



DEUTSCHE  
PFANDBRIEFBANK

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Please check against delivery.

## 1. INTRODUCTION

Good morning, Ladies and Gentlemen.

It is my pleasure to welcome you to the Annual General Meeting 2017 of Deutsche Pfandbriefbank AG.

Allow me to start by highlighting a few key aspects that characterised the year 2016. After that, I will give more details about the development of our operating business, as well as an outlook for 2017. You will find that some of the topics we talked about in 2016 are continuing to be relevant in 2017.

So, what were the key aspects of the 2016 financial year? (*CHART 1*)

- 1) At €301 million, in 2016 pbb achieved the **best consolidated profit in accordance with IFRS**, in its relatively short history since its restart in 2009. First and foremost, we owe this very good result to a good, solid core business, plus non-recurring income from the reversal of value adjustments for Heta Asset Resolution AG (Heta).

At €10.5 billion, the volume of **new business** was high – even though a very prudent approach to selection meant that the total fell short of the €12 billion record set in 2015. We also succeeded in increasing the **gross margin** slightly, despite the ongoing competitive pressure – whilst maintaining our strict and conservative risk standards.

- 2) You, our shareholders, should benefit from this success story. The Management Board and the Supervisory Board therefore propose to the Annual General Meeting to pay a **dividend of €1.05 per share**. This includes a full disbursement of the Heta result, and equates to a dividend yield of 11.5% based on the pbb share price as at year-end 2016.
- 3) The environment in the banking industry was, and continues to be, defined by **regulatory changes**, therefore most certainly leading to an increase in risk-weighted assets. However, the extent and timing is as yet uncertain.

What matters though is pbb's excellent capitalisation – with a common equity tier 1 ratio of 19.0%, this significantly exceeds most of its market peers. This gives us room to manoeuvre, not only to meet the regulatory challenges but also to secure further business growth.

- 4) We will tackle the ongoing highly competitive environment by implementing a bundle of measures aimed at **further enhancing pbb's profitability**. We want to develop new target customers and markets, offer additional products and invest in the digitalisation of our business. We are preparing to broaden and deepen our range of products and services, whilst maintaining our high risk standards.

In brief: 2016 was a good year for pbb, and one non-recurring effect turned it into a very good year. The 2017 financial year will be no less challenging. Nonetheless, we are confident about meeting those challenges – and not running out of good ideas while doing so.

## 2. THE YEAR 2016

### 2.1 New business

The year 2016 was defined by **strong competition** in our strategic business segments (*CHART 2*).

- **Commercial Real Estate Finance** experienced significant excess supply from banks and other investors looking for somewhere to park the funds they had raised. At the same time, real estate investors faced a similarly significant pressure to invest – at a time of shrinking real estate supply, accompanied by commensurately lower transaction and volume numbers for real estate transactions in many markets.
- We significantly reduced the volume of new business in **Public Investment Finance**.

Persistently low levels of public sector investment limits business opportunities that meet our risk and return requirements. In addition, the negative effect of the partial suspension of credit protection offered by export financiers for Airbus directly restricted our business opportunities in export finance.

pbb's strong market penetration and acknowledged expertise nonetheless allowed us to generate a relatively **high volume of new business at higher gross margins** compared to the previous year, whilst applying the same high risk standards. In this business environment, pbb originated **€10.5 billion in new business**. 2016 was the second-best year for pbb since its restart in 2009.

The **Real Estate Finance segment** generated **€9.5 billion** in new business.

- It is worth noting that the volume of **pure new business** (in other words, not including extensions) was able to keep pace with the previous year's level.

We had to make considerable compromises regarding **extensions**. Existing financings provided by our bank are obviously "attractive goods" – i.e. targets for our competitors. Furthermore, we no longer wanted to compete with some terms that contravened our clear risk/return requirements.

- We have been aware for quite some time now that concluding **transactions which we consider suitable** involves greater effort.
  - But this time-consuming selection has its benefits: our gross margins have remained stable since the first quarter of 2015, up to and including the third quarter of 2016. The **margins increased noticeably for the first time again** in the fourth quarter of 2016, enabling a slight increase over the year from around 170 basis points on average, to more than 175 basis points.
  - This result reflects not least our **expertise in structuring** complex transactions, which in turn represents added value for our clients, allowing us to demand higher gross margins.

The margin increase is also due to the regional breakdown of new business, and to the larger proportion of so-called development financing projects, which generate higher margins.

