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PFANDBRIEFBANK

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Annual press briefing

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Manuela Better
CEO

Alexander von Uslar
CFO

Deutsche Pfandbriefbank AG, Munich

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1. Introduction (Manuela Better)

Good morning, ladies and gentlemen

Welcome to the annual press briefing of pbb Deutsche Pfandbriefbank. We are pleased that you have been able to attend today.

During the 2013 financial year pbb Deutsche Pfandbriefbank maintained its successful business performance of the recent years, clearly **exceeding its targets for profit and new business in its operating business** (slide 1):

- **At € 8.2 billion,** new business volume reached a record, exceeding the previous year's level by almost 50 per cent. We thus demonstrated our origination strength, with a risk/return profile that continues to be attractive.

- Based on **preliminary figures, pre-tax profit** rose to € 165 million, up approximately two-thirds on our original projections.

We also **further optimised our strategic position**:

- We **terminated the portfolio servicing for FMS Wertmanagement**, as planned; these activities were non-strategic. This allowed us to reduce complexity and to focus more closely on the core business.

- In this way we built the foundations for implementing **new structures** within pbb, and to **optimise processes** – which are now fully in line with our requirements for a specialist Pfandbriefbank that is consistently geared towards its clients.

In other words: **pbb is ready for the future**. Based on this market position, the Group looks ahead to 2014, and to the planned privatisation in 2015.

In 2014, we will continue to demonstrate the skills that will be decisive for privatisation. We will demonstrate pbb's **origination strength** and **funding power**, and we will showcase our **risk management skills**.

I will cover these aspects in more detail later. First, my colleague Alexander von Uslar will now present and discuss the preliminary results for the 2013 financial year in detail.

2. Results 2013 (Alexander von Uslar)

Good morning, ladies and gentlemen.

Allow me to make a few introductory observations before commenting on the preliminary results:

- pbb generated a **pre-tax profit** of € 165 million, in accordance with IFRS, during 2013 – a result that was very significantly higher than our guidance of at least € 100 million as communicated at the beginning of 2013. In fact it also exceeds the raised forecast, as given in October 2013, by another 10%.

  pbb's profitability has improved: the return on equity before taxes rose to 5.0% (2012: 3.8%), and to 4.9% after taxes (2012: 2.1%).

- There were two opposite **one-off effects**, which together had a positive impact on results of approximately € 37 million.

  - Effects from the **valuation of derivatives** led to a non-recurring expense of € 55 million. To date we were using three-month interest rates for valuation purposes; now we are using overnight rates. This is the new standard, and we are one of the first institutions to have fully implemented this new market convention. The € 55 million expense also includes costs incurred for the optimising our derivatives portfolio.

  - This effect was more than offset by the sale of an office property in London, which we had acquired years ago from a borrower in the course of a **loan restructuring**. We realised € 92 million income upon the sale.

    No doubt we benefited from the current favourable market environment. But this required the successful repositioning of the property, by which we significantly enhanced tenancy rate. pbb thus proved that banks are indeed able to restructure – a skill that is often denied.

- Following the optimisation of our market presence and the termination of the servicing function for FMS Wertmanagement at the end of September last year – both points which Manuela Better already mentioned – we have lowered **general administrative expenses** as planned, thanks to cost savings. This effect will be clearly visible during 2014 – in the year under review it only impacted on the fourth quarter.

  The **cost/income ratio** improved from 73.0% to 64.7% – also reflecting the one-off effects on income. The ratio will fall further during 2014; on a medium-term horizon, we want to achieve a figure below 40%.

2.1 Consolidated results of Deutsche Pfandbriefbank

I will now present the details of pbb's preliminary consolidated financial statements in accordance with IFRS. As in the previous years, I will structure my presentation of the various line items in line with our business logic.

All figures of the 2013 financial statements are preliminary and unaudited. We will publish the audited financial statements and the annual report on 3 April 2013.

2.1.1 Results from the lending business

Income from our core lending business is recognised in two items: net interest income and net commission income *(slide 2)*.

