue to increase and jobless numbers decrease. The Kiel Institute for the World Economy (IfW) estimates that the average unemployment figure for the year will be 5.4 percent.

In the interim, the normalisation of monetary policies is viewed as the primary risk facing the German and the global economy, and could lead to uncertainty in the capital markets. At the beginning of 2018 economic experts also mentioned political risks, such as the outcome of the Brexit negotiations, or protectionist tendencies, especially in the USA, as possible factors that could burden the global economy, although they were not as strongly weighted as they were in the previous year.

The central banks' monetary policies will still vary in 2018 as, at least, two interest rate hikes are expected in the USA where the Fed is likely to continue shrinking its balance sheet. In contrast, the ECB and the Bank of Japan are expected to leave their key interest rates at their respective low levels and continue buying bonds on the market. At the beginning of 2018 the ECB already announced that it was reducing its monthly volume of purchases from € 60 billion to € 30 billion. This is interpreted to mean that the ECB could raise interest rates for the first time in 2019 – if the rate of inflation moves toward 2 percent. In this environment we anticipate slightly rising interest rates. Yields on 10-year bunds could rise from the 0.43 percent noted at the start of 2018 to a level around 1.0 percent within the remainder of the year.

The euro strengthened in the currency markets in past months. In the interim the euro has largely achieved its purchasing power parity level of USD 1.25 to the US dollar and to a great extent has ended its prevailing under-valuation. We do not expect to see a further rise in the near future. The value of the euro also gained vis-à-vis the Swiss franc and in the interim almost reached CHF 1.20, a level that the Swiss National Bank previously defined as its minimum exchange rate.

The ECB's continuing purchases of bonds within the framework of CBPP 3 should also result in favourable financing conditions for Pfandbrief issuers in 2018. Experts expect that issuing activities will be concentrated in the first months of 2018 as spreads could widen again as the ECB reduces its volume of newly purchased bonds. The total volume of new benchmark covered bond issues is expected to decline further to about € 100 billion. This decrease is mainly due to issuers' notably lower refinancing requirements compared to 2017. All in all, Pfandbriefe and other covered bonds will, however, remain important refinancing instruments. This especially applies to special institutions like MünchenerHyp.

PROPERTY AND PROPERTY FINANCING MARKETS

Property markets will benefit from the favourable economic outlook for another year and expand again. This means that the markets where MünchenerHyp is active will be affected as follows:

The German housing market will again be characterised by excess demand in 2018. This will apply equally to the user market – in other words, demand for owner-occupied housing and rental housing – and institutional and private property investor markets. Demand will continue to be driven by both low interest rates as well as demographic developments. The increase in the number of single-person households, in particular, will lead to a further increase in the number of households, as will population numbers which are growing again. In addition, demand on the part of owner-occupiers and capital investors will remain at a high level because the tight supply of properties noted in recent years was unable to satisfy existing demand.

In view of the high capacity utilisation rates noted for the construction industry, and the declining number of building permits recorded during the year under review, the supply of housing cannot be expected to increase noticeably in the future. Furthermore, the vacancy rates posted over many years in cities is substantially below the required fluctuation reserve. As a result, the accelerated pace of price increases will also continue in 2018.

The outlook for the German commercial property market is also favourable. Heavy demand for commercial properties, and especially office properties, will continue to be shown by national and international investors. The number and volume of transactions will be generally determined by the limited supply of available properties, especially in the seven biggest markets. Thus, experts anticipate the volume of transactions to stabilise at the high level seen in 2017.

Market conditions in the user market in 2018 will be driven by unbroken high demand for office space, which will remain in very tight supply – especially in the preferred office locations. Newly built office space will also remain scarce in view of the high rate of pre-completion leases signed. This situation is likely to lead to a renewed increase in rents in the seven biggest markets. Coupled with great pressure on institutional investors, which will lead anew to slightly declining yields, prices paid for commercial properties will initially rise further. It is felt that only a notable increase in interest rates in the capital market can halt the decline in initial yields and stop prices from rising even further.

