ECONOMIC REPORT

OVERALL ECONOMIC CONDITIONS

» **Economic momentum continues to slow globally**
» **High demand for Pfandbriefe and other covered bonds, new issue volume increases**
» **German residential and commercial property markets continue to see positive development**
» **European property markets in good condition**

Economic development

The growth of the global economy weakened in the second half of the year due mainly to growing trade conflicts initiated by the USA with China and Europe as well as the tightening monetary policy in the USA. The pace of economic growth slowed in both developed and emerging economies. Nevertheless, the International Monetary Fund (IMF) reported that global gross domestic product (GDP) once again grew quite strongly and expanded by 3.7 percent, putting the increase just slightly below the 3.8 percent rate of growth noted in the previous year.

Business sentiment within the euro area along with the European economy was particularly weighed down by the uncertain outcome of the Brexit negotiations, the conflict surrounding the national budget in Italy, as well as the protest movement in France. Growth of the euro area's GDP fell by 0.6 percentage points to 1.8 percent. Economic growth was mainly driven by consumer spending while investments hardly generated any growth. The contribution made by foreign trade was negative in 2018 as exports stagnated.

In 2018, growth of the German economy amounted to
1.5%

Following the strong upswing seen in previous years, the German economy was unable to resist the downward pull of global developments in 2018 as its GDP grew by a significantly slower 1.5 percent. Domestic demand, in particular, developed at a stable pace with investments and consumer spending making the most important contributions to economic growth. Although the volume of exports also grew, the noted rate of expansion in this sector was below the previous years' performance, which coupled with the strong increase in imports led to a negative net exports figure. Investments in construction rose by 3.0 percent and were somewhat stronger than in the previous year with considerably more investments noted for public sector spending for civil engineering projects. Construction of residential housing again posted strong growth and expanded by 3.7 percent although it was primarily hindered from growing even faster as the construction industry was operating at almost full capacity.

The annual average rate of inflation in 2018 was 1.8 percent, a level which was last recorded in 2012. The increase in inflation was primarily driven by energy prices.

The favourable development of the labour market continued in 2018 as the annual average number of employed persons rose by about 560,000 to approximately 44.8 million. Unemployment declined further as the average number of unemployed persons reported in 2018 was 2.3 million, or about 200,000 less than in the previous year. The unemployment rate fell by 0.5 percentage points to 5.2 percent.

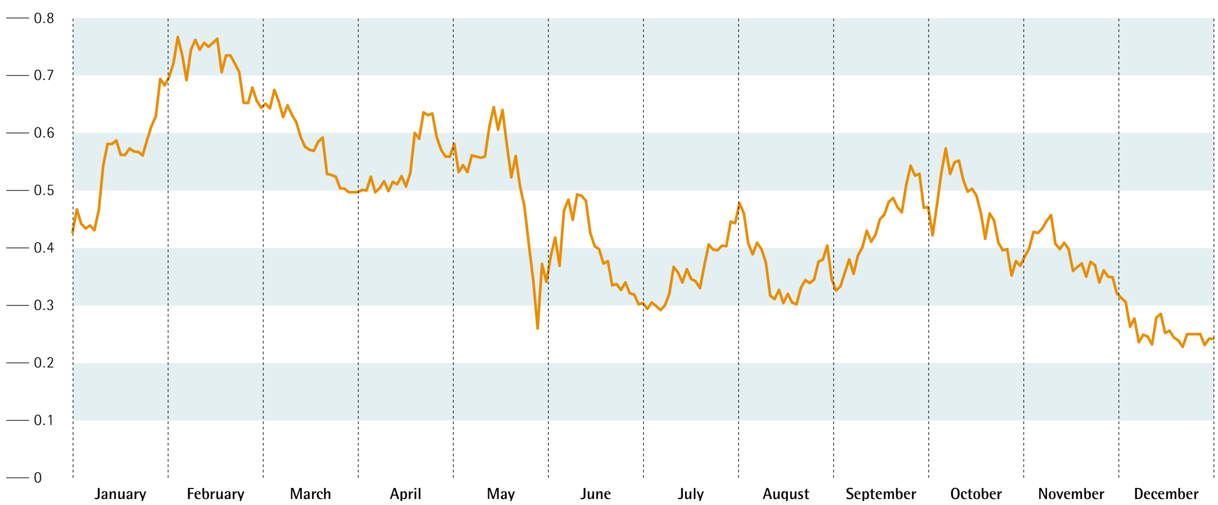
Financial markets

The European Central Bank (ECB) started to slightly taper its expansive monetary policy over the course of the year and gradually reduced its bond-buying operations until it stopped its net purchases of bonds at the end of 2018. Nevertheless, the ECB reinvested in bonds bought under its purchase programme as they matured, which resulted in the ECB purchasing a high average volume of € 17 billion each month. The ECB kept its deposit facility rate for banks unchanged at minus 0.40 percent and its main refinancing operations rate at 0 percent. Other central banks, such as the Bank of Japan and the Swiss National Bank, left their rate policies unchanged.

Despite higher inflation rates the Bank of England only raised its key interest once. In contrast, the American central bank, the Federal Reserve (Fed), took advantage of friendly economic conditions in the USA and raised its key rate four times to a rate corridor of 2.25 to 2.50 percent. The Fed also made progress in reducing the size of its balance sheet, which contracted by about US$ 400 billion since the autumn of 2017 as the Fed stopped replacing maturing securities.

Driven by good economic conditions the bond market in Germany saw noticeably higher yields at the start of the year as 10-year Bunds returned 0.8 percent at their peak. Despite the ECB cutting its net bond purchases, the level of interest rates tended to move sideways over the remainder of the year although they even fell as economic development weakened towards the end of the year. Ten-year Bunds yielded 0.24 percent at the close of the year.

YIELD ON TEN-YEAR BUNDS 2018
IN %



Source: Bloomberg (closing rate)

In the currency markets the US dollar was able to strengthen overall and benefited from the more robust American economy vis-à-vis economic growth seen in Europe. Furthermore, the US dollar also gained strength compared to other currencies due to the widening gap in interest rates as the Fed repeatedly raised its key rate. At the end of the year the euro was trading at just under US$ 1.15, although it had been valued at US$ 1.25 in February 2018. The Swiss franc also gained strength over the course of the year rising from CHF 1.17 to the euro to about CHF 1.127 at the end of the year. The euro was burdened by weaker economic data as well as political uncertainties in Europe. The British pound was encumbered by political turmoil surrounding the Brexit and the possible consequences facing the future economic development of the United Kingdom. At the end of the year the pound was slightly weaker vis-à-vis the euro at GBP 0.898 compared to the rate of GBP 0.895 recorded at the start of the year.

