Aareal Bank Group is a leading provider of smart financing, software products and digital solutions for the property sector and related industries. It is active in more than 20 countries across three continents – in Europe, North America and Asia.

Group Management Report

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Fundamental Information about the Group

The Group's business model

Aareal Bank AG, headquartered in Wiesbaden, Germany, is the parent company of the Group. Its shares are admitted to trading on the regulated market (Geregelter Markt) of the Frankfurt Stock Exchange, and are included in the mid-cap MDAX® index. Aareal Bank Group provides financing solutions and services to clients in the national and international property industry.

Aareal Bank is a member of the Association of German Banks (BdB) and the Association of German Pfandbrief Banks (vdp).

Aareal Bank Group's business model comprises two segments:

Structured Property Financing

The Structured Property Financing segment comprises all of the property financing and refinancing activities.

In this segment, Aareal Bank facilitates property projects for its domestic and international clients, and is active in this respect in Europe, North America and Asia. It stands out here especially for the direct and long-standing relationships it has established with its clients. Aareal Bank offers commercial property financing solutions, especially for office buildings, hotels, retail, logistics and residential properties. The Bank's particular strength lies in it successfully combining local market expertise and sector-specific know-how. This allows Aareal Bank to offer tailor-made financing concepts that meet the special requirements of its national and international clients.

Aareal Bank manages its sales activities in the individual regions worldwide via a network of sales centres (hubs), of which five are located in Europe. In addition to the locally-based experts, the distribution centres for sector specialists covering hotels, shopping centres and logistics properties are located in Wiesbaden.

The regional hubs or branch offices in Europe are located at the following offices, and are specifically responsible for the following regions:

- Wiesbaden: Germany and Austria;
- London: United Kingdom, the Netherlands and the Northern European countries;
- Paris: Belgium, France, Luxembourg, Switzerland and Spain;
- Rome: Italy;
- Warsaw: Central and Eastern European countries.

In addition to these five regional hubs in Europe, there are locations in another five countries (in Brussels, Istanbul, Madrid, Moscow, Stockholm) that are each assigned to the corresponding regional distribution centre. The business in Turkey is an exception; it is managed from the Wiesbaden head office, reflecting the importance of shopping centres and hotels for the Bank's activities in the Turkish market. Aareal Bank Group also has a presence in Germany through its WestImmo subsidiary, which has twin registered offices in both Mainz and Münster.

Aareal Bank Group maintains an active presence in North America through its subsidiary Aareal Capital Corporation, which has an office in New York and also manages new business activities in the US.

The Singapore subsidiary Aareal Bank Asia Limited conducts the sales activities in the Asia/Pacific region. The Group also has a representative office in Shanghai.

Aareal Bank has a broad and solid refinancing base. It has established itself as an active issuer of Pfandbriefe, which account for a major share of its long-term funding. The AAA rating of the Pfandbriefe – affirmed by rating agency Moody's in January 2017 – additionally confirms the quality of the cover assets pool. To cater to a broad investor base, Aareal Bank covers a wide range of other refinancing tools, including promissory notes and debt securities. Private placements are the focal point of the Bank's capital market activities. These are complemented by larger, public placements that are issued depending on market conditions. In the Consulting/Services segment the Bank also generates deposits from the housing industry, which represent a strategically important additional source of funding. Furthermore, it has recourse to institutional money market investor deposits. The success of our capital and money market activities, and the business with housing industry clients, are the results of a combination of a sustainable business model with a sound understanding of the capital markets, and the quality of the cover assets pool.

Consulting/Services

The Consulting/Services segment offers the property industry services and products for managing property portfolios and processing payments. Within this segment, our subsidiary Aareon AG and the Bank's Housing Industry division work together closely.

We provide IT systems consultancy and related advisory services to the property industry through our Aareon AG subsidiary, which looks back at almost 60 years of experience. Aareon offers its customers secure, standard-setting solutions in the areas of consultancy, software and services to optimise IT-based business processes in the digital age. Its Enterprise Resource Planning (ERP) systems, which are tailored to meet the requirements of the respective target market may be supplemented by other digital solutions for process optimisation. Together, the large variety of these integrated systems constitute Aareon's digital ecosystem – the "Aareon Smart World", which links property companies with their customers, staff, and business partners, and also connects technical devices in apartments and buildings to one another. Aareon Smart World can be used to restructure and optimise processes. The applications help to reduce costs, enable the creation of new business models by providing links between all participants and offer more ease-of-use in the dialogue between tenants and employees of the housing industry.

Aareon offers software solutions both in Germany and abroad that may be used in various types of operating environments: in-house services, hosting and Software as a Service (SaaS) from the exclusive Aareon Cloud. Data from Aareon's Cloud Computing is held in Aareon's certified data-processing centre in Mainz, which guarantees data security and protection at the highest level. Following successful advice, implementation and training, customers usually opt for a maintenance model covering regular support services.

In its Housing Industry division, Aareal Bank offers its customers process optimisation, electronic banking and asset management and markets its BK 01 software which is the leading procedure in the German housing property industry for the automated settlement of mass payments. The procedure is integrated in licensed bookkeeping systems. Therefore, customers in Germany may process their payment transactions and account management from the administration software employed. In addition to the German property industry, the German energy and waste disposal industries form a second major client group of the Bank's Housing Industry division. This enables the offer of further products, facilitating the cross-sector cooperation of target groups and realising synergies via end-to-end digital processes. The use of the payment transaction products of Aareal Bank generates deposits that contribute significantly to Aareal Bank Group's refinancing base.

Management system

Aareal Bank Group is managed using key financial performance indicators, taking the Group's risk-bearing capacity into account. Management takes place primarily at Group level, and is additionally differentiated by business segment. Group management is based on medium-term Group planning, prepared annually, which is geared towards the Group's long-term business strategy. An extensive (management) reporting system regularly provides the information required for management and monitoring purposes.

The indicators set out below are key financial performance indicators for Aareal Bank Group; they are used for the purposes of managing the business and the Group's profitability.

- **Group / consolidated:**
  - » Net interest income (in accordance with IFRSs)
  - » Allowance for credit losses (in accordance with IFRSs)
  - » Net commission income (in accordance with IFRSs)
  - » Administrative expenses (in accordance with IFRSs)
  - » Operating profit (in accordance with IFRSs)
  - » Return on equity (RoE) before taxes[1]
  - » Earnings per ordinary share (EpS)[2]
  - » Common Equity Tier I ratio (CET I ratio)
  - » Liquidity Coverage Ratio (LCR)
- **Structured Property Financing segment**
  - » New business[3]
  - » Credit portfolio of Aareal Bank Group
- **Consulting / Services segment**
  - » Aareon's contribution to consolidated operating profit (in accordance with IFRSs)

The Group's existing risk management system is used to manage and monitor the various risk exposures of Aareal Bank Group entities, in a centralised manner. All management-relevant information is systematically collected and analysed, to develop suitable strategies for risk management and monitoring. We also employ forecasting models for balance sheet structure, liquidity and portfolio development for strategic business and revenue planning.

[1] RoE before taxes = $\frac{\text{Operating profit ./. consolidated net income attributable to non-controlling interests ./. AT1 coupon}}{\text{Average equity (IFRS) excluding non-controlling interests, other reserves, AT1 bond, and dividends}}$

[2] Earnings per share = $\frac{\text{Operating profit ./. income taxes ./. consolidated net income attributable to non-controlling interests ./. AT1 coupon (net)}}{\text{Number of ordinary shares}}$

[3] New business = newly-originated loans plus renewals

In addition to business-related management tools, we also use various other instruments to optimise our organisation and workflows. These include comprehensive cost management, centralised management of project activities and Human Resources controlling, for example.

Structured Property Financing also deploys supplementary management tools and indicators. For example, we manage our new business in this segment using lending policies which are specific to the relevant property type and country, and which are monitored within the scope of the lending process.

The property financing portfolio is actively managed throughout Aareal Bank Group, with the aim of optimising its risk diversification and profitability. To develop risk and return-oriented strategies for our portfolio, we evaluate market and business data, using this as a basis to simulate potential lending strategies, and to identify a target portfolio, which is part of Group planning. This helps us to identify – and to respond to – market changes at an early stage. Active portfolio management makes it possible for us to optimally allocate equity to the most attractive products and regions from a risk / return perspective, within the scope of our three-continent strategy. By taking into consideration maximum allocations to individual countries, products and property types, we ensure a high level of diversification and avoid risk concentrations.

In the Consulting / Services segment, management of the Group entities allocated to the segment is oriented on specific indicators, depending on each entity's business focus – primarily Aareon's contribution to consolidated operating profit. We also use specific performance indicators that are typical for consulting and services in the IT business, the focus of this segment. These include indicators relating to regular client satisfaction surveys, as well as capacity utilisation indicators in the consultancy business. The volume of deposits is a key performance parameter in the Bank's Housing Industry division.

Report on the Economic Position

Macro-economic environment

The economy was characterised by low interest rates and moderate growth in 2016, but above all the year was defined by several political events that created uncertainty and volatility in the markets.

Economy

At 2.2 %, global economic output expanded in 2016 at a significantly lesser pace than in the previous year (2.7 %). Besides stagnating global trade, the structural transformation in China and political uncertainties worldwide, investment activities in particular were moderate in many economies over the entire course of the year. The industrial nations reported moderate but stable growth. The emerging markets, on the other hand, enjoyed slightly higher growth levels but were burdened by structural problems and lower raw material prices. Several political events increased uncertainty about further economic trends in the course of the year. In a referendum held on 23 June 2016, Britons voted in favour of the UK leaving the European Union ("Brexit"). While the outcome of the referendum caused political uncertainty, the real economy appeared to be unaffected for the remainder of the year. Italy rejected legislation to reform the senate in December. The global economy proved stable in face of all these events and continued to maintain positive growth.

Growth in the euro zone was stable in 2016 – without being particularly dynamic. The growth rate eased slightly compared with the previous year. Economic output was disappointing at the start of the year, on the back of weak demand from the emerging markets, but was supported by strong private consumption and by investments. Despite all the uncertainty factors, the economic situation proved robust in the second half of the year.

German economy was more dynamic in early 2016 than in the second half of the year. All in all, the economy remained quite strong, however.

Private consumption and strong construction activity boosted growth from mid-year onwards, while industrial production and exports weakened on the other hand over the course of the year. Consumer sentiment as well as expectations of the manufacturing industry were at a high level at the end of the year.

French economic growth, which got off to a solid start in 2016, was halted by strikes, among other things. Weak exports in particular inhibited stronger growth in the second half-year. The overall economic growth rate in 2016 was comparable to the previous year.

Economic growth in Italy was weak up to the middle of the year. Activity was overshadowed in the second half-year by the referendum held in December on reforming the senate. Economic output rose only slightly for the year 2016 as a whole compared with the previous year and therefore continued to grow at a slow pace. The referendum on reforming the senate caused volatility for a short period only, with Italian government bonds yields reacting relatively indifferent to events. The high share of NPLs held by the big Italian banks impacted on the economy, despite the increase of the bank rescue fund set up by the government.