In other words: we think it is too early to derive a trend from current developments, an assumption supported by declining margins in the first quarter of 2017.

- It is important to note that we did **not** realise these margins **by compromising on risk**. Going forward, we have no intention of deviating from our strict risk standards. These are rooted in our strategy, and in the way we do business.

- One sector where we deliberately extended our business was commercial real estate finance in the **US**. We generated new business there starting in the second half of the year, and are very satisfied with what we have achieved to date.

At **€1 billion**, the volume of new **Public Investment Finance** business was down significantly on the previous year (2015: €1.6 billion). However, the gross margin rose from an average of just above 75 basis points to 85 basis points.

## 2.2 Funding

Funds we extend to our clients in the form of loans, we primarily borrow on capital markets via Pfandbrief and unsecured bond issues.

In 2016, we realised new long-term funding of **€5.6 billion**, which is some 25% more than in the previous year (2015: €4.5 billion) (*CHART 3*). Staying true to our name, a material share of this funding was issued as Pfandbriefe – a refinancing instrument that has lost nothing of its competitiveness in this low interest rate environment.

- In total, we issued **€2.9 billion** in **Pfandbriefe** (2015: €1.9 billion), and increased the volume for Mortgage Pfandbriefe in particular (€1.9 billion; 2015: €1.1 billion).
- The volume of **unsecured funding** remained constant at **€2.6 billion**.

Looking beyond these figures, it is important to note that we have further extended our **investor base**. In 2016 we also issued in **foreign currencies**, namely USD, GBP and SEK. This is important to avoid incurring costs for hedging currency risks for business operations in the US, UK and Sweden.

## 2.3 Rating

The assessment of our creditworthiness by rating agencies is essential for our funding activities. pbb is rated for its unsecured refinancing instruments, i.e. bearer bonds and promissory note loans, and for covered refinancing instruments (*CHART 4*).

- Changes to the rating agencies' methodology resulting from changes to the legal framework - in particular on the growing specifications with regard to implementing the Bank Recovery and Resolution Directive (BRRD) - had a material impact on pbb's **unsecured ratings** in 2016.

**Standard & Poor's (S&P)** has split the rating class for "senior unsecured" debt. Depending on the ranking in a bail-in or insolvency scenario, such debt will be allocated either to a new "senior subordinated" rating class, or remain in the current "senior unsecured" rating class.

- At the end of March, S&P downgraded pbb's unsecured funding instruments, to be allocated to the "**senior subordinated**" rating class, to BBB-, one notch below the previous rating.
- However, the bonds remaining in the "**senior unsecured**" or "**senior preferred**" rating class, or new bonds meeting the requirements of this class, are given a rating of A-; in other words two notches higher than previously.

All in all, this might result in pbb's **funding costs** falling in the future. However, issuing new senior unsecured bonds would require changes to German law, in accordance with the proposed harmonisation of the EU Bank Recovery and Resolution Directive (BRRD), as submitted at EU level during the fourth quarter of 2016. Currently, no one knows when and whether this legislative process will actually take place. We do not expect to yield any potential related funding benefits before 2018, if at all.

## 2.4 Financial Statements

This brings me to the financial statements for 2016. I would like to begin with two remarks:

- The result achieved in 2016, and the comparable basis of 2015, were strongly impacted by the effect regarding **Heta Asset Resolution**, or former Hypo Alpe Adria.
  - We recognised a **write-down** of €79 million in 2015 – together with the write-downs from 2014, we had written down the exposure against Heta with a notional value of €395 million by around 50%.
  - In 2016 however, we were able to **recoup €132 million of the value adjustments**, after accepting a buyback offer by the Republic of Austria.

The **effects** are shown in two items of the income statement for 2016, specifically in loan loss provisions (€9 million for two promissory note loans) and in the net financial result (€123 million for seven securities).

Although we welcome the fact that the impairment was written back for the most part, the **default of receivables** that were guaranteed by an Austrian federal state is **highly unsatisfactory**. Nonetheless, we have decided against a judicial enforcement of our claims, in order to reduce the complexity and costs for us and to arrive at a secure result more quickly.

- pbb holds a synthetic securitisation in its books, issued by a pbb predecessor to hedge a real estate portfolio. This **securitisation instrument called Estate UK-3** has been discussed on several occasions. The issue is, in our opinion, as follows:
  - The portfolio underlying the securitisation **incurred losses**. We want to allocate these losses to investors in the securitisation, according to the terms of the transaction.
 