The ECB's Covered Bond Purchase Programme (CBPP 3) once again marked proceedings in the Pfandbrief and covered bond markets for another year. Following the ECB's announcement that it would end asset purchases at the end of 2018 it began to steadily reduce its share purchases of primary market issues. At the beginning of 2018 orders placed for bonds in the primary market the ECB accounted for 50 percent of the total volume of the issues. By the end of the year this figure had declined to 10 percent. As a result, spreads in the primary market widened significantly during the second half of the year. Differences in spreads for different categories of covered bonds also increased. Issuance activities greatly exceeded experts' expectations as a total volume of € 134 billion in euro-denominated benchmark covered bonds was issued, or about 20 percent more than in the previous year. The greatest volume of new issues was again placed by issuers based in Germany and France.

Property and property financing markets

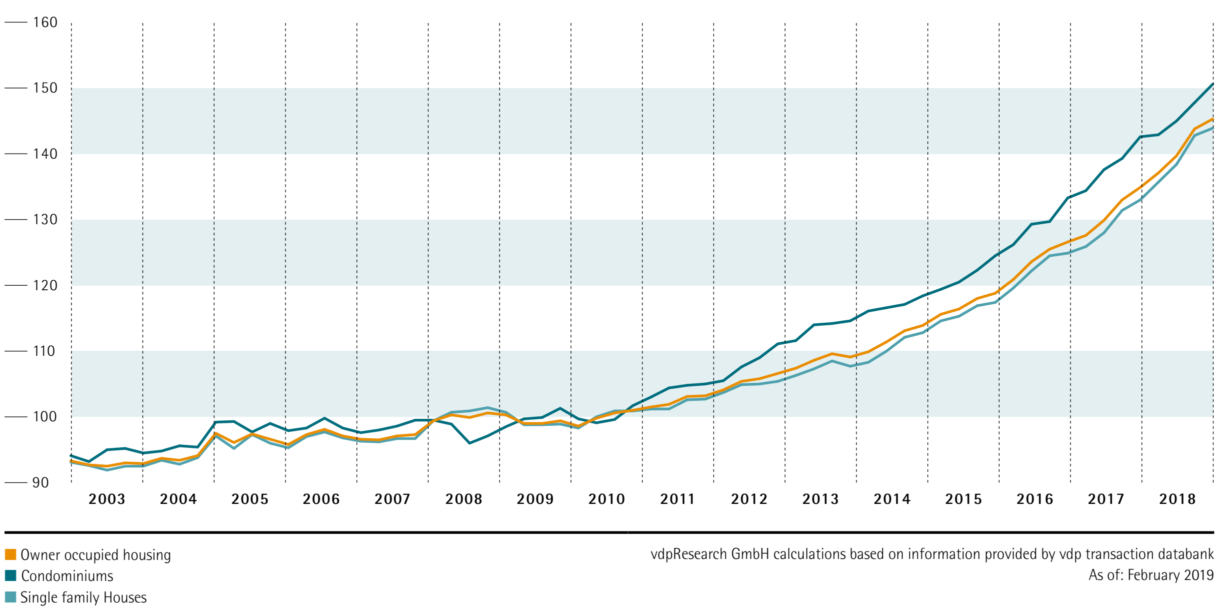
Residential Property – Germany

German residential property was again in very great demand by both professional investors and private buyers in 2018. Purchase prices and rents continued to post strong gains. According to the Association of German Pfandbrief Banks' (vdp) index for residential property prices, in 2018 prices rose by 8.3 percent year-on-year. The greatest increase of 9 percent was noted for multi-family houses. Prices for owner-occupied residential property accelerated by 7.7 percent. Prices paid for residential property in Germany's seven largest cities grew by 9.9 percent, making this the most dynamic segment albeit not quite as strong as in 2017.

In 2018,
13%
more was invested in the residential property portfolio than in the previous year.

The high level of prices in the major metropolitan areas, in particular, did not, however, frighten institutional investors. On the contrary: Ernst & Young calculated that the total volume of residential property portfolio transactions in 2018 amounted to € 17.6 billion, or 13 percent more than in the previous year. The institutional housing market continues to be dominated by German investors representing more than three-quarters of total turnover. The volume of transactions outside the seven largest cities rose at a rate that was far higher than the average: by 27 percent to about € 10 billion. Berlin was clearly the unchallenged number one among the seven biggest cities. The two reasons behind the shift in activities to cities other than the top 7 were the very tight availability of properties and the very high level of prices. Prices for multi-family houses in the seven biggest cities increased by 10.4 percent in 2018. This is due to a further decline in returns sought by investors and the very tight situation in the rental housing markets in the major metropolitan areas as reflected by an additional 5.1 percent year-over-year increase in rents noted for

DEVELOPMENT OF PROPERTY PRICES IN GERMANY
YEAR 2010 = 100

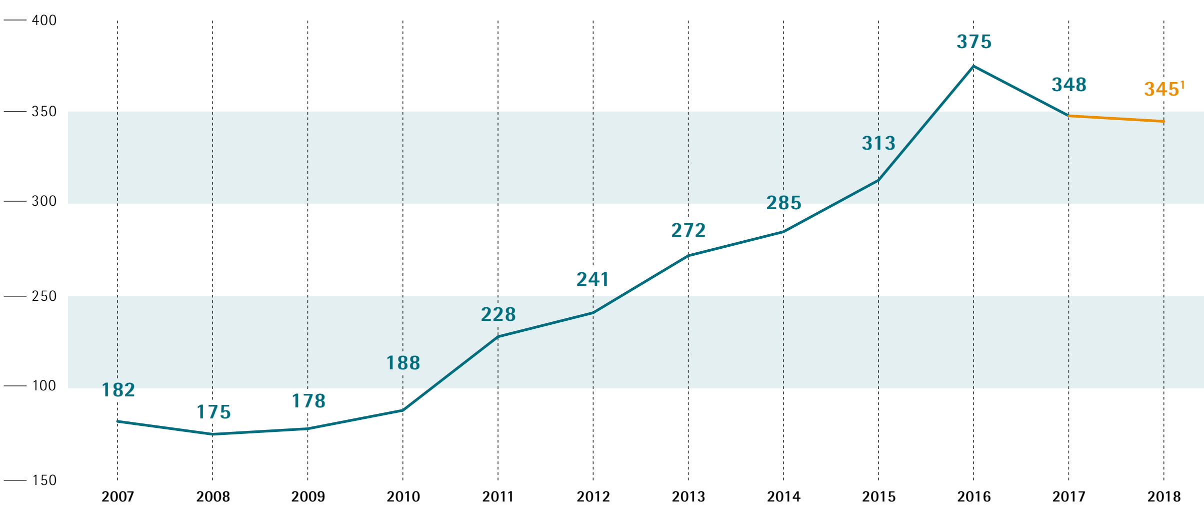


vdpResearch GmbH calculations based on information provided by vdp transaction databank
As of: February 2019

housing in these areas in 2018. On a national level rents rose by 4.6 percent according to vdp figures.

