DEUTSCHE PFANDBRIEFBANK

Annual General Meeting 2018

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1. Introduction

Good morning, Ladies and Gentlemen, dear Shareholders,

Welcome to the 2018 Annual General Meeting of Deutsche Pfandbriefbank AG, and may I also welcome you on behalf of my fellow members of the Management Board, Thomas Köntgen and Andreas Schenk.

In my report, I will initially be taking a look at **the year 2017** under the four following headings:

- new business and portfolio,
- refinancing and rating,
- income statement and
- dividend proposal and capitalisation.

I will then offer you an **outlook** for the current financial year and its challenges. I will also comment on the Q1 result in this context.

2. 2017 – operating business and financial results

Commercial real estate finance in 2017 was defined by strong competition and margin pressure as well by continued regulatory activities, while the macroeconomic market environment basically remained intact. It is self-evident that this mixed starting point also substantially affected pbb's performance last year, as one of the leading real estate finance providers in Europe. We nonetheless succeeded in **increasing the volume of new business** as well, **once again generating a good result**. The operative result significantly exceeded the previous year that benefited from non-recurring effects.

2.1 New business and portfolio

New business (including extensions by more than one year) amounted to **€11.6 billion** and was thus higher than the previous year's figure of €10.5 billion (diagram 2). The increase was attributable exclusively to Commercial Real Estate Finance, where new business rose from €9.5 billion the year before to **€10.7 billion** in the year under review. By contrast, the volume of public-sector investment finance fell slightly. The fourth quarter was once again particularly strong in terms of volume and – in adding together the two strategic business divisions of Real Estate Finance and Public Investment Finance – reached a record of €4.2 billion. We made no compromises on the quality of new business in the fourth quarter – or in any of the other quarters.

The expansion of our business activities to **new markets and customer groups** as well as the **broadening of our product range** made a significant contribution to the growth in commercial real estate finance.

- This concerns on the one hand the **US business**, which accounted for 8% of new business in 2017.

- On the other hand, Commercial Real Estate Finance for **high net worth individuals** gained in importance.

- And finally, **low leverage lending**, in other words, the business with low loan-to-value ratios, accounted for a considerably higher portion of new business.

This approach strengthens the Bank's conservative risk profile. After all, we want to keep pbb weatherproof and stable in order to face potential challenges in the future. It is therefore not all that surprising that conservative financing profiles impact on the achievable average gross interest margin – as is the case here too. Nonetheless, pbb has further improved its position on the funding markets in recent years – thanks not least to stable results and rating improvements. As a result, we succeeded in considerably reducing the cost of borrowing in 2017 and thus maintained **largely stable net new business margins in 2017**.

Supported by the positive performance of new business, the volume of the **strategic portfolio** increased to €31.9 billion in 2017 (31 December 2016: €31.5 billion; diagram 3). This equates to an increase of around 3% in the core business of commercial real estate finance. We are thus quite clearly above the average of our relevant competitors in Germany, some of whom recorded a marked decline in their real estate finance portfolios. Nevertheless, the high volume of new business would have led one to expect a sharper increase in the portfolio's size. As in previous years, however, high prepayments prevented more pronounced growth in the strategic portfolios.

The **Value Portfolio** fell by €2.0 billion to €13.8 billion in 2017. This represented a continuation of the non-strategic portfolio's scheduled run off pbb's balance sheet.

2.2 Funding and ratings

We raise the funds required for the loans we disburse mostly on the capital markets. As I just explained, we clearly reduced our funding costs in 2017.

- In 2017, pbb realised new long-term funding of **€6.1 billion**, which was some 8% more than in the previous year (diagram 4). At €3.8 billion, Pfandbriefe accounted for more than 60%, with €2.3 billion placed in unsecured issues. We also issued €0.5 billion in subordinated liabilities.

- Conversely, we significantly reduced the expensive **surplus liquidity**. This is reflected in the balance sheet line items of cash reserve, loans and advances to banks, and financial assets. This allowed us to reduce total assets and scale back expensive funding raised in previous years.

  In addition to the resulting effect on current interest expense, the further sharp reduction – especially in the **risk premiums** on our newly issued bonds – was a key factor in the reduction of refinancing costs.

