MANAGEMENT REPORT 2016
RISK, OUTLOOK AND OPPORTUNITIES REPORT

RISK REPORT

The ability to monitor and keep risks under control at all times is essential for the successful steering 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 is advised about the Bank's risk profile no less than on a quarterly basis and additionally as required. This takes place using the reports concerning the Bank's risk-taking capabilities, lending risks, 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 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. A procedure based on the credit value-at-risk (Credit-VaR) is used to determine lending limits. The individual contribution of every borrower (aggregate debtor or limit group as appropriate) – the Marginal Credit-VaR – to the Bank's total credit risk is limited. 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 consists of top tier loans with moderate loan-to-value ratios. The current breakdown based on loan-to-value ratios is as follows:

TOTAL PORTFOLIO OF MORTGAGE AND OTHER LOANS (INCLUDING OPEN COMMITMENTS)				
MORTGAGE LENDING VALUE RATIO	31 Dec. 2016		31 Dec. 2015	
	€	relative	€	relative
Up to 60%	13,728,296,351.62	46.2%	13,271,710,357.89	47.9%
60.01% to 70%	5,677,718,196.80	19.1%	5,042,708,598.93	18.2%
70.01% to 80%	6,311,223,356.12	21.2%	6,073,353,119.95	21.9%
80.01% to 90%	2,154,390,691.97	7.3%	1,908,858,072.86	6.9%
90.01% to 100%	1,106,925,787.91	3.7%	780,335,345.71	2.8%
over 100%	711,366,203.19	2.4%	636,039,606.63	2.3%
without	25,419,250.26	0.1%	5,311,692.91	0.0%
Total	**29,715,339,837.87**	**100.0%**	**27,718,316,794.88**	**100.0%**

The regional breakdowns within Germany and abroad are as follows:

TOTAL PORTFOLIO OF MORTGAGE AND OTHER LOANS (INCLUDING OPEN COMMITMENTS)				
REGION	31 Dec. 2016		31 Dec. 2015	
	€	relative	€	relative
Baden-Wuerttemberg	2,616,357,406.41	8.8%	2,458,167,385.30	8.9%
Bavaria	5,646,905,936.17	19.0%	5,110,606,411.84	18.4%
Berlin	1,621,952,619.85	5.5%	1,608,952,190.17	5.8%
Brandenburg	490,537,743.87	1.7%	429,326,781.99	1.5%
Bremen	72,477,010.74	0.2%	64,728,357.23	0.2%
Hamburg	714,905,017.62	2.4%	734,733,778.71	2.7%
Hesse	1,616,366,977.79	5.4%	1,546,523,049.03	5.6%
Mecklenburg-Lower Pomerania	338,336,073.85	1.1%	274,672,252.37	1.0%
Lower Saxony	1,947,571,402.44	6.6%	1,810,173,371.57	6.5%
North Rhine-Westphalia	4,175,437,802.38	14.1%	3,880,816,308.44	14.0%
Rhineland-Palatinate	1,090,638,755.50	3.7%	895,637,075.59	3.2%
Saarland	224,663,431.89	0.8%	165,114,350.93	0.6%
Saxony	830,836,929.91	2.8%	775,623,988.84	2.8%
Saxony-Anhalt	432,564,548.35	1.5%	334,218,552.71	1.2%
Schleswig-Holstein	1,675,695,390.58	5.6%	1,641,592,673.04	5.9%
Thuringia	235,292,855.09	0.8%	220,928,993.69	0.8%
Total domestic	**23,730,539,902.44**	**79.9%**	**21,951,815,521.45**	**79.2%**

TOTAL PORTFOLIO OF MORTGAGE AND OTHER LOANS (INCLUDING OPEN COMMITMENTS)

SOVEREIGN STATE	31 Dec. 2016		31 Dec. 2015	
	€	relative	€	relative
Austria	129,371,291.34	0.4%	83,712,117.34	0.3%
France	306,183,794.26	1.0%	253,680,546.05	0.9%
Great Britain	389,373,033.56	1.3%	427,226,244.83	1.5%
Spain	187,861,502.87	0.6%	173,868,358.99	0.6%
Luxembourg	48,626,000.00	0.2%	48,626,000.00	0.2%
Sweden	0.00	0.0%	0.00	0.0%
Switzerland	4,321,626,705.80	14.5%	4,040,513,104.46	14.6%
The Netherlands	326,947,813.21	1.1%	281,486,842.93	1.0%
Belgium	49,976,456.52	0.2%	22,079,844.29	0.1%
USA	224,833,337.87	0.8%	435,308,214.54	1.6%
Total foreign	**5,984,799,935.43**	**20.1%**	**5,766,501,273.43**	**20.8%**
Total domestic and foreign	**29,715,339,837.87**	**100.0%**	**27,718,316,794.88**	**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. It is a portfolio with little credit risk. 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 January 10, 1994.