The continuing climb of residential property prices in Germany is not only based on strong demand. The shortage of housing in numerous regions is also a key factor. Although construction of new housing increased across Germany in 2018, the 300,000 newly completed housing units were far below the actual 350,000 to 400,000 needed per year to satisfy demand. A major reason behind the gap is that construction companies were operating at the limit of their capacities, which in turn meant that many projects were not begun in a timely manner. The approximately 315,000 building permits issued in the first eleven months of the year in Germany reflect this situation as this number represents an increase of only 0.5 percent year-on-year. Over the last few years this situation has created a construction backlog of over 650,000 housing units that have received building permits but have not yet been completed.

RESIDENTIAL BUILDING PERMITS IN GERMANY 2007–2018
IN TSD



¹ Estimated.

Source: German Federal Statistical Office

Production costs are another factor driving prices for residential property. Along with steadily rising building land prices, higher construction costs are playing an increasingly greater role. In the fourth quarter of 2018 these costs rose by 4.8 percent year-on-year, which is the sharpest increase noted since 2008.

€ 170 billion
was allocated to financing residential properties by the end of September 2018.

Higher property prices and strong demand for home ownership led to significant growth in the volume of housing loans during the year under review for the first time since 2015. According to vdp figures, about € 170 billion in residential property loans were made in Germany during the first three quarters of 2018, or 6.7 percent more year-on-year. The German Bundesbank stated in its Financial Stability Review that it does not regard the expansion of lending as unusual when compared to the development of the German economy. The Bundesbank did, however, take a critical view of the easing of lending standards noted for housing loans, as well as the dangers that could arise from overvalued properties in urban areas. The Bundesbank reports that according to estimates for 2017 these properties may be overvalued by 15 to 30 percent. The Bundesbank further noted that an unexpected strong downturn in the economy would force a notable correction in prices. This in turn could generate losses from credit defaults which might not be covered by proceeds from the sale of property serving as collateral, which could critically affect property loan portfolios.

Residential Property – International

The upswing in the European housing markets continued on an overall basis in 2018, although the pace accelerated in some countries and weakened in others. Based on Eurostat figures, house prices rose in the second quarter of 2018 by 4.3 percent year-on-year in both the European Union (EU) and the euro area. Growth advanced by double-digits rates in Slovenia, Ireland, Portugal and Hungary. Signs of a slight weakening in the rate of growth were noted in some eastern European countries like Bulgaria and the Czech Republic. Weak economic performance in Italy again drove property prices down slightly. Property prices in Sweden also declined in the first two quarters.

In Great Britain the pace of rising house prices continued to slow due to the Brexit decision. While prices noted for houses in November 2017 climbed by 5.1 percent on a year-over-year basis, in November 2018 the same figure stood at just 2.8 percent. Above all, London is being confronted with the effects of the UK's decision to leave the EU as house prices there fell by 0.7 percent. This is due to hesitant demand mirrored by the 9.1 percent decline in the number of transactions. The rate at which prices rose also slowed in the rental housing market as rents increased across the UK by 1 percent and by only 0.2 percent in London.

The French housing market is showing signs that it might cool slightly. Record-breaking volumes of transactions and mortgage loans noted in 2017 were followed in 2018 by a slight decline in demand for residential property. Although prices continued to rise in 2018, prices for houses rose at a slightly slower pace. Prices for houses in France in the third quarter increased in total by 2.8 percent. The market for rental housing showed no signs of easing as rents in the fourth quarter of 2018 rose by 1.7 percent year-on-year, which was the highest increase seen since 2013.

The upswing in the Dutch housing market continued and was driven by very solid domestic economic conditions. The Netherlands recorded the fifth highest rate of price increases in Europe. Just taking the first six months of 2018 year into account, when prices for existing properties climbed by 9.3 percent year-on-year, allows expectations that a very high rate of growth will be recorded for the entire year. The volume of transactions noted in the investment market rose significantly with a total of over € 6 billion invested in Dutch residential property in 2018.

The Swiss housing market was weaker in 2018. The number of vacancies for housing rose again marginally with a total of 72,000 housing units reported vacant in September 2018, which set a new high point. There were, however, significant regional differences with the highest vacancy rates in the country noted in eastern Switzerland and Ticino, and the lowest in the cantons of Geneva, Basel, Zug and the city of Zurich. The majority of the vacant housing units are rental units, and as a result rents declined again. In the third quarter of 2018 rents on average were 2.1 percent below the previous year's figure. The pace of rising prices paid for single family houses and condominiums slowed further over the course of 2018. Prices for single family houses only rose by 1.3 percent in the third quarter of 2018, while prices for condominiums were stable.

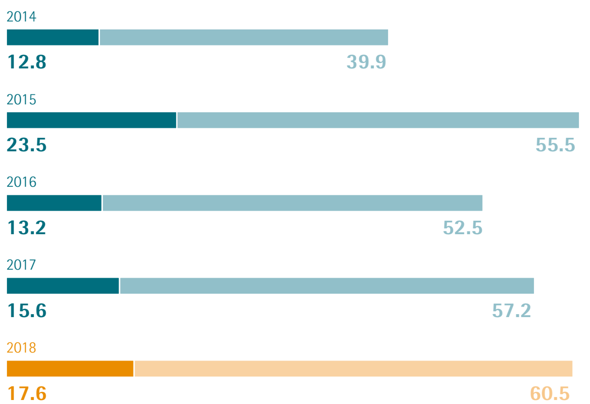
House prices in Switzerland increased
by 1.3%
in the third quarter of 2018.

The upswing in the housing market in the USA continued in 2018 as vacancy rates fell again. As a result, institutional investors were strongly focused on residential property. In the first nine months of the year alone USD 115.7 billion was invested in multi-family houses, or about 15 percent more year-on-year. In contrast to the previous year, investors preferred to acquire residential property in major metropolitan areas. Prices noted in the private housing market rose at a slightly weaker pace. On a nation- wide basis house prices increased by 5.5 percent in October 2018 on a year-over-year basis with clearly visible regional differences noted. While prices in Las Vegas climbed by almost 13 percent, prices paid in New York and Washington D. C. only rose by about 3 percent.