Growth in Spain was robust in 2016, supported by private consumption, investments, and strong exports. The growth rate was in line with the previous year's level, and well above the euro zone average – with the political uncertainty in the country having no real effect on the economy.

Economic growth in various non-euro countries within the EU was slightly higher than in the euro zone, but lower year-on-year. Growth in the Czech Republic fell by almost half compared with the previous year and Poland painted a similar picture. While growth in Sweden was not as strong as in the previous year, the weakening was not as pronounced. Economic growth in Denmark on the other hand was markedly weaker than the year before.

Britons voted in favour of the UK leaving the European Union in a referendum held on 23 June 2016, triggering volatility on the financial and capital markets, as well as economic and political uncertainty. The uncertainty fed through to the property market, which led to the temporary suspension of trading in British property funds. Nonetheless, the vote hardly had any real effect on economic output in the course of 2016 but had a short-term negative impact on the relevant trend barometers instead. Economic expansion was more or less in line with the previous year. Growth in the second half of the year was supported by the services sector, while industrial production and the construction industry significantly declined. Investment eased slightly and private consumption was strong despite the sharp devaluation of the pound sterling.

The failed coup attempt in Turkey by parts of the military in July determined events in the country. The consequences impacted more on the economy so that growth rates were weaker compared with previous years, especially owing to a lack of investment and exports.

The rate of economic decline slowed in Russia, leading to a slightly negative growth rate compared with the very weak previous year, not least because of weak private consumption.

Economic growth in the US was significantly weaker for the year as a whole over the previous year. The slightly weaker growth in the first half-year due to lower investments in the oil industry recovered slightly in the second half of the year. Growth was sustained by private consumption, as was the case in the previous year too. The presidential election in November attracted great attention but had no material consequences for the economy in 2016.

Economic output in China reached the growth rate targeted by the government but fell short of the previous year's level. Government-backed measures and programmes supported borrowing at the start of the year but low global demand had a dampening effect on growth in the second half. Corporate debt grew continuously and significantly in the course of the year. China experienced another boom in residential property and in the construction industry, which – together with the high level of private debt – was a growing cause for concern. The government restricted capital export at the end of the year in response to the high outflow of capital. Weak consumption in Japan resulted in muted economic growth.

The unemployment rate in the euro zone fell slightly during the course of the year but remained at a high level nevertheless. The rate of unemployment fell below 20 % in Spain for the first time in five years; in the EU the rate fell slightly in 2016. The unemployment rate in the US fell to a very low level up to mid-year, before stagnating in autumn. The good increase in the workforce towards the end of the year led to a further reduction in unemployment, thus reaching a level last seen before the financial crisis.

Financial and capital markets, monetary policy and inflation

A persistent low interest rate environment, with temporarily negative interest rates, continued to characterise the financial and capital markets of the developed economies in 2016. Interest rates rose in some regions by the end of the year but there was no sign yet of a general end to the environment of low interest rates. Markets remained receptive at all times. A series of political events and occasional doubts about the solidity of some big European banks (whereby one Italian bank was bailed out by the state) led to pronounced volatility at times.

Following a good first half-year 2016 with euro-denominated covered bond issues in the amount of around €93 billion, the volume eased considerably in the second half of the year: total issuance for 2016 reached € 127.8 billion (2015: € 154 billion). Investors are demonstrating a generally cautious buying behaviour, are selective with regard to their choice of issuer and sensitive to spreads. Covered bond repayments totalled € 148.6 billion during 2016, leading to a decline in outstanding covered bond volumes.

As expected, Germany was once again the strongest country in terms of issuance in the euro benchmark segment (€ 26.9 billion), followed by Scandinavia (€ 22.3 billion), France (€ 20.3 billion), Spain (€ 13.3 billion), and Canada (€ 12.5 billion).

Spread development on the covered bond market was defined by low volatility during the year under review, with spreads widening initially at the start of the year before moving towards a sideways trend.

Annual rate of change in real gross domestic product

in %	2016[1]	2015[2]
Europe		
Euro zone	1.7	1.9
Austria	1.5	0.8
Belgium	1.2	1.5
Finland	1.4	0.2
France	1.1	1.2
Germany	1.8	1.5
Italy	0.9	0.6
Luxembourg	3.5	3.5
Netherlands	2.1	2.0
Portugal	1.2	1.6
Spain	3.3	3.2
Other European countries		
Czech Republic	2.4	4.6
Denmark	1.1	1.6
Poland	2.4	3.9
Russia	-0.5	-3.7
Sweden	3.1	3.8
Switzerland	1.4	0.8
Turkey	2.0	6.1
United Kingdom	2.0	2.2
North America		
Canada	1.3	0.9
USA	1.6	2.6
Asia		
China	6.7	6.9
Japan	1.0	1.2
Singapore	1.8	2.0

[1] Provisional figures; [2] Adjusted to final figures

A high volume of new issues prevented spreads from tightening in the first quarter of the year. Spreads tightened significantly in the second and third quarter of 2016 as the number of new issues declined and the European Central Bank (ECB) continued to buy covered bonds within the scope of its third covered bond purchase programme. Even the British vote to leave the European Union failed to end this trend, and the outcome of the US election had no impact on the covered bond market. Spreads started to widen in mid-November, prompted by portfolio adjustments and profit-taking by covered bond investors.

Pfandbrief yields are often no longer sufficient for insurance companies in particular to reach their earnings targets. This is traditionally one of the most important buyer groups of registered mortgage bonds. In fact, according to the German Insurance Association (GDV), the volume of direct covered bond holdings of the German direct insurers has been decreasing steadily in recent years (2015 vs. 2012: -10 %), despite the increase in investments overall (+13 %).

The long-term trend of falling yields on ten-year government bonds continued essentially in all currency areas up to autumn 2016. The Brexit vote in the UK in June, the speculation about the end of the ECB's bond purchase programme in October and the presidential election in the US in November represented special events that impacted on government bond yields at the long end. Heightened inflation expectations in autumn were another reason for the trend. Yields on ten-year government bonds in the UK fell sharply as a consequence of the Brexit vote, but rose again strongly in the further course of the year. Ten-year German government bond yields continued to fall in the first three quarters and even reached negative territory at times. Yields were no longer negative from October onwards and even rose again marginally up to the end of the year. Yields on ten-year US government bonds rose in autumn – and after the presidential election in November – to slightly above the level seen in 2015.

Long-term interest rates[1] in the most important currencies for Aareal Bank portrayed a similar pattern to that of government bond yields during the year under review. They fell significantly in the euro zone up to the third quarter, after which they rose again and remained slightly below the previous year's figure. They fell up to the third quarter in the US dollar area too, but then rose again more strongly towards the end of the year so that they closed above the previous year's level. The development for the Canadian dollar was comparable. The performance of long-term GBP interest rates was similar to that of the euro zone, with marked declines until the third quarter followed by a moderate increase. The impact of the Brexit referendum here was equally strong as it was on UK government bonds. Long-term interest rates in the Swedish krona and Danish krone fell until the third quarter. They also rose up to the end of the year but were down significantly compared with the end of the previous year. Long-term interest rates in Japan were slightly negative up to mid-year but climbed again slightly into positive territory again by the end of the year.

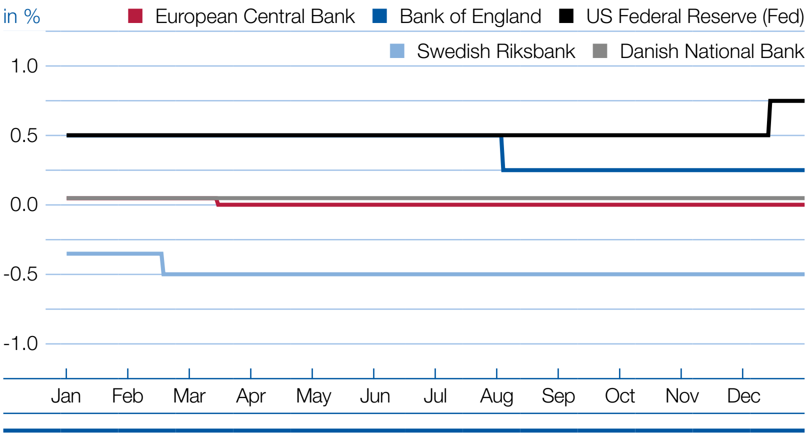
The changes in the short-term interest rates[2] in the various currencies areas that are relevant for Aareal Bank were less than for their long-term counterparts. They fell consistently year-on-year in the euro zone and stabilised slightly just below zero per cent at the end of the year. They were stable in the UK until the Brexit vote but then fell quite sharply and stabilised towards the end of the year at a marginally lower but still positive level at year-end. Short-term Swedish krona interest rates fell sharply in the first quarter of the year under review. They then fell gradually but slightly throughout the year, and thus remained in negative territory. Short-term Danish krone interest rates fell considerably year-on-year up to mid-year and remained negative until the end of the year. On the other hand, short-term interest rates in the US dollar area rose significantly to around one per cent,

[1] Based on the 10-year swap rate
[2] Calculated on the basis of 3-month Euribor or the corresponding LIBOR or other comparable rates for other currencies.

with a more pronounced increase in the second half of the year under review. Short-term interest rates in Canada rose slightly last year over the previous year.

The central banks in the currency areas that are relevant for Aareal Bank continued to pursue their expansionary monetary policy during the year. The big central banks made only a few slight adjustments to key interest rates. The ECB cut its main refinancing rate by five basis points in March to 0.0 % and the deposit rate by 10 basis points, to -0.4 %. The quantitative easing measures were extended, with the objective of bringing inflation to or close to the ECB's self-imposed target value of just under 2 %. The ECB therefore expanded its purchase programme of government and private euro-denominated bonds by € 20 billion to € 80 billion per month in June. It thus implemented the Corporate Sector Purchasing Programme (CSPP) in June, through which it buys investment-grade corporate bonds issued by non-financial enterprises. In December, it announced the extension of the programme up to at least the end of 2017, with a reduced amount of € 60 billion per month as from March 2017. Added to this was the continuation of the long-term refinancing measures (TLTRO II), which are another of the ECB's expansionary tools. The Bank of Japan (BoJ) lowered its deposit rate to -0.1 % at the start of 2016 and extended the equity purchase programme during the year in order to further stimulate the economy. The Swedish National Bank lowered its key interest rate by 15 basis points in March 2016, to -0.5 %, whilst extending its existing purchase programme for Swedish government bonds by SEK 45 billion in April and by another SEK 30 billion in December. The US Federal Reserve (Fed) raised its benchmark interest rate by 25 basis points in December 2016, to a corridor between 0.50 % and 0.75 %, on the basis of good economic and labour market data. The previous decision to move interest rates was made in December 2015, when the Fed had also raised the corridor by 25 basis points. In response to the Brexit vote, the Bank of England (BoE) lowered the key interest rate by 25bp to 0.25 % in August and also expanded its quantitative easing measures.

Key rate developments in 2016 [1)]



[1)] The upper level of the Fed Funds corridor of 0.50 % to 0.75 % is shown.