- At € 319 million, **net interest income** exceeded the previous year's figure of € 296 million and remained the key source of income.
    - **New business** was a key driver of this increase: the nominal volume of new business originated in the strategic business segments of Real Estate Finance and Public Investment Finance offset repayments, and the average margin earned on newly-originated exposures exceeded the figure for the existing portfolio.
    - Early **repayments** of receivables and early redemptions of liabilities had a positive effect totalling € 27 million during the year under review (2012: € 17 million).
    - The low interest rate levels – which once again dropped during 2013 – resulted in lower **interest income from own funds and liquidity reserves**.
- **Net commission income** totalled € 9 million (2012: € 23 million). We generate commissions, for example, in the form of syndication and other fees.

This income from the bank's business activities is offset by **provisions for losses on loans and advances**, which we recognised in a net amount of € 8 million in 2013. Whilst this was higher than in the previous year (when we were able to release a net € 4 million), it remained on a low level. This low level is a reflection of the good overall situation on the markets, but also of the high quality of our portfolio.

2.1.2 Other results related to our business activities

We reduced **general administrative expenses** by almost 10%, to € 312 million (2012: € 341 million) *(slide 3)*. This shows that the restructuring measures of the past few years have come to fruition.

- We reduced **personnel expenses** by € 10 million, to € 121 million during the period under review (2012: € 131 million). This decline already reflected the transfer of pbb staff to FMS Wertmanagement's service company which took place at the beginning of the fourth quarter, in line with the transfer of the servicing function. We expect another marked decline in personnel expenses in the current financial year.

- Non-personnel expenses were down to € 191 million (2012: € 210 million), mainly due to lower advisory and IT expenses.

The **balance of operating income and expenses** decreased to € 100 million during the 2013 financial year (2012: € 131 million),

- mainly due to the termination of **servicing for FMS Wertmanagement** at the end of September. The bank generated income of € 60 million from these services in 2013 – the year before, the figure was € 106 million.

  As you know, this income item was offset by administrative expenses of virtually the same amount. This is due to the fact that we invoiced these services using a 'cost-plus' method, with only a small mark-up.

- We generated € 36 million (2012: € 40 million) in net income from **IT services** provided to our affiliate, DEPFA Group.

- The **bank levy** weighed on the balance of other operating income and expenses in an amount of € 11 million; the € 24 million figure for the previous year included back payments from the preceding year.

The **balance of other income and expenses** of € 3 million (2012: -€ 6 million) mainly reflected changes to restructuring provisions required for pbb's realignment. Updated calculation parameters had an impact here.

2.1.3 Effects from the valuation of financial instruments

Let me now turn to the effects resulting from the valuation of financial instruments *(slide 4)*. We already anticipated negative effects at the beginning of 2013 – an assessment which turned out to be accurate. These effects were clearly positive in 2012. The fluctuations show that our influence on such effects is very limited indeed, since they are driven by changes in market value. One exception during the period under review was the net income from financial investments.

- **Net trading income**, which in 2012 still showed income of € 10 million fell to a deficit of € 51 million in 2013. This showed the impact of the switch to overnight yield curves, as I described earlier, and of optimising our derivatives portfolio.

  We do not have any profits or losses from trading activities – in fact, we do not have a trading book at all.

- At € 92 million, income from the deconsolidation of Little Britain Holdings (Jersey) Ltd accounted for the lion's share of **net income from financial investments**, which amounted to € 96 million (2012: € 13 million).

  In addition to this item, which I already explained earlier, there were several further minor effects.

- **Net income from hedge relationships** – better known under the concept of 'hedge accounting' – improved to € 9 million in the year under review (2012: € -6 million). The net figure was largely due to hedge inefficiencies. The Group no longer holds any financial instruments designated at fair value through profit or loss.

2.2 Total assets

Consolidated total assets of the pbb Group amounted to € 74 billion on the reporting date, down 23% from the previous year's level (31 December 2012: € 97 billion) *(slide 5)*.