Commercial Property – Germany

The German commercial property market recorded a very good year in 2018. According to Ernst & Young the volume of transactions set a new record and totalled € 60.5 billion. Professional investors increased their investments in German commercial property due the continuing lack of alternative investment opportunities, and the solid economic conditions. Although domestic investors still accounted for the majority of transactions, other European and Asian investors, in particular, expanded their activities.

DEVELOPMENT OF COMMERCIAL PROPERTY TRANSACTIONS IN GERMANY 2014–2018
IN € BILLION



Residential (only portfolio)
Commercial

Source: EY Research, January 2019

Investments in office properties amounted to nearly € 29 billion and represented about half of the total volume of transactions made as the segment retained its role as the most popular class of investment. The seven biggest cities in Germany accounted for the highest turnover of office space with Munich and Berlin at the top of the list. Moreover, with a vacancy rate of just 1.5 percent Berlin was also the leader in this category. Viewed on an overall basis, vacancy rates in Germany's biggest cities declined. Demand for office space received additional support from further rising employment figures.

Sinking vacancies and a relatively low level of construction activities led to a 5.5 percent increase in rents for newly leased office space in 2018, which was stronger than in the previous year. At the same time, prices for office property continued to rise at an unchanging strong rate. According to vdp figures, prices for office property rose by 9.6 percent in 2018 on a year-over-year basis.

In contrast, the significance of retail buildings in the investment market declined in 2018 as the volume of transactions fell by 9 percent on a year-over-year basis to € 10.5 billion. The pace of rising prices reflected weaker demand and slowed to 1.7 percent in 2018. In particular, the retail rental property market contributed to the poor results. Demand for retail space came under pressure from growing competition posed by online business. According to the vdp-Index, this resulted in a lower number of new rental contracts signed in the third and fourth quarters of 2018.

Commercial Property – International

Commercial property worth about € 177 billion was bought across Europe by institutional investors during the first three quarters of 2018. This figure was at the previous year's level, however, a slight decline in the volume of transactions was expected on a year-over-year basis for the entire year. Once again, results were particularly driven by strong investment activity in Germany.

The unbroken dominant role played by office property in the investment market is due to the very sound condition of the office markets in many countries. Although the turnover of space in Europe declined somewhat, the second best results noted since 2001 were nevertheless achieved. This development was due to the shortage of suitable office space. Only 6.3 percent of office space across Europe was vacant in 2018 marking the lowest rate since 2002. Against this background, rents paid climbed by 5.5 percent. Many major European office cities currently find themselves, however, in a phase where the rate of rental increases begins to flatten. Thus, the overall rate of growth was driven by the eastern European markets where rents continued to rise at a strong rate.

6.3%
of office space is vacant in Europe, it has not been as low since 2002.

Activities noted in the London office property market in 2018 were barely affected by uncertainties surrounding the effects of Brexit as turnover of office space exceeded figures recorded in the past two years rising to 13.7 million square feet, while the vacancy rate fell to 4.6 percent. This increase was not reflected in peak rents paid, which remained stable in the fourth quarter following previously noted gains. On an overall basis, the British investment market was, however, somewhat weaker weaker than in the previous year as the volume of transactions decreased slightly to about £ 55 billion.

The French investment market was stable with a volume of transactions of about € 28 billion. The office property market with more than a 70 percent share of the market was also the most important segment in France. Three-quarters of the market's activities took place in the greater Paris area, which benefited from a notable increase in employment figures in this area. Turnover of office space increased to about 2.8 million square metres while the vacancy rate fell to 5.5 percent.

The Dutch commercial property market was supported by favourable economic development as the volume of transactions recorded in the investment market totalled about € 20 billion. Investors also focused on office properties in the Netherlands. The availability of office space was tight due to the high demand seen. By the end of the year the vacancy rate in the greater Amsterdam area had fallen to 3.5 percent.

US$ 340 billion
was invested in commercial properties in the US by September 2018.

The commercial property investment market in the USA experienced strong inflows of capital. During the first three quarters of the year a total of about USD 340 billion was invested, or 14 percent more year-on-year. The biggest increases were posted by retail buildings and industrial properties with the volume of office property transactions recording notably more moderate growth. Investors critically viewed the quite advanced position of the user market in the property cycle as rent paid for office space fell in Washington, New York and Houston, while Chicago, Denver, San Francisco and numerous other cities were still at the end of their respective growth phases in the cycle. At the same time, vacancy rates for office space increased due to lively new construction activities. At the end of 2018 about 15 percent of total available office space across the nation was vacant. However, despite worsening overall conditions, office buildings remained the most important class of commercial property investment as about USD 93 billion were invested in this segment in the first nine months of 2018.

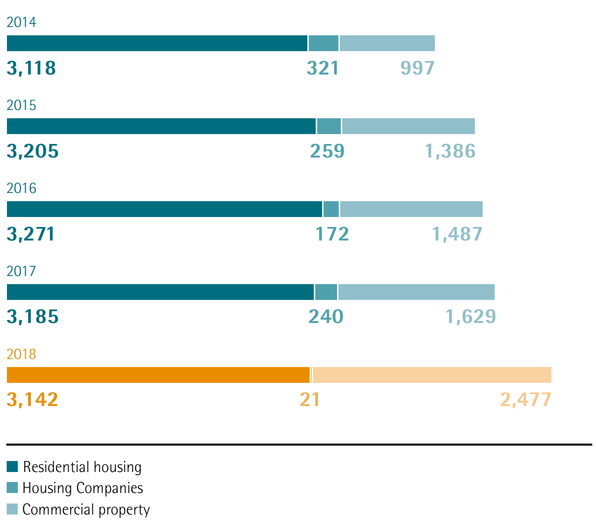
BUSINESS DEVELOPMENT

» Record result in new mortgage business at € 5.6 billion
» New business in commercial property financing increases by 34 percent to € 2.5 billion
» MünchenerHyp issues first ecological ESG Pfandbrief
» Successful entry into deposit business with GenoFestgeld

New mortgage business

MünchenerHyp's new mortgage business once again developed very well in 2018. The volume of lending commitments made rose by 12 percent to € 5.6 billion (previous year € 5.1 billion), and was significantly stronger than anticipated. The second half of the year, in particular, contributed to the new record results following the initially weaker start noted for new business in first half of the year.

MÜNCHENERHYP NEW MORTGAGE BUSINESS 2014–2018
COMMITMENTS IN € MILLION



New business in our private residential property financing area amounted to over € 3.1 billion and remained almost at the previous year's very high level (€ 3.2 billion). Achieving such a strong volume of financing in the face of intensifying competition that is increasingly price-based is a satisfying accomplishment.