The currencies that are important for Aareal Bank and the global economy faced increased volatility with regard to the exchange rates to the euro during the year under review, not least owing to a number of political events and measures taken by central banks. The US dollar fell marginally against the euro in the first half of the year but then appreciated continuously from October onwards – almost reaching parity against the euro in December. During the final days of 2016 the US dollar slightly lost ground again. Pound sterling lost a little ground to the euro in the first half of 2016 until just before the Brexit vote. It then depreciated significantly, and was at times even weaker than during the financial crisis, when the Pound sterling was very weak compared to the euro. The pound sterling recovered slightly against the euro at year-end but still remained considerably weaker than at the start of the year. The Swedish krona depreciated considerably against the euro during the year under review, as a consequence of the very expansionary monetary policy pursued in Sweden. An uptrend of the Danish krone was suppressed during the year under review by central bank measures – in accordance with Denmark's membership of the European Exchange Rate Mechanism II (ERM II)[2)],

[2)] Under ERM II, the exchange rate of the domestic currency vis-a-vis the euro must remain within a predefined range in order to meet one of the euro zone accession criteria.

so that the currency remained stable. The Japanese yen appreciated strongly against the euro in the first half of the year – a trend that was reversed during the second half of the year: the yen eased slightly towards the year-end, but was still higher year-on-year.

Inflation picked up noticeably in many economies towards the end of the year, this being one of the results of the slight increase in the oil price during the second half of the year, as well as due to basis effects. At 0.2 %, average euro zone inflation for the full year 2016 was slightly higher than the previous year, but still well below the ECB's target of just under 2 %. The general inflationary pressure from the real economy remained low. Inflation rose noticeably to a two-year high in the UK due to the sharp fall in the value of the pound sterling in the second half of the year but remained under one per cent nonetheless at the end of the year. At just below one per cent, US inflation was above that of the euro zone. The annual rate of inflation in China rose slightly year-on-year but remained below the target of three per cent.

Regulatory environment

The environment in which banks are operating continues to be defined by highly dynamic regulatory requirements, as well as by changes in banking supervision. Especially when considering the extensive work the Basel Committee is undertaking to complete the already-implemented Basel III regime, it is currently not possible to fully assess the impact. In addition, the amendment to the Minimum Requirements for Risk Management (MaRisk), especially with regard to the aggregation of risk data and risk reporting, the EU Commission's proposals to revise supervisory regimes (CRR, CRD IV, BRRD and SRMR) as well as the EBA consultation paper on "Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures" will all lead to further regulatory changes.

Following the introduction of the Single Supervisory Mechanism (SSM), Aareal Bank Group has been directly supervised by the ECB since 4 November 2014.

The ECB's Supervisory Review and Evaluation Process (SREP) ensures a common approach on the supervisory review of banks, within the framework of Pillar 2. The SREP is built around a business model analysis, an assessment of governance and controls, as well as of the capital and liquidity risks. The results of the individual areas are aggregated in a score value, from which the ECB derives supervisory measures on holding additional capital and / or additional liquidity requirements. The ECB converted the SREP requirements from a pure CET 1 ratio to a total SREP ratio (total SREP capital requirements, TSCR) with effect from 1 January 2017. This will be 9.75 % as of 1 January 2017, and includes the 8 % total capital ratio for Pillar 1 and a (Pillar 2) capital requirement of 1.75 % from the ECB's SREP. In addition, the Bank is required to hold a capital conservation buffer of 1.25 % (phase-in), plus a countercyclical capital buffer of 0.03 % as of 2017. Aareal Bank's pure SREP-driven CET 1 requirement has been at 7.53 % since 1 January 2017, comprising 4.5 % for Pillar 1, the Pillar 2 requirement of 1.75 % (as mentioned above) as well as the capital conservation buffer (1.25 %) and countercyclical buffer (0.03 %). Additional liquidity requirements were not demanded of Aareal Bank.

Sector-specific and business developments

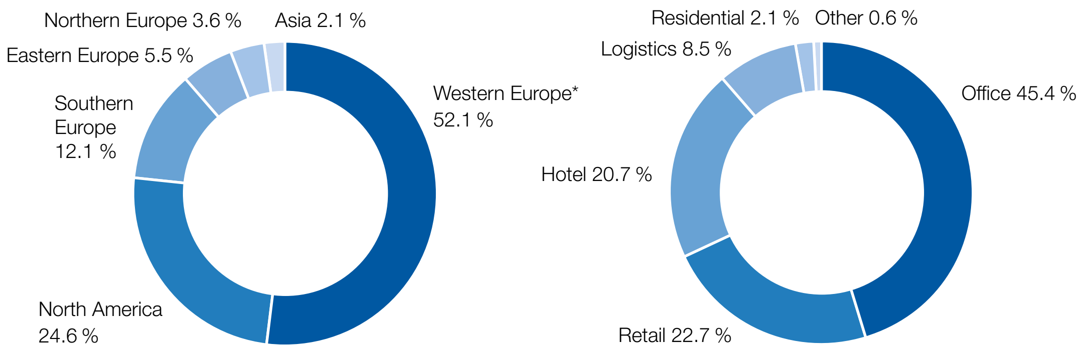
Structured Property Financing segment

Transaction volumes in commercial property worldwide – measured in US dollar terms – fell significantly compared to the particularly high levels seen in the previous year. Transaction activity fell most in Europe compared with a less pronounced decline in Asia and North America.

However, commercial property was in demand as an asset class in the financial year under review, not least owing to the persistent low interest rate environment. The volatility – and temporary closure – of British property funds in conjunction with the EU referendum barely impacted property markets in Europe.

New business 2016

by region | by type of property



* Incl. Germany

The rental markets reported stable to slightly higher rents – compared with the previous year – in most of the big markets. Rents declined marginally in some markets; this applies to office, retail as well as logistics properties. Hotel markets presented a mixed picture overall. Although the average revenues per available room rose in many markets, this was offset on the other hand by significant losses incurred on markets affected by terrorism.

When assessing the description of fundamental market trends, it should be noted that commercial property markets do not represent homogeneous markets. Individual properties differ – even within a regional market or for a given property type – with regard to the factors that determine their value and rents, such as construction quality, modernity, floor space and energy efficiency, flexibility and property management. The location – within regional or local markets – is of course an important factor as well. Hence, rents, income, vacancies, yields and values of individual properties from the same regional market or property type may develop differently.

Commercial property financing was defined by considerable competitive pressure in the year under review. Even though the margins for structured commercial property loans came under pressure in some markets during the course of the year, they strengthened in most European markets and in the US. Margins in the UK rose slightly as a result of the Brexit vote. The loan-to-value ratios remained moderate. The readiness to provide for large-volume investments was unchanged in an environment of strong competition.

In a highly competitive environment defined by uncertainties, Aareal Bank Group[1] originated new business totalling € 9.2 billion (previous year: € 9.6 billion) during the year under review, markedly exceeding its original target of between € 7 billion and € 8 billion. The higher amount was largely due to early renewals.

The share of newly-originated loans relative to new business amounted to 63.3 % (2015: 52.4 %) or € 5.8 billion (2015: € 5.0 billion). Renewals amounted to € 3.4 billion (2015: € 4.6 billion).

At 73.3 % (2015: 78.0 %), Europe accounted for the highest share of Aareal Bank Group's new business, followed by North America with 24.6 %

[1] Excluding new business for private clients and local authority lending by WestImmo

(2015: 20.6 %) and Asia with 2.1 % (2015: 1.4 %).[1) The slightly higher share of financings in North America reflects our growth strategy as part of the "Aareal 2020" programme for the future.

With a share of 45.4 %, office properties accounted for the largest share in new business in terms of property type (2015: 43.1 %). This was followed by retail property with 22.7 % (2015: 19.9 %), ahead of hotel property with 20.7 % (2015: 19.0 %) and logistics property with 8.5 % (2015: 9.8 %). The share of residential property was 2.1 % (2015: 6.0 %) while other property and financing amounted to 0.6 % (2015: 2.2 %).

Europe

In Europe, the transaction volume in commercial property was down significantly on the previous year, with volumes clearly falling in Germany, France and the UK while rising – against the general trend – in Spain and Poland. Private investors were net sellers, while institutional investors and listed companies tended to be more on the side of the net buyers.

Rents for first-class office properties increased for new rentals in many of Europe's economic centres during the year. Top rents in some markets, such as Barcelona, Berlin, Birmingham and Stockholm, were considerably higher than in 2015 due to the strong rental demand. Slight increases were observed in Edinburgh and the centre of Paris, for example. Top rents fell compared with 2015 in a few markets such as London and Moscow, but were largely stable in many other markets such as Amsterdam or Rome. The picture varied more in the sub-markets or in smaller locations. While rents increased for example in sub-markets of Madrid and Barcelona, they fell slightly in many sub-markets in the Netherlands. Rents in Paris were stable in most of the sub-markets. Average rents in Germany rose in three out of the six largest markets.

Rents in the market for retail property was largely stable. However, some markets, for example London and Warsaw, benefited from rising top rents on the back of robust consumer spending. Declines were observed in Istanbul, for example.

Demand for logistics space was strong at the start of 2016, but the momentum eased somewhat during the year. All in all, the take-up of space was in line with the very high level of the previous year. Top rents rose only sporadically, for example in Berlin and Edinburgh. However, they remained stable in many markets – while markets such as Hamburg and Warsaw also saw a slight decline.

Investment yields for almost all types of newly-acquired premium properties fell slightly in Europe compared with 2015. Relatively strong declines were observed for retail properties in Eastern Europe and throughout Europe in the best locations of the large logistics markets. The spread between prime and peripheral locations did not widen any further during the year. Yields for secondary office property in Germany fell consistently throughout the year. Investment yields remained stable in Italy's secondary locations, but rose slightly in contrast in the UK after initial declines in response to the uncertainty triggered by the Brexit vote. They rose slightly more for secondary than for top-quality properties. Investment yields in the UK remained stable over the remainder of the year.

The situation varied on the European hotel markets. Occupancy ratios declined moderately year-on-year in some markets, such as Milan or Munich. The decline in Milan was due to the particularly high figure for the previous year, which can be explained by the fact that the Expo was held here in 2015. The occupancy ratio in London remained at a very high level; it declined significantly year-on-year in Paris and Brussels, a result of the terrorist attacks. On the other hand, occupancy ratios rose in Barcelona and Madrid. The first half of the year was better on the whole than the second.

The important indicator of average revenues per available room (RevPar) recorded a slight increase in 2016 compared with the previous year in most European markets. Average revenues increased for

[1)] New business is allocated to the individual regions on the basis of the location of the property used as collateral. For exposures not collateralised by property, the allocation is based on the borrower's country of domicile.

example in Amsterdam, Barcelona, Berlin, Copenhagen, Hamburg and Madrid, and higher room rates could thus be achieved overall. As expected, average revenues fell significantly in Brussels, Istanbul and Paris as a consequence of the terrorist attacks. Marginal declines were observed in London and Munich, albeit remaining at a high level in both cases.

Aareal Bank Group originated new business of € 6.7 billion (2015: € 8.1 billion) in Europe during the year under review. At € 4.8 billion (2015: € 4.3 billion), Western Europe accounted for the largest share of new business in 2016, as it had in previous years. The remaining new business was originated in Southern Europe (€ 1.1 billion; 2015: € 1.7 billion), followed by Eastern Europe with € 0.5 billion (2015: € 1.0 billion) and Northern Europe with € 0.3 billion (2015: € 0.5 billion).