Individual adjustments to value taken remained at a low level for our residential property financing business due to the great stability of the residential property market. This also generally 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. In the future we will use a so-called Central Counterparty (CCP) as the preferred basis for settling derivative trades.

The individual and general adjustments to value developed as follows in 2016:

TOTAL LENDING BUSINESS						
in € millions	Opening balance	Addition	Reversals	Utilisation	Changes related to exchange rate shifts and other factors	Closing balance
Individual adjustments to value	69.8	15.7	-4.8	-15.6	0.9	66.0
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 are:

- 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 generally not employed in the capital market business for speculative purposes. Option positions are generally 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 are currently not relevant for MünchenerHyp as our total investments in this asset class – in addition to our investments in the Cooperative Financial Network – amount to less than € 5 million. The Bank plans to invest in a mixed fund (a special fund) in 2017. The specific content of the fund is still open. This investment will, however, increase our stock exposure.

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 to currency exchange rates are identified by changes in the present value that occur with a 10 percent shift up or down in exchange rates, as well as the effect of volatility on the present value when volatility increases by 1 basis point.

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 are:

- Legal supervisory requirements: The current interest rate curve is completely parallel shifted up and down by 200 base points for every separate currency used. 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 100 base points across all currencies. The worst result of the two shifts is used for calculation purposes.
- Steepening/flattening: The current interest rate curve is rotated in both directions around the 5-year rate as the fixed point.
- Basis Spread Worst Case: A worst case scenario is used to quantify basis spread risks. The scenario analyses the effects of different developments in the basis curves on the portfolio of loans with variable interest rates.
- Historical simulations:
  - September 11, 2001 terror attack in New York: Changes seen in market prices between September 10, 2001 and September 24, 2001 – the immediate market reaction to the attack – are played out using the current levels.
  - The 2008 crisis in the financial markets: Changes in interest rates seen between September 12, 2008 (last banking day before the collapse of Lehman Brothers) and October 10, 2008 are played out using the current levels.
  - Euro-crisis: changes in interest rates that took place during the Euro-crisis between 21 May 2012 and 4 June 2012 are played out in this scenario. Interest rates fell sharply during this period.

The maximum Value at Risk (VaR) of the banking book (interests, currencies and volatilities) at a confidence level of 99 percent at a ten-day holding period in 2016 amounted to a maximum of € 78 million. The average figure was about € 44 million.

Due to the fact that MünchenerHyp is a trading book institution (only for futures) we also manage potential risks in this area on an intraday basis. Furthermore, these trades are also integrated into our normal reporting procedures. Once again, no futures deals were conducted in 2016.

MünchenerHyp manages its credit spread risks by calculating the present value of its asset-related capital market transactions on a daily basis along with credit spread risks. The Bank uses the Summit programme to calculate the Credit Spread VaR, the 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 base 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 October 1, 2010 and November 8, 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 € 109 million in 2016, while the average figure was about € 102 million.

The credit spread VaR for current assets (only third-party securities) using a 95 percent level of confidence and holding period of one year stood at a maximum of € 3 million in 2016, the average figure was about € 1 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 four 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 September 11, 2001 terror attack, or the financial market/sovereign debt crisis.
4) Combined stress: Simultaneous occurrence of bank and market stress.

MaRisk demands that an institution must be able to meet the liquidity requirements arising from this scenario for at least 30 days.

Varying model assumptions for all important cash flows were derived for each scenario; for example utilisation of our liquidity lines or guarantees (Aval), 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 francs. Positions in other currencies are negligible. Limitation in the stress scenarios takes place over a 90-day (yellow status) or 60-day (orange status) horizon, and in the base case over a one year (yellow status) or 90 days (orange status) horizon.

In addition, the Liquidity Coverage Ratio (LCR), including a forecast, pursuant to CRD IV is calculated at least once a week for all currencies, and presented separately for all relevant currencies. Currently, these currencies are the euro and the Swiss franc. The required ratio of 70 percent for 2016 was notably exceeded at all times.

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 and presented separately for all relevant currencies; these are currently the euro and the Swiss franc. As the supervisory authority has not yet issued any binding plans for complying with NSFR requirements, and the values are currently relatively stable at just over 100 percent, this ratio is still 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.

MünchenerHyp does not have any investments in less liquid bonds, like Mortgage Backed Securities (MBS), 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.