The **reduction in total assets** was attributable to the following factors in particular:

- pbb participated in **three-year LTRO offered by the ECB** in December 2011 and February 2012, in an aggregate volume of € 4 billion. The bank repaid these funds at the earliest possible date, in January and February 2013, respectively.

- In the course of transferring assets to FMS Wertmanagement in 2010, some mortgage loans were transferred synthetically. This means that whilst the economic risk was transferred to FMS Wertmanagement at the time, the loans remained within pbb's cover pool, and thus on pbb's balance sheet. These **loans were transferred 'physically' to FMS Wertmanagement** in August 2013, at which point they had a carrying amount of € 6.4 billion.

- The remaining effects arising from the transfer of assets to FMS Wertmanagement were reduced further during the 2013 financial year and are only of minor importance now. For instance, the balance of positive market values of back-to-back derivatives was reduced to virtually zero, through novations (2012: € 1.0 billion). Following maturities, the pbb Group no longer holds any securities issued by FMS Wertmanagement. This reduced total assets by € 2.2 billion compared with 31 December 2012.

- pbb continues to carry **non-strategic portfolios** in public-sector budget finance. The nominal value of these portfolios, which will run off on pbb's books as planned, was reduced by a further € 4.9 billion, to € 22.8 billion (2012: € 27.7 billion).

2.3 Regulatory capital ratios pursuant to Basel III

Since we calculate the capital ratios at the level of the HRE Group, all ratios for the pbb sub-group are on a pro-forma basis. Deutsche Pfandbriefbank remains well-capitalised – in fact, the bank's**capital ratios** even **improved** during the year under review.

- The tier 1 ratio was 20.3% (31 December 2012: 18.9%), and

- the core tier 1 ratio was 17.8% (31 December 2012: 16.6%),

particularly as a consequence of the reduction in risk-weighted assets, from € 15.3 billion to € 14.2 billion. The bank's capitalisation – excluding net income for 2013 – remained stable, at € 2.9 billion.

Even when applying all effects known under Basel III today, capital ratios in accordance with Basel III (fully phased in) would remain at these sound levels: the tier 1 ratio would be 17.6% and the core tier 1 ratio 11.6%.

3. Review of the year 2013 (Manuela Better)

Ladies and Gentlemen,

pbb looks back on a successful year – both in our operating business and in terms of our strategic position. I would like to cover both aspects before I give you an outlook for 2014.

3.1 Markets

3.1.1 New business

Let me start with our new business (slide 6), which developed very favourably indeed in 2013.

- pbb originated new business in an aggregate volume of **€ 8.2 billion** during 2013. The year-on-year increase of 46% is clear evidence of the origination strength we have reached by now. As in the past, the fourth quarter was the strongest, with a volume of € 2.7 billion.

- As expected, the bulk of new business was in **Real Estate Finance**, which accounted for € 7.0 billion or approximately 85% of the total figure.

  - As in the previous year, we originated the majority of real estate loans in **Germany**. The share of business in Germany rose from 32% to 53%, which is in line with the share of German exposure in the total portfolio.

    With an unchanged share of approximately 17%, the **United Kingdom** was the second most important market for us, followed by **Central and Eastern Europe** (14 %) and **France** (9%).

  - The average **loan-to-value ratio** for new exposures rose slightly, from 56% in 2012 to 61% in 2013. Still, we continue to originate new business with an attractive risk/return profile –

  - even more so given the average **gross margin**, which remained above 225 basis points.

    At around 4.4 years, the average **maturity** was virtually unchanged from 2012, when it was 4.5 years.

  Whilst Real Estate Finance is set to remain the **more important of our two business divisions**, we anticipate a higher relative share of Public Investment Finance business.

- In the **Public Investment Finance** business, we boosted our new business volume disproportionately, to € 1.2 billion – up by more than 70% year-on-year, albeit compared with a comparatively low volume in the previous year.

    - **France** and **Germany** remained our most important target markets in this segment.

      The **Nordic countries**, where we started offering financings to our public-sector clients in 2013, accounted for a combined share of 10%. This is a respectable result, and a very sensible expansion of our activities in this business.