North America

The volume transacted in the North American property markets was down slightly from the previous year's high level. Contrary to the continuous decline in Europe, the transaction volume in the third quarter rose sharply at times but then lost momentum in the fourth quarter. Listed companies were predominantly on the seller side, while institutional investors were net buyers again for the first time in three years. Investors from the Asian region were cautious in the first three quarters but stepped up their activity again on the market in the fourth quarter.

Rents increased across the board throughout 2016 as a whole in the large American office markets, with particularly strong growth reported in Boston, Los Angeles and San Francisco. In contrast, office rents rose only slightly in Washington D.C. All in all, growth momentum was slightly stronger in the first half-year and eased a bit in the second. Rents for retail property rose overall in line with office rents, although these varied considerably in the big cities. The rent increase was particularly strong in Boston, Los Angeles and San Francisco. Rents in Chicago, on the other hand, fell slightly during the first half of the year – at the end of 2016, they were unchanged from the previous year. In New York and Washington D.C., rents for retail space remained stable at year-end compared with the previous year.

Yields on office properties in the large centres declined only slightly overall throughout 2016, but nonetheless reached an all-time low. In comparison, yields in the two Californian office markets of Los Angeles and San Francisco rose slightly from mid-year onwards. On the other hand, falling yields on retail property were observed over the entire year in all large locations. Generally, the declines were however only marginal and eased during the course of the year. Yields here were at an all-time low, too.

The scenario was largely positive on the hotel markets in North America. On a national average, utilisation figures were slightly weaker than at the start of the year, but finished 2016 overall at the previous year's levels. On the other hand, average revenues per available room had climbed quite substantially on a national average in spring compared to the same period of the previous year; the level was confirmed for the year as a whole towards the end of the year. Utilisation in Canada was at the previous year's high level. The average revenues per available room once again exceeded the previous year's good figure.

Aareal Bank Group originated new business of € 2.3 billion (2015: € 2.0 billion) in North America during the year under review, exclusively in the US. The higher volume compared with the previous year underlines our growth strategy in the region.

Asia

The volume transacted in commercial property fell slightly – in US dollar terms – in the Asia-Pacific region, too. Institutional investors were net buyers while private investors sold more. The transaction volume in China was a bit lower than in the previous year, despite a stronger fourth quarter.

Top rents for office properties in Asia showed a mixed picture; they decreased significantly in Singapore yet slightly increased in Beijing, Shanghai and Tokyo compared to the end of 2015. Rents for retail properties remained stable in Beijing and Shanghai, while easing slightly in Singapore.

Yields of premium office property in Asia were stable compared with the fourth quarter of 2015. They fell slightly in Beijing and Shanghai and remained stable in Singapore and Tokyo. The yields on premium retail property fell marginally in Shanghai and remained stable in Beijing, Singapore and Tokyo.

Developments in the market for hotel property varied during 2016. In Beijing and Shanghai the utilisation figures as well as the average revenues per available room rose quite strongly and consistently throughout the year. The figures for utilisation and the average revenues per available room improved in Singapore in the first half-year but declined slightly towards the end of the year compared with the previous year. The utilisation figures in Tokyo eased slightly from a very high level at the start of the year. Nonetheless, average revenues per available room were up slightly. New business in Asia amounted to € 0.2 billion in the year under review (2015: € 0.1 billion) and was generated exclusively in China.

Consulting / Services segment

Bank division Housing Industry

Clients of the Bank's Housing Industry division are drawn largely from the housing and property housing industries, as well as the utilities and waste disposal industries.

The German housing industry continued to show solid overall development in 2016, too. This was supported mainly by stable rental income thanks to the highly-diversified tenant group and long-term financing structures. The housing industry companies continue to focus on a sustainable development of portfolios and on improving energy efficiency. The housing and property companies organised in the German Federation of German Housing and Real Estate Enterprises (Bundesverband deutscher Wohnungs- und Immobilienunternehmen – "GdW") and its regional federations, invested more than € 14 billion in the future of their portfolios.

The German housing market demonstrated that it was largely unaffected by short-term economic fluctuations, since long-term factors such as income and population development tend to impact on the price level. In October 2016, rents throughout Germany were approx. 2.8 % higher than in the previous year.

The housing market continued to be subject to significant regional differences. Whilst demand for housing rose in growth regions, driven by job creation, weak economic locations experienced population declines. Vacancy ratios fell moderately to 8 % in the Eastern Federal German states, compared with vacancies of around 2 % in the West German states.

The Bank's Housing Industry division further strengthened its market position in the 2016 financial year and significantly increased the revenue from payment services through acquiring new customers as well as intensifying business relationships with existing customers. This brought in more clients from the housing industry – managing more than 180,000 residential units between them – for the payments and deposit-taking businesses. Roughly half of these newly-acquired companies manage housing assets on behalf of third parties, in line with our strategic orientation. Moreover, new clients were acquired in commercial property management, and the existing clients there connected more managed units to our payment transaction processes year-on-year. More companies from the utilities and waste disposal industries opted for Aareal Bank's payment transaction systems and / or investment products. We also have an established customer base in this sector and therefore a solid base for further growth.

We also invested in products in 2016 that simplify and automate processes. Special attention was paid to the improvement in the collaboration of our target industries – housing industry and energy industry – for example through BK 01 eConnect, which facilitates the total automation of invoicing and settlement.

At present, more than 3,200 clients throughout Germany are using our process-optimising products and banking services. In line with the Aareal 2020 strategic agenda, the volume of deposits from the housing industry rose to an average of almost € 9.6 billion in the 2016 financial year (2015: € 9.0 billion). Deposits averaged more than € 10.0 billion in the fourth quarter of 2016. Besides the increase in sight deposits, the share of rent deposits was also raised. All in all, this reflects the strong trust our clients place in Aareal Bank.

Aareon

Aareon Group is pursuing a profitable growth strategy and continued to grow organically in the 2016 financial year. The key growth areas are the digital solutions, the ERP systems and exploration of new markets associated with the property sector. A strategic programme was developed in 2016 in order to realise this growth in a systematic and sustainable manner. The programme will position Aareon Group as the leading partner for digitalisation in the property industry. The programme will also break down the digital transformation process at Aareon across all business units, and will translate it into the corporate culture. Aareon also continues with the process of internal optimisation to enhance efficiency and profitability. Aareon's strategic programme is integrated in the "Aareal 2020" programme for the future.

The research and development activities form the basis for the new digital solutions. By developing digital solutions, Aareon is supporting the property industry and related markets so that they can exploit the opportunities presented by digitalisation. The focus here is on creating added value for customers. The research and development activities benefit from the country-specific focus on digitalisation in order to expand the entire Aareon Smart World. Aareon adopts an agile approach to development so as to carry out intensive tests at an early stage and move as quickly as possible from concept to prototype. The Aareon data centre plays a central role for the range of solutions, as a growing number of customers use the Aareon solutions provided as a service from the exclusive Aareon Cloud. Data protection and data security are therefore of great importance to Aareon, and are ascertained through regular certifications, among other things.

Aareon recorded a positive business development in 2016 in its Germany and International Business divisions, as planned. Overall, sales revenues were boosted significantly, from € 187 million to € 211 million, and the contribution to consolidated operating profit from € 27 million to € 34 million.

Germany

The ERP business developed successfully for Aareon in Germany. A large number of solutions were rolled out at the start of the year, 36 companies managing around 100,000 units started in parallel with Wodis Sigma. In addition, many GES customers opted to change to Wodis Sigma in 2016 within the framework of our migration campaign. The migration projects have been progressing on schedule. As expected, the favoured version is the one that uses Wodis Sigma as a service from the exclusive Aareon Cloud. With a total of around 840 clients that have already opted for Wodis Sigma, this ERP solution is the leader in the German housing industry. Because of the ongoing migration, Aareon continues to see a – planned – decline in the business with the ERP product GES. The licensing business for SAP® solutions and Blue Eagle has been developing positively, especially through the acquisition of new customers and additional licenses sold to existing clients. The increase in the maintenance business is largely due to product roll-outs in the previous year.

Business with digital solutions has also been developing positively, with the Mareon service portal, Aareon Archiv kompakt, Aareon CRM, Aareon Immoblue Plus, and Mobile Services being particularly in demand. The digital solutions also benefit from the migration business with the ERP products, as a change in software results in the analysis of further potential for process optimisation. Customer interest was particularly pronounced regarding Mobile Services: Aareon has been successful in winning around 150 companies for this offer.

Aareon also recorded positive business development with add-on products, such as insurance management with BauSecura and IT outsourcing. The IT outsourcing business was extended considerably thanks to a higher number of approvals. Aareon concluded its first full year in the energy business with phi-Consulting, which was acquired the year before, in line with expectations. The energy utilities industry is an important partner to property companies. Based on Aareon's portfolio of products and services, phi-Consulting complements the service range by offering an advisory and development service on the basis of SAP for Utilities. The portfolio is complemented by solutions provided by Aareal Bank. The volume of insurance management business with BauSecura was increased as expected.

International Business

In the Netherlands, additional customers opted for and rolled out the Tobias AX ERP solution. Many new clients and an extended product portfolio resulted in significantly higher revenues. Demand was also evident for digital solutions, especially Mareon, Aareon Archiv kompakt, Aareon CRM, tenant app, the call centre function and the Trace & Treasury solution. The integration of the Dutch Square DMS B.V. (previously Square DMS Groep B.V.), acquired effective 1 October 2015 in order to include a case management solution with the associated process advisory service into Aareon Smart World, was concluded successfully and strengthened the market position. Aareon Nederland B.V. acquired the remaining (50 %) stake in its Dutch subsidiary SG2ALL B.V. from de Alliantie, Hilversum, with effect from 27 December 2016, enabling Aareon to further extend its outsourcing competence on an international level.

In France, Aareon reported successful business this year too with platinum maintenance contracts for the PortalImmo Habitat and Prem'Habitat ERP products. Similarly, Aareon France is supporting several customers with the realisation of Aareon Smart World digital solutions. Tenant portals, invoicing services and mobile property inspection, as well as Mareon, were particularly in demand.

In the UK, Aareon UK took part in several calls for tender with the QL.net ERP solution, winning most of them and thus gaining further market share. The new ERP product generation QL.net was presented to the market, where it met with a very good response. Looking at digitalisation, the UK market has already reached a high degree of maturity, especially regarding mobile solutions. Subsidiary 1st Touch with 360° Tenant Portal and 360° Field Worker is providing new impetus by offering new functional features and design.

Swedish Incit Group has won further new customers for its Incit Xpand ERP solution, including a major hotel group in Scandinavia. A campaign for acquiring new clients was successful, particularly with regard to small and medium-sized companies, and implementation has started. The advisory business also picked up well, and the digital signature for rental agreements was introduced successfully.

Financial Position and Financial Performance

Financial performance

Group

Consolidated operating profit in the 2016 financial year amounted to € 366 million, exceeding both the previous year's figure of € 320 million (adjusted for € 150 million in negative goodwill from the initial consolidation of WestImmo) as well as the range of € 300 million to € 330 million forecast at the beginning of the 2016 financial year.