In its role as trustee of Estate UK-3, Deloitte has raised doubts about the allocation of losses and will call in an **expert**.
  - We continue to believe the **prerequisites for the full planned allocation of losses have been met**. We have therefore not recognised any loan loss provisions for this case, and also see no grounds to do so under the applicable accounting standards.

### 2.4.1 Income statement 2016

I will concentrate on the material aspects of the income statement (*CHART 5*), but you will find more detailed information in our annual report.

- Our **pre-tax profit** increased substantially in 2016, to €301 million (2015: €195 million).
- We achieved an **aggregate of net interest and net commission income** of €412 million (2015: €440 million), of which €404 million was from interest income and €8 million from commission.

The decline in the bank's **net interest income** is explained by lower holdings of interest-bearing assets in the non-strategic Value Portfolio, which is being wound down, on the one hand; on the other hand, net interest income was – and still is – strained by the low level of market interest rates, which have negative implications for income generated from investing own funds and liquidity the bank is required to hold.

The strategic portfolio, however, increased slightly in 2016, and net interest income in Commercial Real Estate Finance managed a 4% improvement on the previous year (2016: €321 million; 2015: €308 million).

- Income from the lending business stands directly opposite to risk costs. **Loan loss provisions** (*CHART 6*) were almost neutral in 2016 – as was the case in 2015; the additions amounted to €1 million. The continuing positive real estate environment and our strict risk policy impacted here.
- We reduced our **general and administrative expenses** further in 2016 through good cost management. We have reported lower expenses for the fourth consecutive year now, falling below the €200 million mark (€198 million, to be precise) in 2016 (2015: €207 million).
  - This reduction was due mainly to lower **personnel expenses** of €103 million (2015: €112 million). Reversal of provisions that had been created in prior periods impacted here in particular. The average number of employees also fell, to 801 (2015: 832).
  - **Non-personnel expenses** remained at €95 million, despite additional investments having been made in a bank-wide project that was necessary to implement new regulatory requirements and to enhance efficiency.
- **Profit after taxes** amounted to €197 million or €1.46 per share.

## 2.4.2 Dividend proposal

On this basis, the Management and Supervisory Boards propose to you, our shareholders, a **dividend** of €1.05 per share entitled to a dividend. The dividend proposal includes a special dividend in addition to the distribution within the communicated dividend strategy of 40% to 50% of consolidated profit after taxes in accordance with IFRS. The entire non-recurring income from the reversal of write-downs related to Heta pbb will be distributed.

The disbursement based on this proposal amounts to 72% of our 2016 net income. Based on the pbb share price at year-end 2016, the dividend yield - i.e. the yield from your investment in pbb - amounts to 11.5%.

## 3. OUTLOOK

I will conclude by providing you with an outlook for the year 2017, focusing on three aspects in particular: firstly, the sector environment; secondly, our strategic initiatives, and thirdly our expectations vis-à-vis the performance of the relevant indicators.

### 3.1 Business sector environment

#### 3.1.1 Market environment

Despite considerable political uncertainties, we anticipate a stable **market environment** on the whole. This statement applies to the general economic environment, as well as to interest rates and investment in commercial real estate. It is also relevant for the strong competition among the providers of real estate finance and the resulting pressure on margins.

#### 3.1.2 Regulatory environment

**Regulation** on the other hand is anything but stable.

- Although we have become used to change, we are highly critical of the potential changes to the risk-weighted assets resulting from the **initiatives of the ECB and the Basel Committee on Banking Supervision** (*CHART 7*).

We understand the regulatory authorities' desire for harmonisation and comparability – provided that it really is a question of comparable risks. However, where it is apparent that different risks should be equally weighted, i.e. in a more standardised way, this creates an economic incentive to move further along the risk curve. This is unlikely to be in the regulator's interest.

- We need to be prepared for a marked **increase in risk-weighted assets**, because the regulatory authorities are reviewing how risks on banks' balance sheets are being measured, as well as their capital backing.
  - Although **Basel IV** appears to have come much closer in its structural requirements to Germany's requirements in its final negotiation phase, its implementation remains uncertain.
  - The bank-by-bank requirements that are currently being formulated by the **ECB** are causing concern, too. These requirements will materialise either as part of individual model reviews, or in the course of "targeted reviews of internal models" (fittingly referred to as TRIM exercises). These processes will lead to an increase in risk-weighted assets. However, the extent and timing is as yet uncertain.

