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's Risk Committee is advised about the Bank's risk profile no less than on a quarterly basis and additionally as required. In addition to other measures, 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. Individual limits were set for all types of lending e.g. set depending on rating. 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 based on the mortgage lending value of the property. The mortgage lending value is significantly lower than the market value, which can fluctuate more strongly. The mortgage lending value is generally only determined when the loan is made and is not adjusted over the term of the loan. The current breakdown based on loan-to-value ratios is as follows:

TOTAL PORTFOLIO OF MORTGAGE AND OTHER LOANS
INCLUDING OPEN COMMITMENTS IN €

Mortgage lending value ratio	31 Dec. 18	Relative	31 Dec. 17	Relative
Up to 60 %	14,720,901,589.27	42.8%	14,296,965,287.66	45.6%
60.01% to 70%	6,820,895,373.58	19.8%	6,280,906,478.52	20.0%
70.01% to 80%	6,960,099,522.16	20.2%	6,682,115,544.81	21.3%
80.01% to 90%	2,676,516,392.51	7.8%	2,272,306,838.37	7.2%
90.01% to 100%	1,795,904,046.61	5.2%	1,053,463,631.24	3.4%
Over 100%	1,412,897,435.12	4.1%	755,022,711.92	2.4%
Without	2,908,425.35	0.0%	15,847,972.98	0.1%
Total	**34,390,122,784.60**	**100.0%**	**31,356,628,465.50**	**100.0%**

The regional breakdowns within Germany are as follows:

TOTAL PORTFOLIO OF MORTGAGE AND OTHER LOANS IN GERMANY
INCLUDING OPEN COMMITMENTS IN €

Region	31 Dec. 18	Relative	31 Dec. 17	Relative
Baden-Wuerttemberg	3,010,586,219.34	8.8%	2,794,684,631.11	8.9%
Bavaria	6,318,757,224.94	18.4%	5,849,474,855.94	18.7%
Berlin	1,671,039,470.92	4.9%	1,515,024,630.55	4.8%
Brandenburg	568,281,726.53	1.7%	549,477,361.59	1.8%
Bremen	99,892,194.27	0.3%	93,497,213.85	0.3%
Hamburg	954,465,248.40	2.8%	936,793,198.61	3.0%
Hesse	2,057,864,034.04	6.0%	1,742,536,130.56	5.6%
Mecklenburg-Lower Pomerania	408,844,173.55	1.2%	384,874,380.79	1.2%
Lower Saxony	2,304,961,954.58	6.7%	2,102,093,778.96	6.7%
North Rhine-Westphalia	4,872,993,885.28	14.2%	4,502,314,653.67	14.4%
Rhineland-Palatinate	1,394,665,008.86	4.1%	1,227,865,749.56	3.9%
Saarland	331,578,228.58	1.0%	276,568,563.00	0.9%
Saxony	925,694,734.24	2.7%	873,208,941.08	2.8%
Saxony-Anhalt	529,484,804.74	1.5%	479,890,424.73	1.5%
Schleswig-Holstein	1,786,195,963.33	5.2%	1,694,132,583.00	5.4%
Thuringia	312,876,008.63	0.9%	317,419,939.59	1.0%
Total domestic	**27,548,180,880.23**	**80.1%**	**25,339,857,036.59**	**80.8%**

The international breakdowns are as follows:

TOTAL PORTFOLIO OF MORTGAGE AND OTHER LOANS INTERNATIONAL
INCLUDING OPEN COMMITMENTS IN €

Country	31 Dec. 18	Relative	31 Dec. 17	Relative
Austria	136,406,356.80	0.4%	117,228,434.45	0.4%
France	428,521,831.12	1.2%	334,128,112.01	1.1%
Great Britain	506,310,386.23	1.5%	457,267,526.70	1.5%
Spain	305,926,931.31	0.9%	241,773,685.93	0.8%
Luxembourg	64,994,688.44	0.2%	80,026,000.00	0.3%
Switzerland	4,444,846,106.56	12.9%	4,163,212,729.66	13.3%
The Netherlands	421,798,450.39	1.2%	392,584,077.07	1.3%
Belgium	43,445,424.60	0.1%	43,455,852.39	0.1%
USA	489,691,728.92	1.4%	187,095,010.70	0.6%
Total foreign	**6,841,941,904.37**	**19.9%**	**6,016,771,428.91**	19.2%
Total domestic and foreign	**34,390,122,784.60**	**100.0%**	31,356,628,465.50	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 10 January 1994.