This applies especially for our business with the cooperative banks within the Cooperative Financial Network where we granted € 2.4 billion in new lending commitments. Our sales campaigns once again played a key role in our success. Furthermore, our new Family Loan, which we introduced at the start of 2018, has become well established. It is aimed at middle-income families with at least one child and offers them an interest rate rebate. In addition we successfully expanded our Individual Business segment, which especially includes higher volume financing deals for residential property.

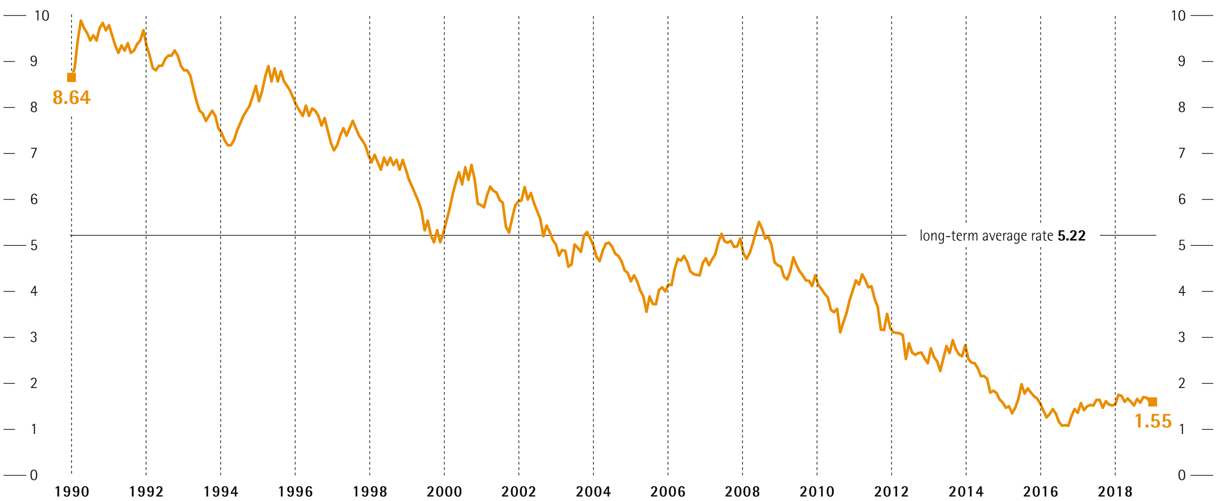
We further developed our services and processes offered to cooperative partner banks: we digitised additional processes involved in our lending procedures. We also integrated loans made by MünchenerHyp in the VR-eBanking system at the end of the year for our customers. This means that our customers can access real-time information regarding their loans and can take advantage of additional services we offer online.

Sales generated by independent providers of financial services rose by 21 percent over the previous year's figure to € 507 million. New business brokered by Swiss Post-Finance amounted to € 282 million and was 24 percent below the previous year's level. The decline is primarily due to steadily intensifying competition in the Swiss market. In contrast, we were able to expand the volume of extensions of loan agreements falling due in Switzerland by over 20 percent to € 389 million thus achieving an extension rate of 79 percent.

We were very successful in our commercial property financing business in 2018 as the volume of our new business exceeded the € 2 billion mark for the first time since the crisis in the financial markets. We made a total of € 2.5 billion in loans for commercial property, or 34 percent more than the previous year's figure of € 1.9 billion.

MORTGAGE RATES MÜNCHENERHYP

TEN YEAR FIXED RATE | IN %



As of: 02.01.2019

We posted gains in our domestic as well as our international business activities. Our domestic business rose by 6 percent to over € 1.3 billion, while our international business almost doubled on a year-over-year basis to about € 1.2 billion due to the again intensified business activities in the USA. The greatest shares were accounted for by France and the USA with about 30 percent each followed by Great Britain, the Netherlands, and Spain.

Following a somewhat subdued first half of the year, the strong second half of the year drove volumes higher. On the earnings side of our business we were also satisfied with the performance of our commercial property financing business, and all the more so as the competitive environment was difficult. The Brexit and American trade policies led to uncertainty in the investment markets. In addition, the extremely pronounced competition seen in recent years, coupled with a lack of investment alternatives, has driven property prices higher and returns substantially lower.

This business environment poses quite a challenge for MünchenerHyp's more conservative approach to financing with its focus on classical financing of existing properties. We stepped up to face price-based competition, increased the average loan size, and further optimised the new business process. This has allowed us to handle a greater number of new business inquiries while maintaining the same level of quality.

In this context an important role was played by the taking on underwritings for larger volume loans and then subsequently syndicating them primarily within the Cooperative Financial Network.

Capital markets business

Our investment strategy concerning securities issued by the public-sector and banks was furthermore determined by regulatory requirements and very low spreads. Sovereign bonds and, to a lesser extent, covered bonds continued to trade at high levels because of the ECB's asset purchase programme that continued until the end of the year.

In accordance with our business strategy, we again limited our capital market business in the past year. The net total volume of our existing portfolio was reduced by nearly € 1.2 billion to € 4.5 billion. Our portfolio of Italian securities was completely liquidated. Our volume of new business in this area totalled € 7 million in 2018 following € 25 million in 2017.

Refinancing

We issued our first benchmark Pfandbrief during the year under review in July with a € 500 million Mortgage Pfandbrief that had a term of term of nine years and four months and a coupon of 0.625 percent. The issue was placed at

8 basis points below the mid-swap rate. The bond was purchased by 52 investors from 12 countries with Germany representing the main region accounting for 61 percent of the issue's volume, followed by buyers in Great Britain, and other European countries. The issue was notable because it marked the return of classical Pfandbrief investors like insurance companies, central banks and asset managers just shortly after the ECB announced the end of its asset purchase programme.

40%
of issue volume of the ecological ESG Pfandbrief was subscribed from investors specialised in sustainable investments.

In November we broke new ground with the successful issue of the first ecological ESG Pfandbrief. This makes us the first issuer to place ESG Pfandbriefe on the basis of both social and ecological sustainability criteria. The € 500 million benchmark issue generated very strong investor demand. About 40 percent of the volume issued was subscribed by investors specialising in green and sustainable investments. The term of the issue is five years and one month and carries a coupon of 0.250 percent. Market interest was also reflected by 80 orders received from fourteen countries with Germany accounting for the greatest share of orders. The issue was placed at a price of 8 basis points below the mid-swap rate.

The Swiss franc was once again the primary currency for our foreign currency denominated issues with a total volume of CHF 1,120 million. Therefore, the share of foreign currency denominated issues rose to 23 percent in the year under review.