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, 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 calculates its ability to bear risks based on the Going-Concern, as well as the so-called Insolvency Case scenario. However, the Going-Concern scenario is the relevant method used for control purposes, which 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 risk bearing capacity was given at all times during the year under review.

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) and interest options (caps and floors) 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 numerous operating instructions. It contains organisational security measures, and ongoing 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

MünchenerHyp continues to pursue a growth strategy focused on its residential and commercial property financing activities built on a solid refinancing foundation that is primarily based on Pfandbriefe and other bonds. The overarching strategic goal will continue to be the further strengthening of the Bank's earning power and thus its ability to retain profits. The Bank's strategic planning is focused on measures to improve net interest income and net commission income, increase cost efficiency, and keep risks under control.

The annual adjustment of our business and risk strategy required by the MaRisk defines the formal planning framework for this. Our integrated annual planning process plays a key role in the planning and management of our operations. This process synchronises our sales goals, management of the decentral and central components of our administrative expenses – including our project portfolio – with the outlook for the profit and loss account as it develops over the course of the year. All of the income and expense elements, as well as our ability to bear risks, are continually monitored, or 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 RISKS

ECONOMIC DEVELOPMENT AND FINANCIAL MARKETS

Economic researchers anticipate that the global economy will grow slightly in 2017. The IWF is forecasting that the global gross domestic product will rise to 3.4 percent in the current year and to 3.6 percent in 2018. This increase is based on the assumption that economic development will pick up, especially in the USA and the emerging markets. The economic forecasts are, however, accompanied by great uncertainty. This applies in particular to the direction of the new American president's economic policies, which still remains unclear. His statements to date point towards a protectionist policy, which can have a negative effect on the American economy over the mid-term. Furthermore, the announcement that the British Prime Minister, Theresa May, will pursue a "hard Brexit" to take the UK out of the EU generated uncertainties concerning future economic developments in the EU and Great Britain.

Despite these uncertainties, economic experts still expect that growth in the euro area will not weaken substantially. The EU Commission predicts a 1.6 percent rise in the EU's GDP in 2017 and 1.8 percent in 2018 with a dampening effect expected, in particular, from high levels of debt in parts of the euro area. Moreover, inflation is expected to rise slightly as oil prices have rebounded in the interim period.

The German economy continues to benefit from strong domestic growth that is expected to carry the upswing into 2017. The German Federal Government's Annual Economic Report, however, anticipates that GDP will grow by a lower 1.4 percent. The report views the lower number of working days as the reason behind the decline and not a weaker economy. According to the report, both consumer spending and capital investments will act as primary growth generators with investments in residential housing construction, in particular, expected to expand. The labour market remains stable with the number of employed persons likely continuing to rise slightly while the unemployment rate could fall to below 6 percent. In addition, inflation is expected to rise to 1.4 percent due to higher prices for energy and food.

Central banks in the advanced economies will also act differently in 2017 as their monetary policies continue to drift further apart. While the Fed is expected to further raise its key interest rate, other central banks, and in particular the ECB, the Bank of England and the Bank of Japan, are expected to continue their expansive monetary policies in view of dampened economic prospects. If the rate of inflation in the euro area stays at the current higher level, it might generate discussions thereby increasing pressure on the ECB to alter its monetary policy regarding interest rates and taper its volume of bond purchases.

The improved outlook for the global economy, tapering discussions in Europe and the expected increase in interest rates in the USA could lead to a slight rise in the level of interest rates around the world and in turn also affect other asset classes. The foreign exchange markets are likely to see the gap between euro and dollar-based interest rates widen even further. However, during the second half of the year a countermovement could be seen if the ECB begins to retreat from its expansive monetary policy. It is anticipated that the British pound could again come under pressure at the start of Brexit negotiations and if the UK economy weakens as forecast. Development of the Swiss franc is expected to be stable to friendly and could benefit from possible political changes in Europe.

The first half of the year is likely to be quite lively for the covered bond and Pfandbrief markets as about three-quarters of the issues maturing in 2017 will come due in this period. Predictions call for a volume of about € 120 billion in benchmark covered bonds to be issued, a figure that is just below the level seen in 2016. The ECB's TLTRO-II Programme is one reason for this as it gives banks access to liquidity at comparatively favourable conditions. Demand for covered bonds will, however, continue to be supported by the ECB's purchase programme (CBPP 3). At a minimum, the ECB plans to pursue this programme until December 2017. This in turn will enable issuers to continue benefitting from favourable funding levels. Experts estimate that German Pfandbriefe will represent the biggest share of new issues followed by French, Spanish and Canadian covered bonds.