Individual adjustments to value taken remain at a low level for our residential property financing business due to the great stability of the residential property market. This also 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 basis for settling derivative trades.

TThe individual and general adjustments to value developed as follows in the year under review:

TOTAL LENDING BUSINESS
IN € MILLION

	Opening balance	Addition	Reversals	Utilisation	Changes related to exchange rate shifts and other factors	Closing balance
Individual adjustments to value	46.5	4.9	-5.8	-6.3	1.3	40.6
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 creditworthiness ratings remain unchanged. The reasons for altered yield premiums can be as follows:

- 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 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 established by Union Investment) 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 basis 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 basis 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:
  - » 11 September 2001 terror attack in New York: Changes seen in market prices between 10 September 2001 and 24 September 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 12 September 2008 (last banking day before the collapse of Lehman Brothers) and 10 October 2008 are played out using current levels.
  - » Brexit: changes in interest rates and currency exchange rates following the Brexit Referendum on 23 and 24 June 2016.

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 2018 amounted to a maximum of € 15 million. The average figure was about € 11 million.

Although MünchenerHyp is a trading book institution (only for futures), the Bank did not enter into any trading deals in 2018, and has not since 2011.

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 basis 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 1 October 2010 and 8 November 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 € 95 million in 2018, while the average figure was about € 90 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 11 September 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 to 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, 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 during the year under review.

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 stable at 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.

In order to diversify its sources of refinancing the Bank has begun to build a deposit-taking business. At the end of 2018 the portfolio of deposits amounted to about € 100 million.

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, as well as to a small extent positions taken in its special balanced fund.

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 calculated its ability to bear risks until the end of 2018 using both the so-called going-concern, as well as the insolvency case. The so-called going-concern scenario was the relevant method used for risk management purposes. This scenario 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.

The methods used were changed at the end of 2018 to the so-called normative and economic approach.

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) 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

Against the background of the future challenges facing the Bank, MünchenerHyp systematically evaluated its business model and then further optimised its business and risk strategy based on this evaluation. Numerous measures within different areas of activity were defined and will be decisively implemented in the coming years thereby enabling us to achieve the strategic objectives. Within these activities the MaRisk-consistent strategy process is of central importance as it also sets parameters for the annual planning process. Within this process the sales goals and the central and decentral components of the administrative expenses are matched with the rolling multi-year profit and loss plan. All of the income and expense elements, as well as our ability to bear risks, are continually monitored, or are 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 RISK

- » **Economic outlook modest for 2019**
- » **Demand for residential and commercial property not significantly affected by economic slowdown**
- » **MünchenerHyp expects good demand for property financing**
- » **Moderate increase planned in net interest income**

Economic development and financial markets

Business sentiment clouded over at the beginning of 2019. Economic researchers also believe that the further development of trade and investments will be accompanied by great uncertainties and risks. The greatest risks include a widening of trade conflicts the USA is engaged in with China and Europe; Brexit, as well as the incalculable consequences if central banks shift to looser monetary policies. In addition, there are also signs that the Chinese economy will weaken to a greater extent than anticipated. All in all, these considerations have led the IMF to lower its prediction of global GDP growth in 2019 to 3.5 percent. It does expect the rate of growth to improve slightly to 3.6 percent in 2020.