  This is particularly evident when comparing the spreads at the start, and at the end, of 2017. Spreads in the first quarter of 2017 were 20 basis points for mortgage Pfandbriefe, 11 basis points for public-sector Pfandbriefe and 82 basis points for unsecured refinancing. The figures for the fourth quarter were 6 basis points for mortgage bonds and 58 basis points for unsecured bonds; we did not issue public sector covered bonds in Q4 2017.

The positive development of the Bank's funding was supported by the performance of its ratings, to which we attribute particular importance with regard to our competitiveness and – if you like – our 'purchasing terms'.

- The ratings for pbb's **unsecured issues** were influenced mainly by changes in the legal framework and resulting changes to the rating agencies' methodologies. pbb's credit rating is assessed in this respect by the rating agency S&P in particular.

  S&P has **split the rating class** for senior unsecured debt. Depending on the future ranking in an insolvency scenario, such debt is either allocated to the new rating class "senior subordinated" or remains in the previous rating

class “senior unsecured”. S&P upped the long-term rating for pbb's **senior unsecured** debt by two notches, from "BBB" to **"A–"** (with outlook negative). On the other hand, the methodology required the long-term rating for **senior subordinated** liabilities to decline by one notch, from “BBB” to **“BBB–”**.

pbb’s rating, which has developed very favourably in recent years, requires a corresponding capitalisation. We therefore continue to take a conservative approach to endowing capital, and have enhanced capitalisation further by way of a subordinated bond; I will go into this transaction from April 2018 in more detail later.

- pbb's **Pfandbrief ratings** assigned by Moody’s remain unchanged, at **Aa1**.

2.3 Income statement

Ladies and Gentlemen, this now brings me to the consolidated income statement under IFRS. For 2017, this was still reported under the previous accounting standard IAS 39; we adopted IFRS 9 as of 1 January 2018. This will change the reporting structure as well as the line items in the consolidated income statement. However, in 2017 everything still remained the way it was and the way with which you are all familiar.

Cheaper funding costs not only benefited the Bank’s net new business margins. They also favoured pbb’s current net interest income and therefore the Bank’s income statement (diagram 5). The more favourable funding terms and the maturity of higher-yielding issues reduced the interest expense considerably. Another factor – which I also mentioned earlier – was the moderate increase in the strategic portfolio, which allowed us to report a much improved net interest income. **Net interest income** rose to €435 million in 2017 from €404 million in2016.

At the same time, the **risk costs** for the loan portfolio remained very low, with net additions of €6 million, having had to make additions of only €1 million to loan loss provisions in 2016 (diagram 6). Loan loss provisions in 2017 were largely attributable to the changed risk assessment of a Southern European region, and also from changed default probabilities and default rates. In other words, individual exposures did not play a role here. The low level of loan loss provisioning reflects pbb's conservative risk policy, as well as the market environment, which has remained benign.

However, **general and administrative expenses** were higher, amongst other things, as a result of further increasing regulatory requirements as well as strategic measures and projects (diagram 7).

- This was due mainly to the increase in **personnel expenses**, from €103 million in 2016 to €119 million in 2017, despte a reduction in staffing levels. The increase almost exclusively reflected technical factors: personnel expenses in 2016 benefited from the utilisation of provisions recognised in previous periods (approx. €12 million). Adjusted for this figure, we arrive at a comparative figure of €115 million – in other words, personnel expenses in 2017 have remained largely stable on an operating level.

- **Non-personnel expenses** of €97 million in the year under review were roughly in line with the previous year (2016: €95 million). Additional expenses, such as those incurred for a Bank-wide IT project, were largely absorbed by a variety of cost savings in all divisions.

  I would like to point out that the IT project costs are either initiated mainly for regulatory reasons, or are innovation-driven; costs for upgrading our systems remain within strict limits, as our basis systems were already con-

verted to new technologies; this is a major advantage, both in implementing complex regulatory requirements, such as harmonising financial and risk data warehousing as well as in the realisation of innovations.