What I can say though is: pbb's capitalisation is good.

- Our **capital ratios** prove this: they have further improved, despite the high dividend payment as at year-end 2016 that we have included in our calculation.

As a result, assuming full implementation of the Basel III rules, our fully phased-in **common equity tier 1 (CET1) ratio** increased to 19.0% (12/2015: 18.2%).

- The **capital requirements** that pbb must meet in 2017 arise from the ECB's Supervisory Review and Evaluation Process (SREP). They refer to the Basel III transitional rules, which are not as rigorous as the fully phased-in rules, assuming full implementation of Basel III. pbb clearly surpasses the applicable requirements.

The pure common equity tier 1 requirement – **CET1 minimum ratio** (CET 1 Requirement) – is now 9% for pbb (excluding the country-specific countercyclical capital buffer, which was 0.08% at year-end 2016). With the new ratio, the ECB has lowered the requirement for pbb by 1.75 percentage points from the previous year.

- Our good **capital buffer** is clearly above that of the market. This is a strategic decision, and gives us room to manoeuvre.

We expect pbb's good capitalisation will prove a **competitive advantage**: we can also support future growth with the necessary capital stemming from our own capitalisation. That is why, for the time being, we adhere to our capital buffer.

We will review the **capital and dividend strategy** as soon as we have gained clarity about the future regulatory requirements. It is important to us to be equipped with an adequate, conservative capital buffer at all times. But any additional capital, above and beyond the capital buffer and our own growth requirements, belongs to you, our shareholders – be it through further dividends, or other capital action.

## 3.2 Initiatives

Ladies and Gentlemen, what does this mean for pbb and our business? pbb will continue to pursue a **policy of conservative risk**. This is not a question of the environment or the current situation, but is rather firmly incorporated in our strategy. We believe that we will reach our ambitious new business targets even with this approach. If the markets fail to provide sufficient volume, we will refrain from originating new business, rather than compromise our standards concerning risk and return.

In the third quarter of 2016, we launched a project to devise initiatives for the further development of pbb. Substantial parts of the project have been completed and will thus be transposed into our ongoing business. With this project, we focus on organic measures for the optimisation of our business model.

What are the details of these measures (CHART 8)?

### 3.2.1 Accelerated geographic expansion into the US commercial real estate market

- As mentioned, we entered the US market at the end of the third quarter 2016. Currently, we generate approx. 8% of our entire new business in the US.
- We intend to significantly broaden our customer business in the US, and will open a **representative office** in New York. We expect to fulfil this objective by year-end 2017 or at the beginning of 2018.

We have applied for approval with the competent US authorities, and will start searching for employees.

### 3.2.2 Expansion of business activities in our strategic business segments

We will expand our range of products and services in both strategic business segments. Despite the stronger competition for traditional clients, i.e. professional investors, paired with a decreasing number of transactions, we are deliberately positioning ourselves at the conservative end of the market range by extending our client groups, which we can now reach better due to an enhanced network and better funding conditions. In other words:

- We will extend our potential client base and range of transactions,
- whilst clearly reflecting and positioning ourselves with regard to potential cyclical risks, by expanding our business with lower loan-to-values.
- We therefore accept that margins in this business may be lower. Considering the good risk profile and low volume of additional investments, and seeing as we prioritise generating a profit contribution, this seems acceptable.

We aim at implementing a variety of measures, of which I would like to present two by way of example:

- Our core business focused – and continues to focus – on investment finance with loan-to-values of around 60%. Improved funding conditions and streamlined processes however allow for an expansion to lower loan-to-value ratios. In this context, we also want to extend our client base towards investment companies and, perhaps, **commercial housing**.
- The business with **wealthy real estate investors** aims at realising transactions with mainly first-class properties in top locations. Here we want to enhance cooperations with partners, especially in the asset management business. Why? Because these investors have access to the clients we are targeting, but – unlike pbb – do not offer expertise in commercial real estate finance.