Further developments in the UK property market will continue to be influenced by the potential economic effects of Brexit. However, as forecasts for 2018 only anticipate a slight weakening in economic growth, international investors are again showing interest, and especially in the London property market. This indicates that Great Britain is likely to hold its top-ranked status in the European investment market in 2018. However, as the office user market is in a very advanced phase of growth, is appears likely that the trend towards more stable rents that surfaced in the second quarter of 2017 will continue. Development of the residential property market depends to some extent on the number of companies that will move their head offices, and the attendant jobs, to other European cities because of Brexit. This is particularly true for the greater London area where prices for houses are expected to rise at a slower pace than in the rest of Great Britain. This development is likely to be far more visible in the rental housing market. While rents are forecast to decline in London, they are predicted to rise by 2 percent in Great Britain in 2018.

The economic upswing is making French property even more attractive for international investors. In addition, favourable fiscal conditions are also contributing to France's appeal. Thus, based on the assumption that there will be a sufficient supply of properties, the volume of investments is expected to increase. In view of the unchanged low level of interest rates, the French property market is predicted to continue on its upward trajectory among users and investors. It is also foreseen that the market will be marked by a further rise in prices paid, and higher rents.

The Dutch investment market is also experiencing overall favourable conditions in 2018. Demand for property will increase again, especially among foreign investors. The market is expected to grow in view of limited supply and investors' willingness to make riskier investments beyond prime locations. Investors will remain focused on office properties as high demand for office space in the user market promises higher property valuations due to rising rents. The tight availability of properties in the institutional housing market is likely to continue and lead to declining residential property yields in portfolios. At the same time, a noticeable revival of new construction activity is expected and will benefit the development of projects and buildings under construction.

The segments within the Swiss housing market will increasingly develop differently. The decline in rents will continue in the rental housing segment as the share of new rental housing as a percentage of total new housing under construction is expected to remain high. In contrast, prices paid for private homes and condominiums will continue to rise further. This development is supported, on the one hand, by the unchanged low level of interest rates and, on the other, by notable excess demand.

Although forecasts for the American commercial property market are mixed, they do anticipate that the phase of growth will slow. It is expected that the vacancy rate in the office properties market will rise slightly despite declining levels of new construction. Rents are also expected to continue growing at a slower pace in certain regions. This development may lead to a renewed reduction in the volume of investments made in commercial properties. The housing market is experiencing brisk new construction of multi-family houses, thereby offering numerous purchase options to the investment market. In contrast, the pace of rental increases is expected to weaken further in the rental housing market.

DEVELOPMENT OF BUSINESS AT MÜNCHENER HYPOTHEKENBANK

Our new business planning for 2018 is based on overall conditions that do not significantly differ from those noted in the year under review. High demand for property financing is expected to continue in view of the favourable economic conditions and low interest rates. Our planning anticipates a moderate increase in interest rates that will still leave them very attractive. Competition will intensify as the number of finance providers will increase thereby putting further pressure on margins. This situation applies to both private residential and commercial property financing. Against this background we plan to slightly expand our new business compared to figures posted for the year under review. This is because the prevailing competitive conditions and the level reached in the interim do not permit a dynamic increase.

The emphasis of our new business planning remains on financing residential property in Germany. The banks within the Cooperative Financial Network are our key partners in this area of business as they have pronounced sales power and close customer relationships. These attributes have enabled them to steadily expand their share of market over the past years. We anticipate that they will also grow stronger than the market in the residential property financing sector in 2018.

In January 2018 we introduced a new loan product to expand our combined market position: the MünchenerHyp Family Loan. The product offers a sustainable financing solution to families with children and is an innovative offer that favourably distinguishes our Bank from other providers of financial services. In addition, we take a major step toward digitalising the entire lending process by upgrading the Bank's system for disbursements and other portfolio processes. The objective of our efforts in this area is to strengthen perception of our partner banks as modern and very capable property financers thereby expanding the brokered business.