We have also included the start-up costs for CAPVERIANT, a platform for public-sector financings, under innovation costs. And finally, the start-up costs for opening our representative office in New York were also processed in current non-personnel expenses. I will discuss this in more detail in a moment.

All in all, we reported **pre-tax profit** of €204 million for 2017 (diagram 8), which clearly exceeded the adjusted result for the previous year of €169 million. The result for 2017 is not only higher than the adjusted result for the previous year. It is also better in terms of quality, being defined by two positive fundamental operating trends: better net interest income, and risk costs that remain low. **Profit after tax** amounted to €182 million or €1.35 per share, influenced in 2017 by a particularly low tax rate of around 9%.

2.4 Dividend and capitalisation

On this basis, the Management and Supervisory Boards propose to you, our shareholders, a **dividend** payment of **€1.07 per share** (diagram 9). This yields a total distribution ratio of 79% of the consolidated profit after tax in accordance with IFRS. Our dividend proposal exceeds the previous year's dividend, when we distributed €1.05 per share on the basis of a good result that also benefited from non-recurring effects. The Management and Supervisory Boards have also agreed to propose a normal dividend of 50% plus a special dividend of 25% for the financial years 2018 and 2019, i.e. the distribution of 75% of the respective IFRS consolidated profit after tax.

The dividend proposal reflects pbb's unchanged good capitalisation on the one hand, while taking into consideration the necessary **capital buffer** on the other hand, which we are bearing in mind for **future increases in risk-weighted assets** – RWAs – (diagram 10)**:**

- We observe a trend towards RWA inflation resulting from current **regulatory initiatives**. This impacts on changes such as the introduction of 'Basel IV' as well as the ECB's ongoing Supervisory Review and Evaluation Process (or SREP), where the ECB reviews the risk models of all banks under its supervision. The Europe-wide and bank-by-bank harmonisation already resulted in an increase to pbb's risk-weighted assets of approximately €2 billion during the third quarter of 2017. The ECB's review is still ongoing; the deadline was recently postponed to 2019. Hence, it is not yet possible to finally quantify the resulting impact upon pbb's RWA levels.

- Additionally, we hold a sufficient buffer for **cyclical fluctuations**, for planned **portfolio growth** and for any necessary **strategic measures**.

Even taking this aspect into account, pbb is **very well capitalised** to such an extent that it exceeded all regulatory requirements at the end of the year. The common equity tier 1 ratio (CET1 ratio) under the fully phased-in Basel III rules, for example, was 17.6% as at the end of December 2017. This compares with the SREP requirements of 9.325% or 9.95% (fully phased-in).

3. Outlook

Ladies and Gentlemen, this concludes my review of 2017 – let us now look ahead (diagram 11).

3.1 Challenges and initiatives

Those of you as shareholders who follow our industry as shareholders will recognise several aspects that have been a common topic in recent years. These are – in particular – competition and regulation, as well as the topic of digitalisation, which is gaining in momentum and importance.

Competition remains intense and the resulting margin pressure persists.

- The **margin pressure** not only applies to new business and extensions; it is also reflected in early repayments. A loan agreement is generally only protected by prepayment fees in the first years of its term; as a general rule, prepayment fees are completely waived after three or four years. That is the latest point at which competition for existing financings begins – in some cases, financings are terminated despite prepayment fees, if the conditions offered by another finance provider make it seem worthwhile.

  This margin pressure in new and existing business tends to lead to lower interest income, whilst – at the same time – the costs for capital adequacy requirements increase as a result of changed regulatory standards. Margin pressure and regulation will continue to dominate in 2018.

- We are also dealing with the **condition of the real estate financing markets** and the **real estate market cycle**.

  In some markets, we are observing that other finance providers are softening **covenants**, i.e. waiving restrictive contractual terms and accepting less stable financing structures. This willingness varies by degrees. Occasionally, market participants overlook the fact that covenants have a long-term impact: they protect lenders in challenging situations over the entire term of the loan and create transparency for the borrower.

  At the same time, we see lenders as well as borrowers entering into **transactions** that are **outside the scope of their traditional business**, a development which can be problematic, especially if the markets turn around.