### 3.2.3 Digitalisation

- In the past years, we laid an excellent foundation for further important steps toward the digitalisation of our business – by harmonising our IT platform, creating uniform data systems and processes.
- Currently, we are working on establishing an electronic platform devised to bring borrowers and lenders in the public sector loan business together. Within the first roll-out phase, our goal is the German market. However, we are planning on implementing the platform in further markets.
- We want to increase our value-creation chain with this platform, integrating the project into a large-scale digitalisation initiative of our business. We want to transfer the insights gained with the platform in public sector finance into portal solutions for real estate finance, credit processes, and document processes.

## 3.3 Outlook for 2017

### 3.3.1 Financial outlook

I will conclude with our targets for 2017. We will continue to follow our conservative approach to risk, and will make prudent investments in new projects and business segments. We believe interest income will remain stable, or be slightly weaker, as a result of better interest-bearing holdings and stable to weaker margins – in fact, the margin profile at the start of 2017 has turned out somewhat better than we had assumed in the planning.

In concrete terms, this means that (*CHART 9*):

- We are aiming for **new business volume** of between €10.5 billion and €12.5 billion (including extensions of more than one year). Our new business planning is ambitious, but essentially takes into account the following aspects:
  - the pure new business in commercial real estate finance is expected to come in at around last year's level.
  - Added to this will be further new business from the US.
  - A higher volume of new business in Public Investment Finance is to be expected: in 2016 we were punching below our weight here, and have potential to catch up.
- We therefore plan to sharply increase the strategic **financing volume** this year, in view of the new business but especially due to the further decline in early repayments.
- On this basis, we predict **the aggregate of net interest income and net commission income** to be stable or only slightly lower than the level seen in 2016.
- We expect **costs** to rise.
  - We estimate **loan loss provisions** to rise, and expect risk costs in the order of 10 to 15 basis points of the Real Estate Finance portfolio, as in previous years. However, I would like to stress that we currently have no concrete grounds for expecting higher loan loss provisions.

- After four years with falling costs, and achieving cost reductions of more than 40%, the coming year is likely to see a rise in **general and administrative expenses**. This should especially be evident in higher personnel expenses. However, it must also be taken into consideration that a material part of the anticipated increase is technical, owing to the end of the use of provisions. Even so, we expect general and administrative expenses to be in line with our medium-term guidance of €220 million for 2017.
- We are targeting **profit before taxes** of between €150 million and €170 million, which would match the operating result for 2016 as adjusted for non-recurring Heta effects.

### 3.3.2 Results for the first quarter of 2017

In an ongoing challenging interest rate and competitive environment, pbb remained on track in the first quarter of 2017, generating a solid result and satisfactory new business volume.

- During the first quarter of 2017, pbb slightly increased **pre-tax profit** year-on-year, to €47 million.
- The main **drivers of our lending business** remained very stable:
  - the **aggregate of net interest income and net commission income** rose slightly, amounting to €106 million in the quarter under review (Q1 2016: €104 million).
  - **Loan loss provisions** amounted to €2 million in the first quarter, up €2 million on the previous year's quarter; the **level** of loan loss provisions is thus still very **low**.
- **General and administrative expenses** increased, as expected.
- The first quarter was burdened by the **bank levy** which is booked at the beginning of each year for the respective financial year. In 2017 it amounts to €20 million (Q1 2016: €21 million).

At the same time, pbb recognised €7 million in income, including proceeds from the **disposal of assets** from the non-strategic Value Portfolio.

The results of the first quarter thus support our target for the financial year. Regarding new business generated and margins achieved, the **second quarter** has begun promisingly. Our transaction pipeline also gives us reason to be optimistic.

#### 4. SUMMARY

Ladies and Gentlemen,

this brings me to the conclusion of my comments. Please permit me to summarise them:

- 1) When we entered the capital markets with our flotation in 2015, we did this as a company whose aim was to generate an attractive return by way of a conservative approach to risk. In 2016, we once again met our self-imposed goals.

With profit before taxes of €301 million, the bank can look back on a sound operating performance in 2016, with very good financial results.

Our dividend yield of 11.5% clearly exceeds comparable return in the market.

The risk profile of our loan book continues to be very good, whilst our risk appetite remains conservative.

- 2) With a common equity tier 1 (CET1) ratio of 19%, we should be well equipped to meet the challenges the regulatory framework and the markets will present us with in the future.
- 3) We expect a good result in 2017, taking into account the anticipated regulatory challenges as well as higher risk and administrative expenses than in 2016.

We also intend to invest in pbb's future during the course of the current financial year – the key themes being the US market. product expansion and digitalisation.

Thank you very much for your attention.