We plan to moderately expand our new business in collaboration with independent providers of financial services. The negative interest rates in Switzerland will lead to a further intensification of competition in the private property financing business. Working together with PostFinance we therefore anticipate that the volume of new business will be at the previous year's level.

We also expect that our new commercial property financing business will be at the 2017 level. Germany will be the focus of our new business activities. In addition we want to step up our business with foreign investors and accompany their investment activities in Germany with attractive financing offers.

Plans for our international business foresee moderate growth in all of the markets served by the Bank. In this context we will accompany domestic customers outside of Germany as well as foreign clients in their respective target markets. Our activities in the USA will continue to be limited to participating in other banks US financing arrangements.

We anticipate that syndication markets will see lively growth in 2018 as there is a clear trend towards ever larger financing deals. Only few banks, however, are willing to completely carry larger lending volumes of € 100 million or more on their balance sheet. For this reason, we expect that the number of club deals will expand in 2018 along with growing volumes in the secondary market. This is why we are planning to intensify our syndication business. On the one hand we will significantly participate in third-party financing deals, and on the other we will again pass on bigger volumes of loans we generated to other banks. The objective of these efforts is to attain a good diversification of risk. In achieving this we will also expand our successful syndication programme with the Cooperative Financial Network.

Our lending business with the public-sector and banks will remain unchanged and primarily serve to control liquidity and cover pools. For this reason, we will strive to further reduce our capital market business portfolio in 2018, which is anticipated to be smaller than in the previous years.

Our refinancing needs in 2018 are planned to be between € 6 billion and € 7 billion, of which we expect to obtain € 5.5 billion from the capital market, with the remaining volume sourced via the money market. As in the previous year, we anticipate that we will float two large volume issues and have additional potential to tap existing bonds. MünchenerHyp will continue to need Swiss francs due to its collaboration with Swiss PostFinance. Beyond these activities we will take advantage of attractive opportunities offered by other foreign currencies to further diversify our investor base.

We developed a deposit product for private customers in 2017 to broaden our refinancing mix. This product meets the requirements of the Cooperative Financial Network and will be sold by cooperative partner banks. The product's procedures and marketability were successfully tested during pilot phases. As a result, we plan to offer this deposit product on a permanent basis in the future.

We will also expand our sustainability activities in 2018. As part of these efforts we are pursuing the goal of successfully launching the MünchenerHyp Family Loan into the market, thereby expanding our portfolio of sustainable financing. Furthermore, we are working on obtaining the required volume of mortgages eligible to serve as cover to enable us to issue another Sustainable Pfandbrief.

We are striving to achieve a moderate increase in net interest income from business operations in 2018. The stable development in our core markets continues to offer us opportunities to once again expand our new business and thus our portfolio of mortgage loans.

This will continue to have an increasingly favourable impact on the Bank's performance. As a result, we anticipate that our earnings will improve again in 2018.

We anticipate that our administrative expenses will increase anew in 2018. Nevertheless, we currently expect that our cost-income ratio will decline slightly.

Based on the currently available information, we expect that provisions for lending risks will develop stably.

In view of the anticipated favourable market conditions, we are confident that we will achieve our targets for the 2018 business year and further expand our market position. We expect that our net income will exceed the previous year's level.

DISCLAIMER REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report contains statements concerning future expectations and forecasts. These forward-looking statements, especially those pertaining to the development of MünchenerHyp's business and income, are based on our planned assumptions and estimates and are subject to risks and uncertainties. There are a number of factors that could affect our business and which are mainly beyond our sphere of influence. These include, above all, economic developments, the state and further development of the financial and capital markets in general and our refinancing conditions in particular, as well as unexpected defaults on the part of our borrowers. Therefore, the actual results and developments may vary from the assumptions that have been made today. For this reason, they are only valid at the time this report was prepared.