Net interest income declined to € 701 million (2015: € 781 million) and was thus in line with our expectations (€ 700 million to € 740 million). The decline was largely attributable to the reduction of exposures no longer in line with our strategy, and to lower non-recurring income from early loan repayments.

Allowance for credit losses fell to € 97 million in the 2016 financial year (2015: € 128 million) and therefore remained within the forecast range of € 80 million to € 120 million for the full year. It

Consolidated net income of Aareal Bank Group

€ mn	1 Jan-31 Dec 2016	1 Jan-31 Dec 2015
Net interest income	701	781
Allowance for credit losses	97	128
Net interest income after allowance for credit losses	**604**	**653**
Net commission income	193	175
Net result on hedge accounting	0	8
Net trading income/expenses	19	13
Results from non-trading assets	67	-17
Results from investments accounted for using the equity method	0	0
Administrative expenses	547	553
Net other operating income/expenses	30	41
Negative goodwill from the acquisition of WestImmo	–	150
Operating profit	**366**	**470**
Income taxes	132	96
Consolidated net income	**234**	**374**
Consolidated net income attributable to non-controlling interests	19	19
Consolidated net income attributable to shareholders of Aareal Bank AG	215	355

mainly comprises net additions to specific allowance for credit losses of € 109 million.

Net commission income increased to € 193 million (2015: € 175 million), which was mainly due to higher sales revenue at Aareon. The net figure was within the forecast range of € 190 million to € 200 million for the year.

The aggregate of net trading income / expenses and the net result on hedge accounting of € 19 million (2015: € 21 million) resulted largely from the measurement and close-out of derivatives used to hedge interest rate and currency risks.

The net result from non-trading assets amounted to € 67 million (2015: € -17 million) of which an amount of € 61 million was due to the disposal of all shares in Aareal Bank's wholly-owned subsidiary Aqvatrium, which is the owner of a commercial property located in Stockholm. Moreover, the sale of the remaining asset-backed securities (ABS) yielded realised profits of € 5 million.

Administrative expenses amounted to € 547 million and were thus slightly lower year-on-year (2015: € 553 million), and within the € 520 million to € 550 million range projected for the financial year. The figure includes expenses for integration and running costs of WestImmo, as well as expenses for projects and investments. Net other operating income / expenses of € 30 million (2015: € 41 million) includes net income from the successful conclusion of legal disputes with holders of profit-participation certificates issued by the former Corealcredit. This positive effect is offset by a corresponding tax expense of virtually the same amount.

All in all, consolidated operating profit for the 2016 financial year totalled € 366 million, after € 470 million in 2015. Taking into consideration income tax expenses of € 132 million and non-controlling interest income of € 19 million, consolidated net income attributable to shareholders of Aareal Bank AG amounted to € 215 million (2015: € 355 million). Assuming the pro rata temporis accrual of net interest payments on the AT 1 bond, consolidated net income allocated to ordinary shareholders stood at € 199 million

(2015: € 339 million). Earnings per ordinary share amounted to € 3.33 (2015: € 5.66), and RoE before taxes was 13.2 % (2015: 18.6 %).

Structured Property Financing segment

Segment operating profit for Structured Property Financing of € 395 million was above last year's figure (€ 343 million), which was adjusted for € 150 million in negative goodwill from the initial consolidation of WestImmo.

Net interest income declined to € 716 million (2015: € 783 million). The decline was largely attributable to the reduction of exposures no longer in line with our strategy, and to lower non-recurring income from early loan repayments.

Allowance for credit losses fell to € 97 million in the 2016 financial year (2015: € 128 million). It mainly comprises net additions to specific allowance for credit losses of € 109 million.

The aggregate of net trading income / expenses and the net result on hedge accounting of € 19 million (2015: € 21 million) resulted largely from the measurement and close-out of derivatives used to hedge interest rate and currency risks.

The net result from non-trading assets amounted to € 66 million (2015: € -17 million) of which an amount of € 61 million was due to the disposal of all shares in Aareal Bank's wholly-owned subsidiary Aqvatrium, which is the owner of a commercial property located in Stockholm. Moreover, the sale of the remaining asset-backed securities (ABS) yielded realised profits of € 5 million.

Administrative expenses amounted to € 346 million in the 2016 financial year (2015: € 359 million). The figure includes expenses for integration and running costs of WestImmo, as well as expenses for projects and investments.

Net other operating income / expenses of € 27 million (2015: € 37 million) includes net income from the successful conclusion of legal disputes with holders of profit-participation certificates issued by the former Corealcredit. This positive effect is offset by a corresponding tax expense of virtually the same amount.

Operating profit in the Structured Property Financing segment totalled € 395 million. After inclusion of € 143 million in income taxes, the segment result amounted to € 252 million (2015: € 387 million).

Structured Property Financing segment result

€ mn	1 Jan-31 Dec 2016	1 Jan-31 Dec 2015
Net interest income	716	783
Allowance for credit losses	97	128
Net interest income after allowance for credit losses	**619**	**655**
Net commission income	10	6
Net result on hedge accounting	0	8
Net trading income/expenses	19	13
Results from non-trading assets	66	-17
Results from investments accounted for using the equity method	–	0
Administrative expenses	346	359
Net other operating income/expenses	27	37
Negative goodwill from the acquisition of WestImmo	–	150
Operating profit	**395**	**493**
Income taxes	143	106
Segment result	**252**	**387**

Consulting / Services segment

Operating profit in the Consulting / Services segment remained negative, at € -29 million (2015: € -23 million). Compared with the previous year, Aareon made a significantly higher contribution – of € 34 million – to Aareal Bank Group's consolidated operating profit. However, low margins from the deposit-taking business with the housing industry, due to the persistent low interest rate levels, clearly influenced the segment result.

Sales revenues amounted to € 206 million in the 2016 financial year (2015: € 193 million), driven by sales revenues at Aareon increasing to € 211 million (2015: € 187 million). In line with higher sales revenues, the cost of materials purchased rose to € 35 million (€ 24 million).

Staff expenses of € 144 million were higher than the previous year's level, reflecting higher staffing levels and Aareon's acquisitions during 2015, amongst other factors.

On balance, the Consulting/Services segment generated operating profit of € -29 million (2015: € -23 million). After inclusion of tax reclaims in the amount of € 11 million, the segment result amounted to € - 18 million (2015: € - 13 million).

Consulting / Services segment result

€ mn	1 Jan-31 Dec 2016	1 Jan-31 Dec 2015
Sales revenue	206	193
Own work capitalised	6	4
Changes in inventory	0	0
Other operating income	7	9
Cost of materials purchased	35	24
Staff expenses	144	139
Depreciation, amortisation and impairment losses	11	12
Results from investments accounted for using the equity method	0	0
Other operating expenses	58	54
Interest and similar income/expenses	0	0
Operating profit	**-29**	**-23**
Income taxes	-11	-10
Segment result	**-18**	**-13**

Financial position

Consolidated total assets of Aareal Bank Group as at 31 December 2016 amounted to € 47.7 billion, after € 51.9 billion as at 31 December 2015.

Interbank deposits, repos, and cash funds

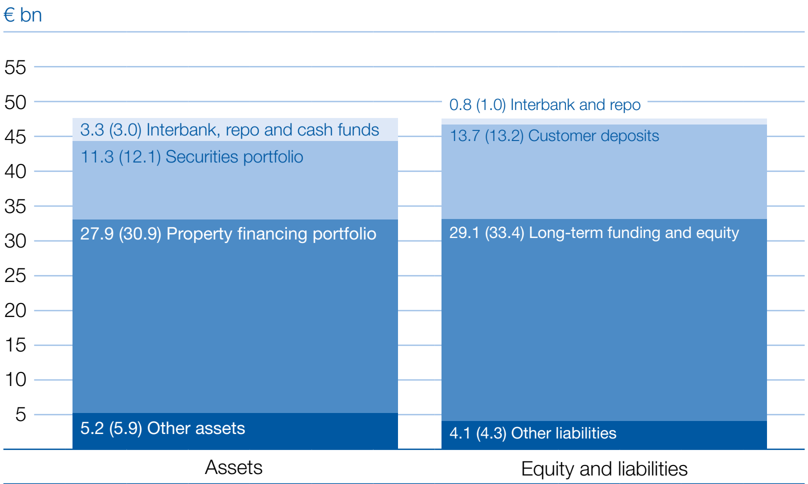
Interbank deposits, repos, and cash funds comprise short-term investments of surplus liquidity. As at 31 December 2016, this comprised predominantly cash funds and deposits with central banks, term deposits and current account balances with other banks.

Property financing portfolio

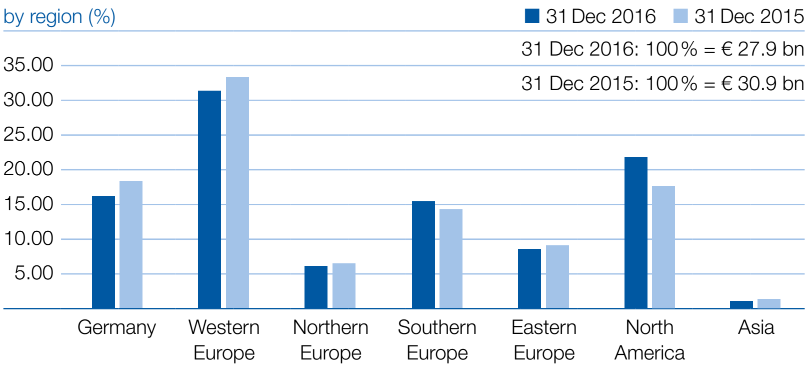
Portfolio structure

The volume of Aareal Bank Group's property financing portfolio stood at € 27.9 billion as at 31 December 2016, a decline of approximately 9.6 % compared to the 2015 year-end figure of € 30.9 billion. This development was largely attributable to the planned reduction of non-strategic portfolios. The international share of the portfolio increased slightly, to 83.9 % (31 December 2015: 81.7 %).

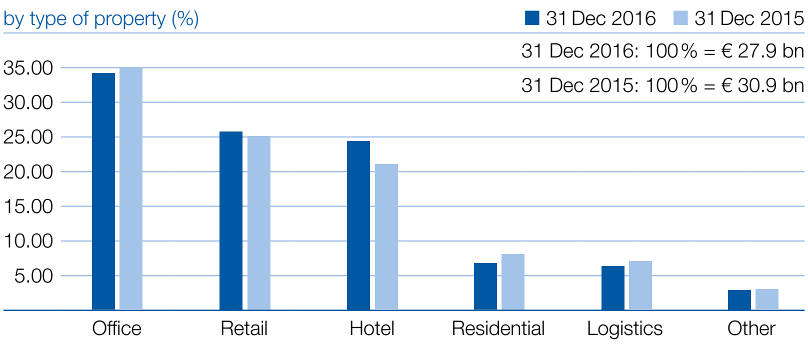
Asset/liability structure as at 31 Dec 2016 (31 Dec 2015)



Property financing volume[1] (amounts drawn)



Property financing volume[1] (amounts drawn)



At the reporting date (31 December 2016), Aareal Bank Group's property financing portfolio was composed as follows, compared with year-end 2015.