    - We have further expanded our activities in **guaranteed export financing** schemes.

    - **Gross margins** came under slight pressure; on average, they were above 100 basis points (2012: > 140 basis points). In this context, it is worth noting that the previous year's result was shaped by high-margin business in France, which makes comparisons less meaningful.

      At around 8 years, the average **maturity** was lower than in the previous year (2012: 7 years),

Momentum in new business has remained intact; we anticipate first-quarter business volume to exceed the figure for the same quarter of the previous year.

3.1.2 Portfolio

During the period under review, pbb Deutsche Pfandbriefbank's **overall portfolio** declined by € 8.4 billion, to € 66.9 billion (shown as Exposure at Default or EAD, in line with Basel II). As in the previous year, the decline was due in particular to maturities in the run-off portfolio, which decreased more than expected, by € 5.1 billion to € 23.5 billion. From 2014 onwards, we will present the run-off budget finance portfolio separately from the strategic portfolio in Public Investment Finance.

Our exposure to borrowers in **European countries in focus** was virtually unchanged during the period under review. What is important in this context is that the situation in these countries has eased significantly – as can be seen in the hidden encumbrances on this portfolio. These are down by a significant margin since the end of the previous year.

As you are all aware, the ECB's **Asset Quality Review** is currently in progress, in preparation for ECB's takeover of supervisory authority over the 138 largest banks in Europe. In our case, this review encompasses the entire HRE Group. However, pbb would also fall under ECB's supervision in its own right. The audit began in mid-February. Of course we do not want to pre-empt the results. But based on the results of audits carried out over recent years, we consider the quality of our portfolio to be good.

We are, however, not in a position to estimate the costs that pbb – or more precisely, HRE Group, which is being audited – will incur in connection with the Asset Quality Review. Overall, we observe a cost increase as a consequence of regulation; this will have an effect on profitability.

3.1.3 Capital markets funding

The prerequisite for the success in originating new business was a further increase in our funding volume, whist simultaneously diversifying the funding instruments used.

During 2013, pbb raised long-term funding in an aggregate amount of some **€ 7.7 billion** on the capital markets, thus increasing its funding volume by around 20 per cent year-on-year (slide 7). The share of public placements rose to above 50%, compared to around 46% in 2012.

- The lion's share of the increase was attributable to **unsecured funding**, where we saw an increase of almost one billion euros, to € 3.2 billion (2012: € 2.3 billion).

  At the same time, we raised funding with longer **maturities** of 5.2 years on average (2012: 4.5 years) – which go far beyond the planned timing of pbb's re-privatisation.

- The volume of our **Pfandbrief issues** increased slightly, to € 4.5 billion (2012: € 4.2 billion), with a slightly shorter average maturity of 6.9 years (2012: 7.5 years) – a maturity range that perfectly complements the terms of our new business.

pbb's **funding power** was also evident in the following placements:

- firstly, a **15-year Public Sector Pfandbrief** – a maturity which no other bank has issued for a decade;

- secondly, **non-euro denominated** Mortgage Pfandbriefe issued in pound sterling and Swedish krona.

  Non-euro denominated Pfandbrief issuance is relevant for pbb with respect to the countries in which we are active. This allows us to eliminate currency risks which we would otherwise have to hedge using derivatives, with additional costs. At the same time, we thus explore new investor groups.

Last year, we launched pbbdirekt.com, offering **overnight and term deposits to private investors** – with the strategic objective to broaden our funding base. This business has met with a very good response from customers: since the launch one year ago, they have deposited more than € 1 billion with pbbdirekt.com. We have thus made good progress in our endeavours to match medium- to long-term target volumes in the low-single-digit billion euro range. Deposit-taking has opened a source of funding for us beyond the capital markets, raising pbb's attractiveness for equity investors.

Our **balance sheet structure** continues to be characterised by matched-maturity funding to the largest extent. In other words: We have financed our portfolio right through to the repayment of the loans funded. Whilst this means that we forego some income that would be available with certain maturity mismatches, it makes pbb attractive for potential investors.