  It must also be noted that – measured by the positive price development of commercial real estate throughout Europe – the **real estate cycle** must be considered to be well advanced, even though the still-decent macro-economic data makes it difficult to predict when the cycle will turn.

Nevertheless, we are standing up to the competition – and in view of the indefinite state of the cycle, we are sticking with our **risk standards and profitability requirements**. We turn away business that does not meet our requirements and will always put quality of new business over volume targets. We have deliberately adopted a cautious approach to business planning, and expect a lower volume of new business for 2018 – I will talk about this shortly.

In this context, the **US** market is highly important for us as it holds large potential. We are thus – cautiously – expanding our solution space, in order to select the right business for pbb.

- As is our nature, we have organised our market entry in a prudent manner. First we concentrated on **co-financing with strategic partners**.

- The successful performance of our business activities on the US market has strengthened the resolve to **cautiously expand our exposure**, making **local presence** essential. By establishing a local presence, we create the conditions for **directly originating new business** and moderately expanding the business beyond the current **regional focus** on the East Coast metropolitan areas of New York, Boston, and Washington.

We are also driving the process of **digitalisation** forward:

- We have already rolled out a **portal site – for the efficient exchange of data and information** with Commercial Real Estate Finance clients – in April 2018. In the current development phase, we are digitalising the process surrounding the submission, checking and releasing of invoices in the business with real estate developers. This allows us to achieve an optimised electronic workflow between us and our clients, and also integrates external units, such as project monitoring, as required. We thus reduce manual operations and provide information in a more timely manner. We want to extend this portal.

- We launched our **electronic platform CAPVERIANT** in May, in order to bring together lenders and borrowers in the public sector financing business. The platform has been online since mid-May; clients can now register with CAPVERIANT and use the platform. A number of local authorities and investors have expressed their interest, and distribution activities are in full swing. Within the first roll-out phase, we are targeting the German market. However, we are planning on implementing the platform in further markets.

3.2 Objectives for 2018 and Q1 2018

This is the framework within which we are moving in 2018. Against this background, we set the following targets at the start of the year:

- We are aiming for a **new business volume** of between €10.0 billion and €11.0 billion, including extensions by more than one year. We would thus be below the level for 2017 – nevertheless, due to the highly advanced real estate market cycle, we consider this cautious approach to be appropriate.

  At the same time, we will select new business (even more) carefully regarding margin and risk. With this in mind, we recorded €1.8 billion in new business in the first quarter, including extensions by more than one year.

- We expect the strategic **financing volume** to slightly rise in the Commercial Real Estate Finance and Public Investment Finance business segments, because we anticipate lower early repayments. We assume **margins** on existing exposures will stabilise, whilst gross margins on new business will continue to fall only slightly.

  This expectation is confirmed by the first quarter figures: the financing volume of the strategic portfolios rose by nearly 3% since the end of the year to €32.7 billion as at the end of March 2018. We increased the average gross margin on new business to more than 170 basis points, compared with over 155 basis points in 2017 as a whole. Whilst this is a positive development, it does not represent a trend turnaround.

- As a result of the new accounting standard IFRS 9, changes apply to individual **income statement** items as of the first quarter of 2018. For this reason, comparing individual items with the previous year will only be possible to a limited extent.

    - On this (adjusted) basis, we expect a slightly lower aggregate of **net interest income and net fee and commission income** in 2018. Although we were able to increase net interest income from €97 million in the prior-year period to €107 million in Q1 2018, we expect net interest income to decline slightly as a result of the persistent pressure on gross margins and the flattening refinancing advantage during the year.

    - Despite our cautious new business selection, we assume a certain convergence of actual risk costs to anticipated risk costs – derived from historical data – in 2018. Thus, due to our cautious approach to business, we have considered an increase of **loss allowance** compared to the low actual level in 2017. We expect risk costs in the order of 10 to 15 basis points on the Real Estate Finance portfolio, without implying individual events or specific requirements. This seems the right path to take, not least in view of the conversion to IFRS 9 and the resulting higher volatility in reporting the risk costs which is expected.

      This level of provisioning did not materialise in Q1 2018, so that we were in fact able to reverse loss allowance in the amount of €4 million net.