The more fragile overall economic conditions are also impairing the economy within the Eurozone. Despite the ECB's unchanged loose monetary policy and good conditions in the labour market, economic experts believe that political uncertainties will weigh so heavily on the economy that the pace of economic growth will slow. Thus, the IMF reckons that the Eurozone economy will grow by 1.6 percent in 2019 and 1.7 percent in 2020.

The Federal Government forecasts
1.0%
economic growth for 2019.

After the German economy had already lost speed in the second half of 2018, the upswing in the economy is not expected to gain energy in the coming years. At the start of 2019 it is difficult to estimate how significantly the upswing will run out of steam. Forecasts of German GDP growth range from a return to the level seen in 2018, down to 1.1 percent. The IMF, for example, significantly corrected its outlook for Germany in January 2019 as it cut its expected economic growth figure for 2019 by 0.6 percentage points to its current 1.3 percent. The German Federal Government is even more reserved and states in its 2019 Annual Economic Report that it only expects the German economy to grow by 1.0 percent. The IMF still expects the economy to grow by 1.6 percent in 2020. Growth should be primarily driven by domestic demand. Furthermore, economic performance should also be supported by government spending and investments in construction. Against the background that the construction industry is still operating at capacity utilisation, the Kiel Institute for the World Economy (IfW) expects investments in construction to rise by about 3 percent in both 2019 and 2020. Consumer prices are expected to rise slightly to about 2 percent. Forecasts for the labour market remain favourable. The number of employed persons is expected to rise, although the rate of growth is expected to be somewhat weaker weaker than in previous years due to the slowing rate of economic expansion.

In view of the more muted economic prospects, central banks' monetary policies are expected to be more cautious in 2019. Although the ECB will maintain its fundamental efforts to normalise its monetary policy, experts are increasingly sceptical that a first hike in interest rates will take place in the autumn. Based on current market rates an initial rate increase is not expected until April 2020. The Bank of England is also likely to act cautiously until the Brexit issue is resolved. Based on statements made by the Federal Reserve Chairman, the Fed plans to make fewer interest rate hikes in 2019 than it did during the year under review. Above all, the Fed will monitor further development of the American economy and only initiate additional interest rate hikes in the face of good economic data. A maximum of two interest rate hikes is anticipated. Based on this environment we expect to see slightly rising interest rates by the end of 2019 and believe that yields on 10-year Bunds will move in a range of 0.50 to 0.75 percent.

Only minor changes in the value of the US dollar vis-a-vis the euro are currently expected in the currency markets as the euro is burdened by the weakness of German industry, political developments, and a possible postponement of an interest rate increase by the ECB. Despite better economic data in the USA, the US dollar is not expected to strengthen in light of America's trade conflicts and the Fed's heightened hesitation to raise interest rates. The Swiss franc will continue to retain its "safe harbour" status for the time being due to political uncertainties in Europe and the stable Swiss economy. Slight declines in the Swiss franc exchange rate could happen if political uncertainties in Europe subside.

€ 130 billion
issue volume of benchmark covered bonds for 2019 expected.

The covered bond markets are expected to see about € 130 billion in benchmark bonds issued in 2019, an amount that would be at the previous year's level. Germany and France are anticipated to once again account for the biggest share of the market. The forecast for the covered bond markets is based on a continuation of strong demand for property and property financing. In addition, the € 102 billion volume of maturing paper is significantly higher compared to previous years. Market observers believe that this will support a high volume of new issues. At this time the impact political uncertainties and economic developments will have on the covered bond markets it is still unclear. Following the end of the ECB's asset purchase programme (CBPP 3) it is likely that risk premiums will rise again. The return of classical investors to the market should also contribute to this development. In contrast, reinvestments still being made by the ECB as part of CBPP 3 will decline.

Property and property financing markets

A broad consensus of experts anticipates that the weaker economic situation and political uncertainties will not have a major effect on demand experienced in property markets in 2019. This means that the outlook for the majority of markets where MünchenerHyp provides financing remains favourable.