During the year under review we issued the following Pfandbriefe that were denominated in Swiss francs: in April we issued a CHF 250 million Mortgage Pfandbrief with a term of two years. In May we were able to successfully take advantage of a window in the market to place an unsecured CHF 120 million bond with a term of five years and seven months. We followed up on this bond in June with a ten-year Mortgage Pfandbrief with a volume of CHF 150 million, and two other two-year Pfandbriefe with respective volumes of CHF 200 million and CHF 75 million in August. In October we floated a CHF 125 million Mortgage Pfandbrief in the benchmark format. Towards the end of the year we issued an additional two-year Mortgage Pfandbrief in December that had a volume of CHF 200 million.

Only one large-volume bond matured during the previous business year: a Public Pfandbrief with a volume of € 0.75 billion that matured in October.

The total volume of issues placed in the capital markets during the period under review amounted to € 4.3 billion, of which Mortgage Pfandbriefe accounted for € 3.0 billion in covered refinancing, while unsecured refinancing amounted to € 1.3 billion. During the period under review we once again did not issue any Public Pfandbriefe due to the direction of MünchenerHyp's business strategy.

During the year under review we introduced a new deposit product, GenoFestgeld (Geno Fixed Term Deposit), for private customers of the Cooperative Financial Network to the market. We developed this product in 2017 in conformity with the Cooperative Financial Network after successfully testing technology and marketability of the product in pilot phases. GenoFestgeld expands our refinancing mix.

GenoFestgeld is marketed exclusively by MünchenerHyp's partner banks within the Cooperative Financial Network, thereby retaining liquidity within the cooperative sector. GenoFestgeld currently has a term of one year and offers an attractive rate of interest. Monthly amounts of € 10,000 to € 100,000 may be deposited. GenoFestgeld soon met with a good response from customers and partner banks. By the end of 2018 we had taken in € 100 million in deposits with our new product. Furthermore, we also gained additional banks from within the Cooperative Financial Network as new partners.

ASSET, FINANCIAL AND EARNINGS SITUATION

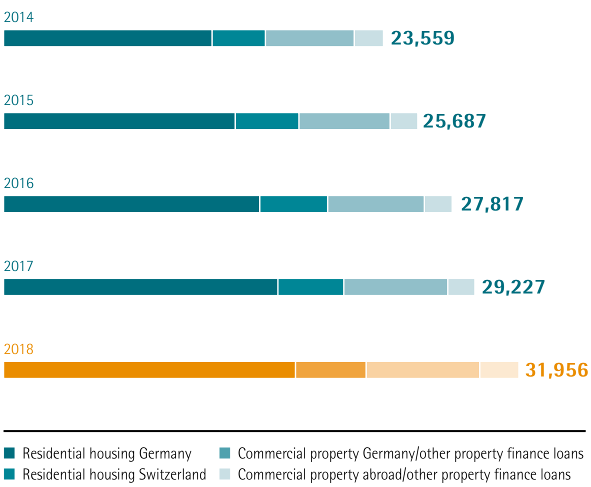
- **» Portfolios in mortgage financing increased to about € 32 billion**
- **» Common Equity Tier 1 ratio of 21.7 percent continues to be very significantly above supervisory requirements**
- **» Net interest income and net commission income increases by 14 percent to € 207.6 million**
- **» Annual net income rises by 5 percent to € 48.7 million**

Balance sheet structure

By the end of 2018 total assets had risen to € 40.4 billion, following € 38.9 billion at 31 December 2017. The increase was driven once again by the ongoing good new business results.

Our portfolio of mortgage loans grew by € 2.7 billion over the course of the year to about € 32.0 billion. Private residential property financing in Germany was the strongest growing segment of our business as it increased by € 1.1 billion.

PORTFOLIO DEVELOPMENT MÜNCHENERHYP 2014–2018
IN € MILLION



Our portfolio of private residential property loans is structured as follows: domestic mortgage loans € 18.1 billion (previous year € 17.0 billion), foreign mortgage loans € 4.4 billion (previous year € 4.1 billion), which are solely loans made to finance residential property in Switzerland.

Our portfolio of commercial property loans totalled to € 9.5 billion (previous year € 8.1 billion), of which € 2.4 billion (previous year € 1.9 billion) represented loans made outside of Germany. Great Britain is our most important foreign market with 21 percent (previous year 25 percent), followed by the USA with 19 percent (previous year 10 percent), the Netherlands with 17 percent (previous year 21 percent), and France also 17 percent (previous year 18 percent).

In accordance with our business and risk strategy, our portfolio of loans and securities related to our business with the public-sector and banks declined further from € 5.7 billion to € 4.5 billion, of which € 2.3 billion were securities and bonds.

At the end of 2018 the net sum of unrealised losses and unrealised gains in our securities portfolio amounted to plus € 41 million (previous year plus € 58 million). These figures include unrealised losses of € 1 million (previous year € 1 million) stemming from securities issued by countries located on the periphery of the euro area and banks domiciled in these countries. The total volume of these securities still amounted to € 0.3 billion (previous year € 0.4 billion) at the end of 2018.

Following a detailed examination of all securities we came to the conclusion that no permanent reductions in value are required. We are keeping these bonds on our books with the intention of holding them until they mature. Write-downs to a lower fair value were not necessary.

The portfolio of long-term refinancing funds increased by € 0.6 billion to € 34.7 billion, of which € 25.0 billion consisted of Mortgage Pfandbriefe, € 2.4 billion of Public Pfandbriefe and € 7.3 billion of unsecured bonds. The total volume of refinancing funds – including money market funds and customer deposits – rose from € 36.4 billion in the previous year to € 37.9 billion on 31 December 2018.

The item "Other liabilities to customers" is structured as follows:

OTHER LIABILITIES TO CUSTOMERS
IN € 000

	Remaining term < one year	Remaining term > one year	Total
Other liabilities to customers as at 31 Dec. 18	**1,204,031**	**2,289,637**	**3,493,668**
Registered bonds	10,759	1,303,470	1,314,229
of which institutional investors	10,716	1,291,470	1,302,186
Promissory note loans on the liabilities side	795,928	816,167	1,612,095
of which institutional investors	390,556	619,667	1,010,223
Other	397,344	170,000	567,344
of which institutional investors	276,777	170,000	446,777

Paid-up capital increased by € 27.7 million to € 1,032.6 million. Total regulatory equity capital amounted to € 1,442.0 million (previous year: € 1,390.9 million).

Common Equity Tier 1 capital rose from € 1,316 million in the previous year to € 1,369.7 million. On 31 December 2018 the Common Equity Tier 1 capital ratio was 21.7 percent (previous year 23.8 percent), the Tier 1 capital ratio was also 21.7 percent (previous year 23.8 percent) while the total capital ratio was 22.9 percent (previous year 25.2 percent). The leverage ratio remained unchanged at 3.4 percent on 31 December 2018.