Portfolio allocation by region and continent changed only marginally compared with the end of the previous year. Whilst the portfolio share of exposures in North America rose slightly (about 4 percentage points), in accordance with the "Aareal 2020" strategy, it declined in Germany and Western Europe (by about 2 percentage points). It remained almost stable for all other regions.

The breakdown of the portfolio by property type did not change significantly during the reporting period. The share of hotel properties rose by 3.5 percentage points, whilst the share of financings for office, residential, logistics, and retail property as well as other financings included in the overall portfolio remained almost unchanged compared to the year-end 2015.

All in all, the high degree of diversification by region and property type within the property financing portfolio was maintained during the period under review.

Securities portfolio

Aareal Bank holds a portfolio of high-quality securities, used as economic and regulatory liquidity reserve as well as for the cover management of Pfandbriefe.

As at 31 December 2016, the nominal volume of the consolidated securities portfolio[2] was € 9.3 billion (31 December 2015: € 10.2 billion).

Key aspects taken into account for portfolio management are good credit quality and the related value stability, as well as a high degree of liquidity, particularly with regard to Basel III criteria. Following the sale of the remaining asset-backed securities (ABS), the securities portfolio comprises three asset

[1] Excluding € 1.1 billion in private client business (31 December 2015: € 1.5 billion) and € 0.6 billion in local authority lending business by WestImmo (31 December 2015: € 0.6 billion)

[2] As at 31 December 2016, the securities portfolio was carried at € 11.3 billion (31 December 2015: € 12.1 billion).

classes: public-sector borrowers, covered bonds and Pfandbriefe, as well as bank bonds.

99 % of the overall portfolio is denominated in euro. 98 % of the portfolio has an investment grade rating.[1] More than 75 % of the portfolio fulfils the requirements of "High Quality Liquid Assets" in the Liquidity Coverage Ratio (LCR).

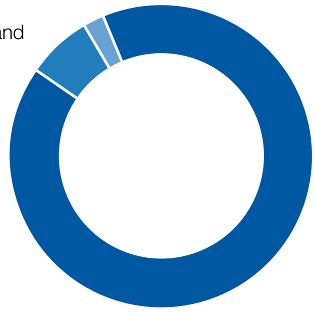
Public-sector borrowers are the largest asset class held, accounting for a share of approx. 91 %. These include securities and promissory note loans that qualify as ordinary cover for Public Sector Pfandbriefe. 99 % of these issuers are headquartered in the EU. Approx. 79 % are rated AAA or AA, and a further 3 % are rated single-A. Overall, 98 % have an investment grade rating.

The share of Pfandbriefe and covered bonds at year-end was 7 %. 92 % consist of European covered bonds, with the remainder invested in Canadian covered bonds. All Pfandbriefe and covered bonds were rated AAA or AA.

Given the emerging regulatory changes, bank bonds may be used for liquidity management purposes only to a very limited extent going forward. Against this background, the share of bank bonds in the total portfolio was only 2 % as at year-end.

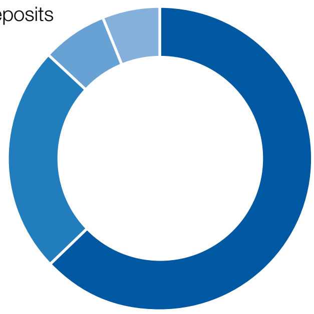
Securities portfolio as at 31 December 2016

% Total volume (nominal): € 9.3 bn



Money market funding mix as at 31 December 2016

% Total volume: € 14.5 bn



Financial position

Interbank and repo business

Generally, in addition to customer deposits, Aareal Bank Group also uses interbank and repurchase transactions for short-term refinancing, the latter being used primarily to manage liquidity and cash positions.

There were no repos and no liabilities vis-à-vis Deutsche Bundesbank or the ECB as at 31 December 2016.

Customer deposits

As part of our business activities, we generate deposits from housing industry customers, and from institutional investors. The volume of deposits from the housing industry could be increased during the reporting period. As at 31 December 2016, they amounted to € 9.2 billion (31 December 2015: € 8.4 billion). Deposits from institutional investors amounted to € 4.5 billion as at 31 December 2016 (31 December 2015: € 4.8 billion).

Long-term funding and equity

Funding structure

Aareal Bank Group's funding remains very solid indeed, as evidenced by the high proportion of long-term refinancing. This encompasses registered and bearer Pfandbriefe, promissory note loans, medium-

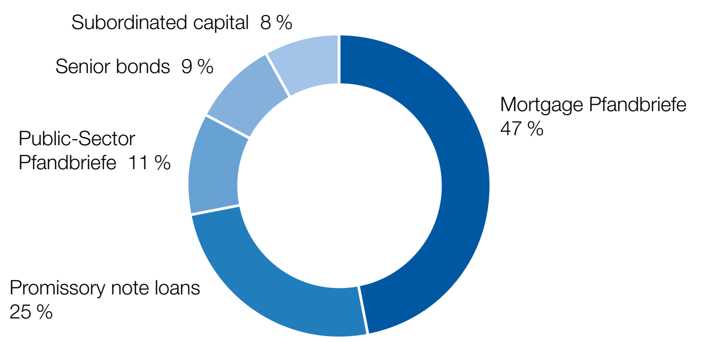
[1] The rating details are based on the composite ratings.

term notes, other bonds and subordinated issues. The latter include subordinated liabilities, profit-participation certificates, silent participations, Additional Tier I (AT I) issues, and trust preferred securities.

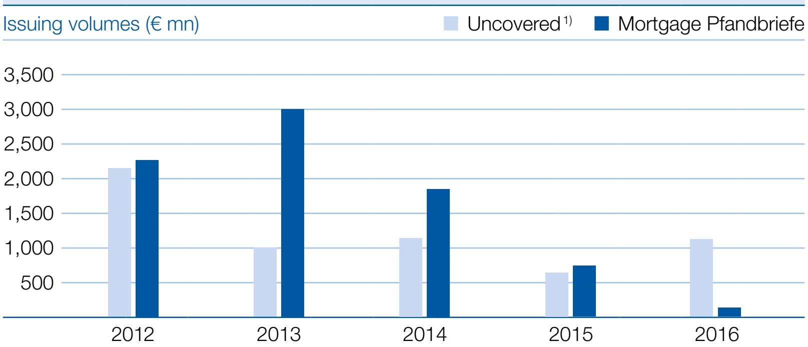
As at 31 December 2016, the long-term refinancing portfolio amounted to € 26.5 billion. Of this amount, Mortgage Pfandbriefe accounted for € 12.5 billion, public-sector Pfandbriefe for € 3.0 billion, uncovered long-term refinancing for € 9.1 billion and subordinated long-term refinancing for € 1.9 billion.

Capital market funding mix as at 31 December 2016

% Total volume: € 26.5 bn



Issuing activities – 2012 to 2016



Thus, Mortgage Pfandbriefe accounted for a total share of 47 % of long-term refinancing. The Liquidity Coverage Ratio (LCR) exceeded 150 % on the reporting days of the periods under review.

Refinancing activities

Aareal Bank Group raised € 1.2 billion on the capital market during 2016, comprising € 1.1 billion in senior unsecured, and € 0.1 billion in secured issues. One of the highlights was the increase of an existing senior unsecured bond by € 150 million in March 2016, to reach a benchmark volume of € 500 million.

Since we conduct our business activities in a range of foreign currencies, we have secured our foreign currency liquidity over the longer term by means of appropriate measures.

Equity

Aareal Bank Group's total equity as disclosed in the statement of financial position amounted to € 3,129 million as at the reporting date (31 December 2015: € 3,044 million), comprising € 300 million in the Additional Tier I (AT I) bond and € 242 million in non-controlling interests.

Regulatory capital[2]

	30 Dec 2016[3]	31 Dec 2015
€ mn		
Common Equity Tier 1 (CET 1)	2,351	2,298
Tier 1 (T1)	2,896	2,882
Total capital (TC)	3,994	3,977
%		
Common Equity Tier 1 ratio (CET 1 ratio)	16.2	13.8
Tier 1 ratio (T1 ratio)	19.9	17.2
Total capital ratio (TC ratio)	27.5	23.8

1) excluding SoFFin-guaranteed issues and subordinated capital
2) Aareal Bank AG utilises the rules set out in section 2a of the KWG in conjunction with Article 7 of the CRR, pursuant to which regulatory indicators of own funds may only be determined at Group level. In this respect, the following disclosures relate to Aareal Bank Group.
3) After confirmation of Aareal Bank AG's financial statements for 2016. The calculation of regulatory capital takes into account the Management Board's proposal for the appropriation of profits for the financial year 2016. The appropriation of profits is subject to approval by the Annual General Meeting.

Our Employees

Age structure and fluctuation

Aareal Bank's fluctuation ratio for 2016 was 1.1 %. The average number of years in service for the Company is 13.9. These two figures are a reflection of the strong relationship between Aareal Bank and its employees. The average age of employees is 45.8 years.

Qualification and training programmes

Qualified and motivated employees make a decisive contribution to a company's economic performance and are thus a key factor to its success as well as a competitive advantage. A company's success largely depends on its employees.

For this purpose, Aareal Bank Group operates a human resources approach aimed at the further qualification of its managers, experts and employees. In line with the corporate strategy, the Bank's human resources approach was adjusted during the period under review to incorporate training innovations and new qualification methods. Aareal Bank Group supports employees' change processes and promotes lifelong professional training.

The Bank further developed its continuous training programme during the year under review, and implemented innovative educational solutions such as learning journeys and digital knowledge pools. For instance, foreign language courses were offered via online platforms, accessible anywhere and at any time, thus featuring the utmost flexibility to course participants.

Furthermore, Aareal Bank Group offered vocational qualifications and study courses, complemented by the opportunity for individual development planning.

The "Structured Appraisal and Target Setting Dialogue" is the starting point for individual development plans at Aareal Bank. Every year, each employee discusses his or her personal development with the responsible manager, agreeing upon concrete measures. In addition, employees may participate in an internal potential method that Aareal Bank has conducted since 2010. This tool is used to systematically select employees and introduce them as managers or experts to new fields of activity, by way of seminars and coaching measures that are tailored to the individuals and their development requirements.

Aareal Bank Group supports all employees willing to develop themselves throughout the different phases of their professional paths, thus establishing

Employee data as at 31 December 2016

	31 Dec 2016	31 Dec 2015	Change
Number of employees of Aareal Bank Group	2,728	2,861	-4.7 %
Number of employees of Aareal Bank AG	933	1,009	-7.5 %
of which: outside Germany	75	84	
of which: proportion of women	45.1 %	45.5 %	
Proportion of women in executive positions	22.9 %	21.7 %	
No. of years service	13.9 years	14.0 years	-0.1 years
Average age	45.8 years	46.1 years	-0.3 years
Staff turnover rate	1.1 %	1.6%	
Part-time ratio	19.7 %	20.5%	
Retired employees and surviving dependants	745	728	2.3 %

a culture of lifelong learning within the Company. Against this background, Aareal Bank established, in 2016, a new concept aimed at the further qualification of its managers, and another system for the qualification of experts, each covering different stages of professional development.