4. Strategic positioning

We not only developed our business throughout 2013, but also further optimised pbb's **strategic positioning**.

- Specifically, this meant terminating the servicing function for FMS Wertmanagement and revising pbb's structures and processes. Our key objective in this context was to strengthen our **origination**, with new sales offices in Germany and abroad, together with additional staff. In particular, we optimised the primary business process – from customer acquisition right through to loan disbursement.

- In our view, both steps were major milestones on the route to making pbb eligible for re-privatisation.

pbb's situation has continuously – and very clearly – improved over the last few years. We have consistently **exploited the opportunities** presented by our mandatory fresh start (*slide 8*).

- Today pbb can rely upon an **efficient banking organisation**, with a lean structure, a state-of-the-art IT environment, and a strong, highly motivated team.

- pbb has a **sustainable business model** with the two divisions Real Estate Finance and Public Investment Finance – which provide a sensible level of diversification but nonetheless offer significant synergies.

- Our **portfolio** reflects the bank's strategic refocusing.

- We have built a very good **market position**:

    - pbb ranks amongst the top three commercial real estate lenders in Europe.

    - In terms of outstanding issue volumes, pbb is number two amongst all Pfandbrief issuers. We have an approximate 10% share in aggregate new issues placed in 2013. No bank placed more benchmark Pfandbrief issues during 2013.

- Thanks to our skills in **structuring financings**, we create real value for our clients. This is based on the following factors:

    - The first factor is our presence in the relevant European markets, not just with sales teams but also with underwriting and property valuation – functions that are crucial for success in the primary financing markets. We also leverage our in-house network, which is why all of our clients benefit from our pan-European competence.

    - The second key factor in this context is our competence as arrangers for all financing requirements: in addition to our own experience gained over many years, we have access to a network of financing partners with different business focuses.

As a result, we are not restricted to local business; instead, we also support our clients for cross-border investments or provide finance for transactions covering assets in several countries. In fact, we are one of the few lenders in Europe with a comprehensive network – a pan-European 'footprint'. In contrast, our competitors are usually only active in their respective home market, or only transact business outside their home market on a selective basis.

We either take loans on our own books or provide finance within the scope of syndicates we arrange in cooperation with banks or other market participants. Syndicated lending is an option if this facilitates the transaction, or if subordinated tranches are required – over and above the senior tranche.

On the basis of this market position and business profile, we **look ahead to 2014, and to our planned privatisation in 2015**. We will demonstrate our origination strength and funding power, as well as our risk management skills. We are determined to convince clients with our structuring skills, our pan-European reach, as well as with our reliability in lending and in dealing with an exposure.

In essence, what we continue to do is to originate more new business, at reasonable margins – thus **enhancing pbb's profitability.**

- Every euro of new business we originate today will boost profitability, thanks to the higher margins compared to existing exposures.

- We will double this effect if our portfolio growth outpaces maturing exposures.

5. Outlook

This brings me back to the outlook. Our focus will be on further **enhancing medium- and long-term profitability**, driven by new business and asset quality.

What are our concrete expectations for the year 2014? Three aspects are important to us (*slide 9*):

- Firstly: we expect an increase in the **results from our lending business**.

  This will be driven by higher net interest income compared to 2013 – which we want to achieve through a marked increase in **new business volume** compared to 2013.

  We have assumed **provisions for losses on loans and advances** to be at normalised levels. Results would be strengthened if no significant provision for losses on loans and advances were necessary – as was the case for 2013.

- Secondly: we anticipate a **pre-tax profit** of at least € 140 million, which would exceed 2013 pre-tax profit, adjusted for one-off effects.

  Return on equity after taxes is targeted at a minimum level of 3.7%.

- Thirdly: **the cost/income ratio**, which we employ as a key performance indicator, will improve compared to the year 2013, especially due to further IT cost savings during the fourth quarter.

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Ladies and Gentlemen,

This brings me to the conclusion of my comments. I would like to thank you all for your interest and attention. We would now be pleased to answer your questions.