Development of earnings

Net interest income[1] increased by € 23.5 million, or 9.2 percent to € 280.1 million. We were able to increase this figure as predicted, which was especially due to our successful new business activities during the year under review and the previous years.

Commission expenses totalled € 81.9 million and were almost at the previous year's level. Commission income increased to € 9.4 million resulting in a net commission balance[2] of minus € 72.5 million following minus € 74.5 million noted in the previous year.

This resulted in a net interest income and net commission[3] figure of € 207.6 million for an increase of € 25.5 million, or 14 percent.

General administrative expenses increased by € 14.8 million to € 108.4 million. Thereby, personnel expenses increased by € 4.1 million, or 9.0 percent. Higher costs were mainly driven by the further increase in the number of employees, in addition to rising tariff salaries.

1 Net interest income is calculated by adding Item 1 Interest income plus Item 3 Current income plus Item 4 Income from profit-pooling, profit transfer or partial profit transfer agreements minus Item 2 Interest expenses as shown in the income statement.
2 Net commission balance is the net sum of Item 5 Commission income and Item 6 Commission expenses as shown on the income statement.
3 The net interest income and net commission income balance is the sum of net interest income and the net commission balance.

Other administrative expenses rose by € 10.7 million, or 22.4 percent. In 2018 the Bank also invested in process optimisation measures. In addition, the Bank incurred expenses related to entering the Austrian retail customer property finance market, which is planned to take place in 2019. Expenses related to regulatory requirements increased again.

Depreciation and write-downs of intangible and tangible assets amounted to € 5.2 million or € 0.8 million less than the same figure in the previous year.

Total administrative expenses[4] amounted to € 113.6 million, compared to € 99.6 million in the previous year. The cost-income ratio[5] remained unchanged at 55 percent.

The net sum of other operating expenses and income totalled minus € 5.6 million.

Results from operations before deducting provisions for risk[6] increased by 12 percent on a year-over-year basis to € 88.4 million.

The item "Write-downs on and adjustments to claims and certain securities, and additions to provisions for possible loan losses", amounted to minus € 12.7 million after allocations to contingency reserves pursuant to Art. 340f of the German Commercial Code. The credit risk situation remained unremarkable. The balance of changes in risks in the lending business (including direct write-downs) amounted to minus € 1.2 million (previous year plus 10.5 million)

Net expenses from the sale of promissory note loans, and the redemption of registered securities and debt securities, amounted to € 1.3 million.

The item "Income from reversals of write-downs on participating interests, shares in affiliated companies and securities treated as fixed assets" amounted to plus € 0.3 million.

Results from ordinary business operations amounted to € 76.0 million.

After a tax expense item of € 27.3 million, annual net income amounted to € 48.7 million, which was 5 percent higher than in the previous year.

4 Administrative expenses are the sum of Item 7 General administrative expenses and Item 8 Depreciation and write-downs of intangible and tangible assets as shown on the income statement.
5 Ratio between administrative expenses and net interest and commission income.
6 Net sum of income statement items 1 to 10.

RATING, SUSTAINABILITY AND REGULATORY CONDITIONS

- **» MünchenerHyp's Pfandbriefe retain best Aaa rating**
- **» ISS-oekom raises sustainability rating to the current top level of B-**
- **» Leverage ratio unchanged at 3.4 percent**
- **» Minimum ratio for Common Equity Tier 1 at 8.5 percent as part of the SREP**

Rating

The rating agency Moody's left its Baseline Credit Assessment (BCA), the standalone rating of the bank, as well as its final rating for the bank – including external support from the government and the Cooperative Financial Network – unchanged in 2018. However, in August 2018 Moody's did change its rating for the Bank's senior unsecured liabilities.

The revision is due to a change in the methodology Moody's employs to make its ratings. The rating agency now assumes that the EU's Bank Recovery and Resolution Directive (BRRD) will be transformed into national law in Germany leading to the federal government providing weaker support to many banks. This is why MünchenerHyp is not the only bank affected by the revision as it affects a total of 14 banks rated by Moody's in Germany. Liabilities previously referred to as "senior unsecured" are now referred to by Moody's as "junior senior unsecured" and rated one notch lower. At the same time structured borrowings will be referred to as "senior unsecured" and were rated one notch higher.

Moody's did not change its favourable opinion that MünchenerHyp had a solid reputation in the capital markets as an issuer of Pfandbriefe and thus has a correspondingly high level of refinancing strength. The agency also noted favourably the Bank's firm ties and related support within the Cooperative Financial Network.

Even to achieve its highest rating of Aaa for Pfandbriefe, Moody's still only requires that legal requirements are observed for the volume of surplus cover needed, thus a voluntary provision of surplus cover is not required. This means that in the worst case – the insolvency of the bank – the cover pool only contains the legally required surplus cover.

CURRENT RATINGS AT A GLANCE

	Rating
Public Pfandbriefe	Aaa
Mortgage Pfandbriefe	Aaa
Junior Senior Unsecured	A2
Senior Unsecured	Aa3
Short-term liabilities	Prime-1
Long-term deposits	Aa3

Our long-term unsecured liabilities are rated AA- by both of the two other major rating agencies, Standard & Poor's and Fitch, due to the group rating assigned to the Cooperative Financial Network by the agencies.

Sustainability

During the year under review we further expanded our commitment to sustainability and decisively pursued our strategic goal of anchoring sustainability in the Bank's core business. This is reflected by our introduction of the "Family Loan" that augmented our range of sustainable property financing offers. In 2018 sustainable loans (the MünchenerHyp Green Loan – Grünes Darlehen – and the MünchenerHyp family Loan – Familiendarlehen) held a 13 percent share of our new private customer business, which means that in the interim every eighth loan made to private customers is a sustainable loan. Furthermore, the issue of the first ecological ESG Pfandbrief additionally strengthened the sustainable refinancing of our property financing business.

13%
of the private customers' new business attributable to sustainable financing.

The sustainability rating agency ISS-oekom raised their rating of MünchenerHyp from C+ to B- , which is currently the top rating in the category of "Financials/Mortgage & Public Sector Finance". ISS-oekom breaks down its rating into individual aspects and rates MünchenerHyp's ecological commitment with a B- and its social commitment with a B. These ratings once again make MünchenerHyp one of the tree top rated institutions in its category. The Bank continues to hold its "Prime Status" rating from the agency.

At the beginning of 2019 the agency imug raised its rating for MünchenerHyp. Their rating for sustainability is "Favourable", while its rating for Mortgage Pfandbriefe is also "Favourable", and "Very Favourable" for Public Pfandbriefe.