PROPERTY AND PROPERTY FINANCING MARKETS

The future development of property markets in Europe, and in particular in Germany, should be seen as being closely linked to political, monetary, and overall economic conditions. On the political side the very difficult to predict policy of the new American president, in particular, is a cause for concern among investors and companies. On the monetary policy side the ECB is not yet expected to depart from its low interest rate policy. This indicates that European and in particular German mortgage rates are only likely to rise marginally.

Despite political uncertainties, interest in property investments is likely to again remain at a very high level in across Europe and especially in Germany in 2017 due to low interest rates pressuring investments, as well as solid economic data. Development in regional markets will continue to be influenced by cross-border investments thereby reflecting the role of foreign investors who were responsible for about half of all property investments made in many countries in recent years.

The great interest shown by foreign and domestic investors in German property remains founded on the ongoing economic upswing, the country's image as a safer location for investments, and the attractiveness of the residential and commercial property markets. The top 7 cities will remain the preferred destinations for new investments while the very tight supply of good properties is likely to be mirrored in a slightly lower level of transactions. Experts are predicting that a volume of transactions within a range from € 60 billion to € 65 billion in 2017, with residential property portfolios accounting for € 10 to € 12 billion of this figure. Against this background it may be expected that returns will see a further slight decline associated with rising prices.

A stable rental market is one of the factors behind the strong interest in commercial property investments. Although market participants anticipate a slight decline in turnover of space in 2017, this change will, however, be solely due to a tight supply of marketable space. This is due to the likelihood that demand will remain high against the background of the good economy. New building activity will be at a similar level as in in 2016, although the pre-completion leasing rate will decline slightly. The combination of these individual factors will ease pressure on rents, which in turn will result in a slightly lower rate of growth on a year-over-year basis. As investor demand is expected to remain high, capital values of office properties should also rise slightly.

No signs are visible that the prevailing trend will change in the German residential property market in 2017 due to two reasons: first, capital investors and owner-occupiers will continue to strongly focus on residential property in view of very low interest rates and a slightly higher rate of inflation. Secondly, forecasts call for population growth in regions with strong and expanding economies at least until 2020, which in turn translates into unbroken high demand for housing.

Investments in housing will again increase notably in 2017. The Bundesbank anticipates growth of 3.7 percent. The number of building permits will also rise further. The Federal association of German housing and real estate enterprises (GdW) estimates that permits for about 400,000 housing units will be issued, a level that corresponds to the predicted number of units needed. This could slightly ease the pace of growth of housing prices and rents.

However, as prices continue rising in 2017 they will again be accompanied by discussions concerning possible formation of a property bubble in the German residential property market. Despite these worries, the risks of a bubble forming have not notably increased. This is particularly visible in the number of loans made and lending conditions. What has happened, however, is that the implementation of the Directive for residential property loans has actually placed greater demands on potential borrowers. At the same time, the faster rise of prices tends to be coupled with a danger of prices overheating in certain markets, making it necessary to continue closely monitoring this development.

Further developments in Great Britain will be influenced by the economic effects of Brexit, as its long-term impact on the property market still remains almost unpredictable. It is anticipated that the normalisation of the office property market will continue and the period of rising rents, especially in London, will be over for the time being. Furthermore, the future direction of prices in the residential property market is marked by uncertainty. It is expected that this will lead to growing hesitation among buyers and sellers. Forecasts for rents and purchase prices in numerous regions vary from no growth at all – for example in London – to even a slight contraction – for example in the North East.

The French residential and commercial property market is likely to continue the favourable development noted in the previous year into 2017 against the background of unbroken strong economic growth. This will generate additional momentum for the office properties market and be reflected by higher demand for office space. Vacancy rates for office space will decline further as new projects will only be completed if they have high pre-letting lease rates. This will continue the trend of slightly rising rents. For the investment market this development means that the appeal of French property will grow. At the same time it may be expected that globally active investors will shift their activities from Great Britain to France. This in turn is likely to generate notably higher demand for property and thus a further decline in returns. The French housing market is also anticipated to develop favourably. A slight rise in new construction activity is facing good demand supported by low mortgage rates. Therefore, rents and prices will rise.

Interest shown by institutional investors in the Netherlands will remain at a very high level in view of the expected continuing favourable economic development. Strong demand will be focused on business centres where the greatest increases in prices are expected to occur. Rents will record another increase as demand will be met by a further tightening of available space.

Experts anticipate that development in the Swiss residential property market will not differ a great deal from 2016. Unchanging low interest rates will keep demand for residential property high as investors also view it as a safe capital investment. The pace of growth in purchase prices and rents will slow once again, although regional differences will remain intact. Thus, prices for condominiums and single-family houses are predicted to rise slightly in the German-speaking part of Switzerland, while the decline in prices seen in western Switzerland is expected to lose momentum.