    - Despite higher regulatory costs, we aim to keep these **general and administrative expenses** below our medium-term guidance of €220 million in 2018 as well. We achieved a figure of €44 million here in the first quarter, which is down slightly from the same quarter of the previous year.

- We are targeting **profit before tax** of between €150 million and €170 million for 2018, having already achieved €48 million in the first quarter.

Thus, we are promising a stable result in line with the adjusted results of the previous years, a belief that we affirm following the first quarter.

4. Current developments

Before I finally summarise my comments, I want to refer briefly to two current events.

- Since the initial public offering in summer 2015, the **Federal Republic of Germany as a shareholder** of pbb indirectly held a 20% stake in the Bank via the Financial Market Stabilisation Fund and Hypo Real Estate Holding GmbH. It significantly reduced its share in mid-May, to 3.5% of the issued share capital. The Government repeatedly stressed in the past that it did not want to remain a permanent shareholder in the Bank. In this respect, this step was understandable – regardless of the fact that the German Federal Government was, and remains, a valued shareholder. According to the Government, it views the remaining share it holds as a medium- to long-term investment.

  The shares were offered to institutional investors within the scope of an - accelerated book-building procedure with a shortened bidding period. On the day following the announcement, the equity markets responded with a modest 4% markdown of the share price: in the days that followed, the price recovered the loss. Rating agency S&P classified the sale as rating neutral, and continues to affirm pbb’s strong funding profile.

  In the course of this transaction, the RAG Foundation joined the ranks of pbb's shareholders and now holds a stake of 4.5%.

- pbb improved its capitalisation further in April and optimised its capital structure. To this end, it raised €300 million in additional tier 1 (AT 1) capital via a **subordinated bond**. This was the first issue of this type for pbb, and it was very successful.

  The issue followed on from the authorisation granted by the Annual General Meeting held on 10 June 2015 with subscription rights excluded. This decision was taken in particular given the transaction structure and the high, albeit standard denomination of €200,000.

5. Summary

Ladies and Gentlemen; in short:

- pbb did **not sway from its road to success** in 2017 – indeed it has repeatedly stepped up its efforts in selecting the 'right' new business.
    - By generating new business volume of €11.6 billion, we were only just below the good year of 2015, and we exceeded the year 2016.
    - Our pre-tax profit of €204 million was the second-highest in the Bank's history.
    - Finally, we aim to distribute a dividend of €1.07 per share (the highest dividend paid to date) to our shareholders. We have also adjusted our dividend strategy for the next two years and are looking to pay a normal dividend of 50% plus a special dividend of 25%.
- We cannot afford to – and we will not – **rest on our laurels**, as our core business will not become easier in the near future.
    - We want to proceed prudently and maintain our conservative profile, faced with a highly advanced real estate market cycle.
    - With a wider presence in the US, and as a result of further digitalisation, we recognise there are further opportunities ahead.
- We are looking to **2018** with a cautious but nonetheless **ambitious guidance,** which will build on the good result of 2017, structurally and before risk costs. This guidance takes into account that
    - the real estate markets remain highly competitive and will remain so for quite some time, which will exercise corresponding pressure on the volume of new business and margins, and hence on net interest income; and
    - the support we have enjoyed from more favourable funding terms is finite.

We do this with a **motivated and highly qualified workforce** that is confronting 2018's heightened challenges with energy, great market knowledge and the ability to recognise the right risk. The entire Management Board would like to express its thanks to our employees.

I would also like to take this opportunity to thank the Supervisory Board. On behalf of the entire committee, we would like to thank in particular the Chairman of the Supervisory Board, Dr Günther Bräunig, who has assisted us along the way with constructive support, critical challenges and a high level of expertise as well as intuition for what is right and possible. In addition to what the Chairman of the Supervisory Board expressed, the Management Board would also like to give a special word of thanks on this occasion to Dr Hedda von Wedel. With your reliability, critical and targeted accuracy of your comments, and absolute focus on the welfare of the Bank, you have always provided dependable support and help – we owe you a considerable debt of gratitude.

Dear shareholders, ladies and gentlemen,
thank you very much for your attention.