The sustainability rating agency Sustainalytics also raised our rating. We currently are rated 65 out of a possible 100 points.

The development of our sustainability ratings since 2016 at a glance:

THE DEVELOPMENT OF THE SUSTAINABILITY RATINGS SINCE 2016

		2016	2017	2018
ISS-oekom		Corporate Responsibility Prime rated by oekom research C+	Corporate Responsibility Prime rated by oekom research C+	Corporate Responsibility Prime rated by ISS-oekom B–
imug	Unsecured bonds:	favourable (B)	favourable (B)	favourable (BB)
	Mortgage Pfandbriefe:	favourable (BBB)	favourable (BBB)	favourable (BBB)
	Public Pfandbriefe:	very favourable (A)	favourable (BBB)	very favourable (A)
Sustainalytics		57 of 100 points	60 of 100 points	65 of 100 points

Separate non-financial report

MünchenerHyp will publish a separate non-financial report pursuant to the Act to Strengthen the Non-Financial Reporting by Companies in their Management Reports and Group Management Reports (CSR Directive Implementation Act) for its 2018 business year for the first time. The non-financial report will be released concurrently with the annual report and appear on the Bank's internet site as well as in the German Electronic Federal Gazette.

Regulatory conditions

Basel III

MünchenerHyp uses the Internal Ratings Based Approach (IRBA) to calculate its equity capital requirements.

The Liquidity Coverage Ratio (LCR) was met throughout the entire year with figures considerably higher than 100 percent. Furthermore, the Net Stable Funding Ratio (NSFR) was also continuously over 100 percent.

Furthermore, within the framework of Basel III a so-called leverage ratio with a limit of 3 percent for the entire nominal volume of loans made by a bank in relation to its equity capital was also introduced. Banks previously only had to report this ratio. However, as at 1 January 2019 it has become a mandatory requirement for banks. At the end of 2018 MünchenerHyp's leverage ratio stood at 3.4 percent.

The Basel Committee on Banking Supervision (BCBS) finalised their equity rules for credit institutions at the end of 2017. The regulatory standards are particularly focused on revising the standard approach as well as the internal approaches used to calculate risk weight for credit risks, establishing a binding definition of a new standard approach for operational risks, and the introduction of a floor of 72.5 percent to limit the effects of internal approaches compared to standard approaches. This means that, banks, in particular, operating with a low level of risk weights, like MünchenerHyp, will be impacted by the changes as the introduction of the floor will have negative effects on MünchenerHyp's equity capital ratios. Based on our very good level of capital, and in light of the current situation, we do not expect that the introduction of the floor by itself will require us to raise additional equity capital.

We attentively follow current discussions and publications of various authorities regarding regulatory requirements. However, it is difficult to comprehensively prepare to meet future requirements early on as varying positions are still held in part by different institutions involved in the current discussions at national, European and international levels. For this reason we will continue to prepare to the greatest extent possible, although we will wait until the final version of the individual rules have been approved before we begin to implement them. We therefore believe it is necessary for the regulators to provide an appropriate amount of time – especially IT requirements – for implementation purposes.

All regulatory issues were, and are being, monitored by a central unit within MünchenerHyp, transmitted to the responsible departments and implemented using various methods and projects. The enormous multitude of new requirements mandated by the supervisory authority does, however, generate significant costs and requires us to continually create new plans to utilise the Bank's tight resources.

Single Supervisory System for EU Banks

The ECB again conducted its Supervisory Review and Evaluation Process (SREP) in 2018 that carefully examined the Bank's business model, its internal governance as well as its available capital and liquidity. The results indicate if additional equity capital or liquidity is required. The results of the SREP for MünchenerHyp revealed a mandatory minimum required ratio of 8.5 percent for the Bank's Common Equity Tier 1 capital for 2019.

Minimum requirements for risk Management (MaRisk)

The MaRisk was last updated at the end of 2017. The new requirements were implemented on time in 2018.

Recovery and resolution plan

The recovery plan was updated and information required for the resolution plan was provided to the resolution authority. Only minor additions were required in comparison to the previous year.

MAIN OFFICE, BODIES, COMMITTEES AND PERSONNEL

Main office

Münchener Hypothekenbank eG's main office is located in Munich. In addition, the Bank maintains a branch office in Berlin, and also has ten regional offices.

Bodies and committees

Bernhard Heinlein stepped down as a member of MünchenerHyp's Board of Management at the end of 2018 and began his retirement. He has served as a member of the Board of Management since 2008. The Supervisory Board thanked Bernhard Heinlein for his successful and dedicated work on behalf of the Bank.

The Supervisory Board appointed Dr. Holger Horn as a member of MünchenerHyp's Board of Management effective 1 January 2019. Prior to his appointment Dr. Horn was a member of the Board of Management of the Depfa Bank in Dublin.

Employees

The number of employees continued to grow during the year under review as a total of 80 new colleagues were hired to fill vacant positions. This means that a focus of our human resources work was again on recruiting and integrating new employees. The number of new hires was also driven by the 40 colleagues who left the Bank during the period under review. The Bank's employee fluctuation figure of only 5.3 percent puts it below the average rate for the sector.

Executive development measures were another focal point of our human resources work in 2018 as executives from all hierarchical levels of the Bank spent time closely reviewing and understanding the Bank's new leadership principles.

On average,
550 employees
and 12 apprenticed trainees were employed at MünchenerHyp.

The average number of persons employed[7] by the Bank during the year under review was 550 (previous year 509), as well as 12 apprenticed trainees (previous year 11). The average number of years of employment per employee fell from 11.3 to 10.9 years due to the numerous new employees hired in the last two years.

Corporate governance statement pursuant to Art. 289f German Commercial Code (HGB)

In 2016 the Supervisory Board approved a resolution defining a quota for women represented on the Supervisory Board, the Board of Management and the top two executive levels below the Board of Management. The quota for the Supervisory Board and the top two executive levels below the Board of Management is 20 percent and 33 percent for the Board of Management. During the year under review the quota for women in the first executive level below the Board of Management was 17 percent and in the second executive level 18 percent, and 8 percent in the Supervisory Board. No women were represented on the Board of Management. In 2017 the Supervisory Board's Nomination Committee resolved to recommend that the target quota should be achieved by the end of October 2021. Notwithstanding the above, MünchenerHyp considers itself to be a modern enterprise as reflected by its social, cultural and business values and views the promotion of the underrepresented gender as a natural element of its embedded leadership culture.

7 Number of employees pursuant to Art. 267 (5) HGB: Excluding apprenticed trainees, employees participating in parental leave, partial retirement (non-working phase), early retirement, or employees suspended with pay.