This applies primarily to the German property market, and namely for both the private residential property and the commercial property segments.

A notable expansion of construction activities in the residential property market is highly unlikely in light of the fact that the construction industry is continuing to operate at capacity utilisation. Most likely, the 350,000 to 400,000 housing units needed to meet demand will again not be reached in 2019. This means that demand will exceed supply in both the tenant and the buyer markets, and especially in the major metropolitan areas and the growth regions of Germany.

This development is supported by the still low level of interest rates, which even slightly declined at the beginning of 2019. As the ECB is not expected to make any substantial changes to the course of its monetary policy, it may be anticipated that interest rates will remain at last year's low level over the remainder of the year with occasional slight fluctuations seen. Furthermore, demand for housing will be supported by the rising number of households as these are expanding at a significantly stronger pace than the number of new housing units entering the market.

House prices and rents are unlikely to decline in 2019 as demand will again exceed supply. Many experts do, however, reckon that the national average rate of price increases will weaken slightly in view of the existing high level of prices. In addition, regions in Germany will diverge even more greatly from each other in terms of population development. Structurally weak regions will continue to lose residents while, in contrast, population shifts into areas bordering the seven biggest markets, and the thriving business locations, will continue.

German residential property market is still in high demand among institutional investors due to its attractiveness despite a shortage of supply and low yields.

Low lending interest rates resulting from the ECB's loose monetary policy were an important factor behind the great demand seen for property financing in past years. Demand for property financing will remain strong as a shift in the ECB's interest rate policy in the foreseeable future does not appear likely due to the state of the economy.

Excess demand will remain intact in the commercial property market in Germany, with the exception of retail buildings. Office buildings will continue to hold the biggest share of the investment market, whereby the user market is likely to grow at a slightly slower pace due to economic reasons. On the supply side the availability of space is expected to increase as more buildings are completed. The market situation will remain tight, however, as two-thirds of the space coming into the market has already been pre-let. As a result, vacancy rates in individual cities should decline further while rents climb anew.

The further development of the property market in Great Britain is facing the greatest uncertainties as the consequences of a possible Brexit for the British property market are difficult to assess at the beginning of 2019 in light of the latest domestic political developments. Further market developments will primarily depend on the number of companies that decide to relocate to other European countries. It may be, however, assumed that the residential as well as the commercial property market is entering a phase of stagnation. This is reflected by the slow pace of price increases, and even reductions in rents and prices noted in some cases.

Overall conditions for a further favourable development of the French property market are encouraging. Despite slightly lower economic growth, the unemployment rate is forecast to decline. These are good prerequisites for good demand for residential property to continue. The office property market in France is already in an advanced phase of its cycle and experts anticipate that the pace of rising rents will increasingly slow.

Forecasts for economic growth in the Netherlands are good and should further stimulate the Dutch property market. Investors remain focused on residential and office properties. On the user side both of these investment categories are marked by unchanging high demand and a tight supply.

A notable weakening of economic growth is foreseen for Switzerland, and is likely to lead to a further decline in demand seen in the housing market. This trend is strengthened by declining numbers of immigrants, which will lead to sinking rents and prices outside the major metropolitan areas. In contrast, housing demand will exceed supply in Swiss cities and purchase prices paid and rents will rise further. This will widen the city-rural region gap.

Following the exceedingly strong increase in the volume of transactions recorded in the USA in 2018, the investment market is foreseen to cool to a certain extent as investors are expected to concentrate on safer investments and markets. For this reason Jones Lang LaSalle is predicting that the volume of transactions will decline by 3 percent in 2019. This development will particularly affect the office property segment within the commercial property market. This segment is in a quite advanced phase of its cycle so that declining rents and rising vacancy rates will be increasingly seen in cities.

Development of business at Münchener Hypothekenbank

Our plans for our new mortgage business assume that the property markets where we are active will develop well and that demand for property financing will remain intact. Our plans are further supported by the assumption that demand for financing will continue to be supported by low interest rates.