Forecasts for the future development of the commercial and residential property markets in the USA are clouded by the unchanging difficulty of understanding the direction of the new president's policies. However, no notable changes are expected for now in the office properties market, although in the interim a few American markets, especially Denver, San Francisco, Silicon Valley and Dallas, could have reached the end of a phase of rising rents. A slight decline is expected in the volume of investments, albeit from a still high level. Forecasts for the housing market tend to see it weakening with rents and purchase prices rising at a slower pace. At the same time, the completion of new housing units will reach its peak in 2017 thereby raising the risk of apartments remaining vacant, especially in the higher-priced segment of the market.

DEVELOPMENT OF BUSINESS AT MÜNCHENER HYPOTHEKENBANK

Our new business planning for the 2017 business year foresees interest rates remaining at a low level, although they could, however, rise marginally. In addition we also anticipate high demand for property financing in markets where we are present. As we noted in the previous chapter, we expect general economic conditions to be stable to favourable. Against this background we believe that our total new business performance will expand to some extent compared to the same figure for the year under review.

Our primary focus will remain on financing residential property in Germany via the banks within the Cooperative Financial Network – our key partners in this area of business. These banks have exceptional sales power and close relationships with their customers, two characteristics that have enabled them to steadily expand their market position in recent years. We anticipate that they will also grow faster than the market in the residential property financing sector in 2017. We will assist them by intensifying our sales support, in particular, and by further developing and optimising the brokerage process within the banking systems. These measures are intended to strengthen the perception of our partner banks as competent property financiers, thereby expanding the brokerage business.

We also want to intensify our collaboration with independent providers of financial services as well as with Swiss PostFinance. We plan to achieve a moderate increase in new business in both of these sales channels.

Our plans call for the volume of new commercial property financing business in 2017 to at least achieve the previous year's level. The prerequisites – unbroken investor interest and overall favourable conditions in our important markets – are in place for us to attain this goal. Furthermore, we intend to participate more heavily in domestic and international commercial property financing deals via the secondary market – and, in particular, again in the USA. Uncertainties are primarily due to the previously described political unknowns, which could make property investors more likely to act cautiously and hesitantly in 2017.

We expect that competition on the financing side of the commercial property business will remain tough in view of the predicted decline in the volume of transactions. As a result, both the pressure on margins and the willingness to accept greater risks will remain unchanged. We also believe that it is more likely that banks will be further burdened by regulatory requirements. These factors indicate that 2017 will again be a challenging year for the commercial property financing business. We will take these general conditions into consideration and take further advantage of the existing latitude we have regarding prices, and concurrently examine the chances of adding new products to our range of offers. We want to strengthen our presence in foreign markets, while in Germany – which will remain the focal point of our financing activities – we will reinforce the support we provide to our foreign investors. Beyond this we will expand the syndication programme within the Cooperative Financial Network. This programme assists and encourages banks within the Cooperative Financial Network to join us in financing commercial property transactions, thereby enabling them, and MünchenerHyp, to participate in additional deals and bigger volumes of financing.

The objective of our lending business with the public-sector and banks will remain unchanged and primarily serve to control liquidity and cover pools.

Our refinancing needs in 2017 are estimated to amount to € 7 billion, and thereby will be above the previous year's volume. We anticipate that we will float two large volume issues. Beyond these activities our focus will again be on issuing non-euro denominated securities for the purpose of achieving matching currency refinancing for our international business activities, especially our collaboration with Swiss PostFinance.

We plan to accept customer deposits from the Volksbanken and Raiffeisenbanken as part of our efforts to expand our refinancing mix. A corresponding product that meets the interests of the Cooperative Financial Network is currently being developed and should be offered during the remainder of 2017.

We want to further expand our sustainability activities. As part of these efforts we are currently developing a sustainability loan that is focused on social aspects. In addition, we want to integrate sustainability criteria even more strongly into our loan processing.

We are aiming to achieve a moderate increase in net interest income from business operations in 2017. The stable development in our core markets offers us unchanging opportunities to once again expand our new business and thus our portfolio of mortgage loans.

This will continue to have an increasingly favourable effect on the Bank's performance. As a result, we anticipate that our earnings will improve again in 2017.

We anticipate that our administrative expenses will increase slightly in 2017. Nevertheless, we currently expect that our cost-income ratio will decline slightly.

Based on the currently available information, we expect that provisions for lending risks will develop stably.

In view of the anticipated favourable market conditions, we are confident that we will achieve our objectives for the 2017 business year and further expand our market position. We expect that our net income will exceed 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.