In addition to the ”manager” career path, Aareal Bank AG has been offering the ”expert” career path since 2006. One feature of this career path is that the entire programme – covering subjects such as assumption of responsibility, business writing, complexity, stakeholder management or lateral leadership – is centred around concrete tasks and goals to be achieved by the participating experts. New formats, such as the Group conference of second-level experts, introduced in 2016, fosters the exchange of expertise and professional networking across all divisions.

2016 also saw the introduction of a fundamentally renewed Leadership Development initiative. Aareal Bank executives may drive their professional education on a modular, individual and subject-specific basis by participating in basic modules (”Essentials”), and in-depth advanced courses (”Elements”). The programme focuses on the transfer of theoretical approaches into the real working environment, and emphasises a common learning experience among colleagues across all hierarchy levels. The hands-on, workshop-like short modules cover a large variety of topics and were also introduced in 2016 with the new Learning Day concept, which is offered every month. Moreover, so-called leadership workshops take place on a quarterly basis, with a variety of different formats: a coaching conference among colleagues, teamwork with smaller/larger group of co-workers, discussion with a moderator.

Our subsidiary Aareon promotes young talent and the sciences with a chair for business informatics at EBZ Business School in Bochum, as agreed by both parties.

In addition, the University of Applied Sciences Mainz and Aareon agreed in 2015 on a practice-oriented partnership in the area of facilities management.

Aareon also continued to focus on the CPD of its managers during the 2016 financial year. Within the scope of the Professional individual executive development (“ProFI”) initiative, the managers were offered training (including labour law for managers and leadership at Aareon), diagnostics (including a development centre for new executives) and advisory measures (including individual coaching and managerial circles). Another focus was to continue supporting the international profile of Aareon, particularly by means of language courses. The training programme to become a certified property manager at the Hochschule für Wirtschaft und Umwelt in Nürtingen-Geislingen was also continued in 2016.

Furthermore, Aareal Bank Group successfully completed the first cross-mentoring programme in 2016. This programme promotes the targeted exchange of employees from different companies, and is used as a means of human resources development and transfer of know-how.

Promoting the next generation

Promoting the next generation through training is a central element of the Human Resources work of Aareal Bank Group. The specialist knowledge required in our business segments requires us to invest continuously – and in a targeted manner – in training the next generation. Nine younger employees were supported during the year under review, as part of the junior training programme. The following employees participated in the programme: trainees for office management (IHK), students in the fields of business administration, banking, and business information systems at the Duale Hochschule Baden-Württemberg Mannheim, one master student/trainee as well as business administration students from the University of Applied Sciences Mainz.

Alongside the trainee programmes, Aareon also offers a training programme for new entrants to the profession. Aareon AG offers vocational training in various careers: office management, IT applications developer, IT system integrator. It also offers the dual course of study: "Business Administration – Property Manager", in cooperation with the College of Advanced Vocational Studies in Leipzig. Aareon cooperated with DHBW Mannheim to set up the "Business Administration – Exhibition, Congress and Event Management", the "Business Informatics – Software Engineering" and the "Business Informatics – Application Management" dual courses of study. During their training, participants benefit from additional education and take over responsibilities early on. As at year-end 2016, Aareon employed 16 trainees and three students from the College of Advanced Vocational Studies.

Aareal Bank and Aareon held the Girls' Day and the Boys' Day in 2016 again as part of its measures for promoting the next generation. A total of 64 boys and girls aged between 8 and 12 years visited the Aareon Science Camps "Batteries and solar cells – energetic experiments", which aim at stimulating and promoting interest in technology at an early age. This was the fourth anniversary for Aareon Science Camps, which have now been attended by a total of more than 250 participants. Aareon awarded the Aareon IT Award "WohnIT" for the first time in 2016. The price was awarded to the Internatsschule Schloss Hansenberg for the development of "IntLight" (Indoor Location for Smart Homes). With this competition, Aareon addressed pupils of all ages and types of school, aiming to spark enthusiasm for the topics of "IT" and "future housing".

Furthermore, Aareon supported the initiative JOBLINGE aimed at socially deprived young citizens. In March 2016, Aareon organised a joint project week centred around the digitalisation of housing as part of this initiative. A total of 16 participants in the JOBLINGE initiative and seven Aareon trainees took part in a series of workshops throughout the week aimed at an extensive exchange of views and an intensification of IT and digitalisation skills. The focal point of the workshops was the creative and constructive approach towards the future of housing.

Within the scope of promoting the next generation, Aareal Bank Group also offers students the opportunity to gain their first impressions of the professional world and Group divisions by actively participating in internships. The internship programme was continued successfully during the year under review.

Remuneration system

The remuneration systems are based on remuneration principles that apply throughout Aareal Bank Group. The Supervisory Board and the Management Board carried out the annual review of the remuneration systems, involving the Human Resources division, the Remuneration Officer, and internal control units in line with their respective functions, supported by external legal and remuneration advisors. External advisors were retained, amongst other things, for examining the appropriateness of remuneration systems, and remuneration for members of the Management Board and employees, as well as regarding the design of the Group-wide remuneration strategy.

In addition to the fixed remuneration that is paid in twelve monthly instalments, all employees receive a performance-related variable remuneration. The variable remuneration of a limited number of employees (senior executives and so-called risk takers) comprises a short-term and a long-term component. The limitation of variable remuneration components is designed to avoid negative incentives for taking disproportionately high risks.

Salaries are reviewed annually, to ensure that individual remuneration packages are appropriate. The objective is to offer a remuneration level that is both appropriate and attractive to all Group employees.

Work-life balance

Aareal Bank Group places great importance on supporting its employees to achieve compatibility of career and family. Employees are supported in many ways.

Since July 2012, the Bank has cooperated with a non-profit organisation, which operates childcare facilities in Wiesbaden. This cooperation agreement offers employees childcare places for children aged between ten months and six years. Aareal Bank also cooperates with the City of Wiesbaden to offer childcare facilities to its employees during the school holidays. Since summer 2013 it has cooperated with the Biberbau children and youth farm in the city, where employees' children can take advantage of educational and leisure opportunities. These offers are supplemented by flexible working hours, part-time work or the possibility to incorporate mobile working and home working into their working hours – provided the respective position allows it. To provide particular support to those employees based outside Wiesbaden in balancing the demands of family and career, we are offering help in finding private childcare solutions.

Another component for improving the work-life balance of Aareal Bank's staff consists of services that make it easier to combine working life with the care of close relatives. This includes the opportunity to use statutory family caregiver leave, and in particular advisory and support services where close relatives are ill or in need of care, all over Germany. Furthermore, employees have access to the Bank-internal nursing care network offering substantial information about nursing and support services as well as the opportunity to get in touch with co-workers in similar situations to share insights and get valuable advice. Our employees may also participate in trainings to develop and hone the skills needed to successfully combine care and career, offered by Bündnis für Familie, Wiesbaden. Given the importance of this topic for Aareal Bank Group, we signed the Charter for the Reconciliation of Working Life and Nursing Care in Hesse (Charta zur Vereinbarkeit von Beruf und Pflege in Hessen) during the year under review.

For the last nine years, Aareon has been certified as a family-friendly company by berufundfamilie gemeinnützige GmbH, a non-profit organisation. Aareon's staff policy services include the promotion of workplace flexibility through part-time work and home working. Aareon also works together with a family service company that supports its employees by providing an advisory service on the topics of childcare, care situation and psychosocial concerns. Together with another company, Aareon offers places at a day nursery and nursery school at a daycare centre in Mainz, where the nursery school places are free of charge for Aareon employees. The "Success Factor Family" competition was held for the first time since 2012, the year in which Aareon won the medium-sized company category. Aareon was once again among the finalists in 2016.

In response to the changing requirements in a digital working world, Aareon is one of the first 100 pilot companies to conduct the INQA (Initiative Neue Qualität der Arbeit – New Quality of Work Initiative) audit, which is supported by the Federal Ministry of Labour and Social Affairs. The German Federal Minister of Labour and Social Affairs, Andrea Nahles, awarded Aareon with the programme certificate in September, acknowledging its sustainable company culture. This certification confirms that Aareon developed and put into practice various measures to implement the INQA topics of human resources management, equal opportunity & diversity, health, knowledge & competence. This also implied the development of human resources policy being aligned towards the various life phases – something that started already the year before.

Besides the various measures for promoting the compatibility of career and family, parent/child offices have been set up at Aareal Bank in Wiesbaden and at various locations of Aareon. The objective is to support employees that are faced with short-term bottlenecks in the provision of care for their children.

Health

Aareal Bank practices Company Health Management to promote employee health. This includes information and trainings on preventative healthcare, physical activity & ergonomics, nutrition as well as mental health & relaxation.

For instance, our employees took advantage of extensive preventative healthcare offers, such as health advice and examinations through the company doctor, as well as expert advice regarding nutrition, physical activity, and lifestyle. Furthermore, we organised an annual influenza vaccination, eye inspections and intra-ocular pressure testing, a blood donation day as well as skin screenings as part of cancer prevention, and early detection of colorectal cancer. The offer was complemented by a new seminar on brain tuning aimed at the improvement of participants' mental performance. Besides substantial information on a sustainable way of living, our employees have access to healthy basic nutrition through our Bank-internal restaurant – the Casino –, featuring regular special campaigns and offering healthy snacks.

Particular emphasis was placed on mental health & relaxation during the year under review. Furthermore, we have provided our employees with the opportunity to utilise the Employee Assistance Program (EAP), a phone service for employees designed to assist in overcoming crises in the professional and private sphere. This facility is available 24 hours a day and 365 days a year. In addition, Aareal Bank in Wiesbaden continued to offer massages to help employees relax, together with seminars on mindfulness and stress management. For its dedication to health and individual performance of its employees, as well as for its forward-looking and sustainable personnel strategy, Aareal Bank was once again distinguished with the Certificate of Excellence at the Corporate Health Awards 2016.

Aareon operated its corporate health management in 2016 under the motto "fit for the working environment 4.0", since the employee survey and the INQA audit had shown that this topic is of particular interest. A mixture of a large variety of seminars – covering subjects such as "recharge your batteries", "Healthy leadership", "deceleration", "time management", a presentation on "how to better deal with the flood of information", an E-Learning-Tool on mental health, massages, influenza vaccinations, and last but not least the Aareon Health Day – support a healthy work environment at Aareon.

Diversity

The Management Board has made an express commitment to diversity in Aareal Bank Group, and published it on the Internet and Intranet. This defines diversity as follows:

- An appreciation for the uniqueness of every individual and respect for their differences,
- equal opportunities at all levels,
- the prevention of discrimination of any kind, along with
- actively representing and living the belief that diversity enriches corporate culture and also represents a success factor in reaching strategic goals.

The goals are to promote Aareal Bank's image as a modern employer, to strengthen employee commitment and increase employee motivation, to ensure skills and competencies are fostered individually in a way that promotes employee performance, to react to demographic change and an ageing workforce, and to take into account individual circumstances and stages of life.