As the overall general conditions are favourable for market participants, competition will further intensify in both the private residential and the commercial property areas of financing. As this competition has been based on lending terms for a considerable time, margins will continue to come under pressure that can increase even further.

In view of these conditions we are confident that we will also achieve a high volume of new business in 2019 that will be similar to the very good level we recorded in the year under review. However, in view of the competitive situation and the weaker economic outlook, we do not anticipate that our new business results will fully repeat the dynamic growth achieved in 2018.

Private residential property financing in Germany will remain the focal point of our new business planning. The banks within the Cooperative Financial Network are, and will remain, our key partners in this area of business as they have pronounced sales power and close customer relationships. We anticipate that, as in previous years, these attributes will also enable them to expand their share of the residential property finance market in 2019. In order to strengthen our market position within the Cooperative Financial Network we will be launching attention-getting sales campaigns in the retail and individual areas of our business again in 2019. In addition, we will optimise our disbursement and other portfolio processes as part of our efforts to digitalise property financing.

We again plan to moderately expand our new business in collaboration with independent providers of financial services. 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 will again launch a sales campaign to support our activities in Switzerland. In addition to these measures we are preparing to enter the private residential property financing market in Austria.

Our objective in the commercial property financing area of business is to retain the extraordinarily strong new business results we achieved in the year under review as far as possible. Germany will remain the focal point of our new business activities. Furthermore, in 2019 we expect to encounter a highly competitive situation in the markets with acquisition yields under pressure accompanied by a high level of competition for financing. Due the good condition of the German market, domestic business via domestic and foreign investors will remain the focal point. We expect our international business to post moderate growth. Economic developments in the markets where we are active promise to be stable – with the exception of Great Britain were uncertainty prevails, as previously described in this report. We will continue to limit our activities in the USA to participating solely in financing deals.

We anticipate that syndication markets will see quite lively growth in 2019 as the trend towards ever larger financing deals continues. Only very few banks, however, are willing to completely carry larger lending volumes on their balance sheet. For this reason we expect to see volumes rise in the secondary market in 2019. On the one hand, we are prepared to significantly participate in third-party financing deals, and on the other hand pass on portions of loans we generated to other banks. 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 serves to control liquidity and cover pools. We anticipate that the existing volume will not be significantly reduced in 2019 as a portion of the maturing securities will have to be replaced to manage liquidity.

Our refinancing needs in 2019 are planned to be between € 6.5 billion and € 7.5 billion, of which we expect to obtain € 5.7 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 to three large volume issues and have additional potential to tap existing bonds. MünchenerHyp will continue to need Swiss francs for refinancing purposes arising from 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.

A large volume bond – a US dollar denominated Mortgage Pfandbrief with a volume of USD 0.6 billion – will mature in July of the 2019 business year. Furthermore, our first ESG Pfandbrief with a volume of € 300 million will mature in September 2019.

We intend to anchor GenoFestgeld even more firmly in the market as a permanent product and are aiming to book deposits of about € 300 million by the end of 2019. In addition, we are cooperating with an interest platform in Switzerland and since January 2019 we have been offering a deposit product with two different terms in Swiss francs.

We will further expand our sustainability activities in 2019. In particular, we want to anchor our sustainable financing offers even more strongly in the market.

We are striving to achieve a moderate increase in net interest income from business operations in 2019. The stable development noted in our core markets continues to offer us opportunities to expand our new business anew and thus our portfolio of mortgage loans.

This will continue to have an increasingly favourable impact on the Bank's performance. On the other hand, growing competition, unchanging regulatory pressures and increased refinancing costs have counteracting effects.

We anticipate that our administrative expenses will increase anew in 2019.

Based on the currently available information, we expect that, at the most, provisions for lending risks will rise slightly.

In view of the anticipated favourable market conditions, we are confident that we will achieve our goals for the 2019 business year and further expand our market position. We expect that our net income will be at 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.