In order to highlight the significance of diversity and document the fact that the concept of diversity is very important to Aareal Bank Group, the Bank signed the Charter of Diversity (an initiative launched by German industry in 2006) in 2013.

Aareal Bank Group currently employs people from 28 different countries. It makes sure that its international operations are filled by mainly local nationalities.

The share of female employees in Aareal Bank AG was 45.1 % in the 2016 financial year, with women accounting for 22.9 % of executive positions. Within Aareon Group, the figures were 32.7 % and 21.8 % respectively.

Severely disabled persons made up 3.9 % of Aareal Bank's staff base in 2016. This employee group is represented in the Group's German entities by a disability representative.

Equal treatment

It is very important for Aareal Bank Group that men and women are treated equally, in relation to recruitment decisions and further development through qualification measures, as well as with regard to remuneration in the Company. As a rule, all vacant positions below executive staff level are filled within the scope of an internal recruitment procedure. All employees may apply for the advertised positions. The employees' remuneration is, so to speak, not differentiated by gender, but – aside from the individual performance – solely on the basis of aspects such as qualification, experience and education.

The employee representative bodies regularly check within the scope of their co-determination rights that qualification is the decisive criteria for filling positions. In addition, recruitment decisions at Management Board and executive staff levels must take into account primarily the qualifications and experience when selecting a suitable candidate.

In Germany, Aareal Bank and Aareon apply the German General Equal Treatment Act (Allgemeines Gleichbehandlungsgesetz – "AGG"), with specially-appointed AGG Officers overseeing compliance. At the same time, AGG training is held for all employees. In the US, the employee manual contains anti-harassment rules to avoid harassment and discrimination in the workplace.

Risk Report

Aareal Bank Group Risk Management

The ability to correctly assess risks, and to manage them in a targeted manner, is a core skill in banking. Accordingly, being able to control risks in all their relevant variations is a key factor for a bank's sustainable, commercial success. Besides this purely economic motivation for a highly-developed risk management system, extensive regulatory requirements apply to the risk management as well. We therefore continued to drive the development of our processes for identifying, measuring, limiting and managing risks in the financial year under review too.

Risk management – scope of application and areas of responsibility

Aareal Bank Group's business activities comprise the Structured Property Financing and Consulting/Services segments. Aareal Bank AG, as the parent entity of the Group, has implemented extensive systems and procedures to monitor and manage the Group's risk exposure.

Uniform methods and procedures are deployed to monitor the risks generally associated with banking business across all entities of Aareal Bank Group. Risks in the Consulting/Services segment are taken into account as part of investment risk. Specific risk monitoring methods have been developed and deployed to suit the relevant risk exposure at the respective subsidiaries. In addition, risk monitoring for these subsidiaries at Group level is carried out via the relevant control bodies of the respective entity, and equity investment controlling.

Overall responsibility for risk management and risk monitoring remains with the Management Board and the Supervisory Board of Aareal Bank AG.

Overall responsibility:
Management Board and Supervisory Board of Aareal Bank AG

Type of risk		Risk management	Risk monitoring
Market price risks		Treasury, Dispo Committee	Risk Controlling
Liquidity risks		Treasury	Risk Controlling
Credit risks	Property Finance Single exposures	Business & Syndication Management, Credit Management	Risk Contolling, Credit Management
Credit risks	Property Finance Portfolio risks	Credit Management, Portfolio Management & Controlling	Risk Controlling
Credit risks	Treasury business	Treasury	Risk Controlling
Credit risks	Country risks	Treasury, Credit Management	Risk Controlling
Operational risks		Process owners	Risk Controlling
Investment risks		Acquisitions & Subsidiaries	Risk Controlling, Acquisitions & Subsidiaries, Controlling bodies

Process-independent monitoring: Audit

The adjacent diagram provides an overview of the responsibilities assigned to the respective organisational units.

The Bank resolved to establish a Risk Executive Committee ("RiskExCo") during the year under review. The RiskExCo supports the entire Management Board in maintaining a holistic risk management system, develops proposals for resolutions in line with delegated tasks, and promotes risk communications and a risk culture within the Bank.

Strategies

The business policy set by the Management Board, and duly acknowledged by the Supervisory Board, provides the conceptual framework for risk management. Taking this as a basis, and strictly considering the Bank's risk-bearing capacity, we have formulated detailed strategies for managing the various types of risk. These strategies are designed to ensure a professional and conscious management of risks. Accordingly, these strategies include general policies, to ensure a uniform understanding of risks across all parts of the Group. They also provide a cross-sectional, binding framework applicable to all divisions. The Bank has implemented adequate risk management and risk control processes to implement these strategies, and to safeguard the Bank's risk-bearing capacity. During the financial year under review, risk strategies as well as the Bank's business strategy were adapted to the changed environment, and the new strategies were adopted by the Management Board and duly acknowledged by the Supervisory Board.

Risk-bearing capacity and risk limits

The Bank's ability to carry and sustain risk is a core determining factor governing the structure of its risk management system. To ascertain its uninterrupted risk-bearing capacity, Aareal Bank Group has adopted a dual management approach whereby its risk management is primarily based on the assumption of a going concern. This approach ensures that risk positions are only established to an extent that the institution's continued existence will not be threatened should the risks materialise.

A secondary management process ensures that risk positions are only established to an extent that even in the event of liquidation there will still be sufficient potential risk cover in order to service all liabilities (the "gone concern" approach). The statements below relate to the going-concern approach which the Bank has implemented as a primary management process.

In accordance with this approach, potential risk cover is determined using data derived from the income statement and from the statement of financial position; this derivation also forms the basis for determining regulatory capital. This involves setting aside the maximum amount of own funds required as potential risk cover to offset risks without causing a breach of minimum requirements pursuant to the Capital Requirements Regulation (CRR). Aareal Bank has decided to considerably exceed this minimum requirement, and to prudently apply a Tier I ratio (calculated in accordance with the CRR) equivalent to 8 % of forecast risk-weighted assets (RWA), plus buffer. The Bank switched to full Basel III implementation during the year under review. Only free own funds exceeding this level are applied as potential risk cover, of which a further minimum of 10 % (currently 11 %) is retained as a risk cushion. This cushion is not applied to risk limits, and is thus available for risk types that cannot be quantified (for example, reputational or strategic risks).

We adopt an equally conservative stance with respect to setting risk limits. The aggregation of individual limits is based on the assumption that no risk-mitigating correlation effects exist amongst different types of risk. Taking into account the prior deduction of a minimum Tier I ratio of 8 % of RWA, the value-at-risk models used to quantify risks are based on a confidence interval of 95 % and a one-year holding period (250 trading days). A monthly report submitted to the Management Board provides information regarding the utilisation of individual limits for the material types of risk, as well as on the overall limit utilisation. The following table (p. 76) summarises the Group's overall risk-bearing capacity as at 31 December 2016.

Consolidated Financial Statements
Transparency

Risk-bearing capacity of Aareal Bank Group as at 31 December 2016
– Going concern approach –

€ mn	31 Dec 2016	31 Dec 2015
Own funds for risk cover potential	2,598	2,937
less 8% of RWA (Tier 1 capital (T1))	1,477	1,606
Freely available funds	**1,121**	**1,331**
Utilisation of freely available funds		
Credit risks	317	313
Market risks	207	244
Operational risks	106	100
Investment risks	24	65
Total utilisation	**654**	**721**
Utilisation as a percentage of freely available funds	**58%**	**54%**

Since aggregate risk cover is an inadequate measure to assess the risk-bearing capacity for liquidity risk, we have defined special tools for managing this type of risk. These tools are described in detail in the section "Liquidity risks".

Stress testing

Stress testing, and the analysis of stress test results, form an additional focal aspect of our risk management system. This involves conducting stress tests for all material risks, using both historical parameters as well as hypothetical stress testing scenarios. To also be able to assess cross-relationships between the various types of risk, we have defined multi-factor stress scenarios, so-called "global" stress tests. For instance, the impact of a crisis affecting financial markets and the economy on individual types of risk and aggregate risk is analysed within the scope of a historical scenario. An escalation of the financial markets and economic crisis is modelled as a hypothetical scenario. The stress testing methodology implemented also takes into account the impact of any risk concentrations. We compare the aggregate risk cover available in a stress situation with the result of stress tests, thus assessing Aareal Bank's ability to bear risk in a stressed environment. The Management Board and the Supervisory Board are informed of the results of such stress analyses on a quarterly basis.

Organisational structure and workflows

Lending business

Division of functions and voting

Aareal Bank Group's structural organisation and business processes are consistently geared towards Group-wide effective and professional risk management. This includes the extensive implementation of regulatory requirements regarding the structural organisation and workflows in the credit business.

Processes in the credit business are designed to consistently respect the clear functional division of Sales units ("Markt") and Credit Management ("Marktfolge"), up to and including senior management level. In addition, the Risk Controlling division, which is not involved in making lending decisions, is responsible for monitoring all material risks whilst ensuring an adequate and targeted risk reporting system at a portfolio level.

Lending decisions regarding credit business classified as relevant for the Bank's risk exposure require two approving votes submitted by a Sales unit and a Credit Management unit. The Bank's Schedule of Powers defines the relevant lending authorities within Sales units and Credit Management. Where authorised persons are unable to come to a unanimous lending decision, the loan involved cannot be approved, or must be presented to the next-highest decision-making level for a decision.

The RiskExCo, which has delegated authority to the heads of Risk Controlling, Operations, and Portfolio Management & Controlling (which are independent of Sales units), is responsible for the approval of counterparty, issuer, or country limits.

We have implemented and documented the clear separation of Sales and Credit Management processes across all relevant divisions.

Process requirements

The credit process comprises the credit approval and further processing phases, each governed by a control process. Credit exposures subject to increased risks involve supplementary processes for intensified handling, the handling of problem loans, and – if necessary – for recognising allowance for credit losses. The corresponding processing principles are laid down in the Bank's standardised rules and regulations. Important factors determining the counterparty credit risk of a credit exposure are identified and assessed on a regular basis, adequately taking into account sector and (where appropriate) country risks. Critical issues regarding an exposure are highlighted, and analysed assuming different scenarios where appropriate.

Suitable risk classification procedures are applied to evaluate risks for lending decisions, as well as for regular or event-driven monitoring of exposures. This classification scheme is reviewed at least once a year; depending on the risk situations, the review cycle may be shortened significantly. Furthermore, the risk assessment results influence pricing.

The organisational guidelines contain provisions governing escalation procedures and further handling in the event of limit breaches, or of a deterioration in individual risk parameters. Measures involved may include the provision of extra collateral, or an impairment test.

Early risk detection procedures

The early identification of credit risk exposure, using individual or combined (early warning) criteria is a core element of our risk management approach.

In particular, the procedures applied for the early detection of risks serve the purpose of identifying borrowers or exposures where higher risks start emerging, at an early stage. For this purpose, we generally monitor individual exposures and the parties involved (such as borrowers or guarantors) regularly throughout the credit term, assessing quantitative and qualitative factors, using instruments such as periodic monitoring and internal ratings. The intensity of the ongoing assessments is based on the risk level and size of the exposure. The Group's risk management processes ensure that counterparty credit risk is assessed at least once a year.

An "On-watch Committee" has been established in order to enhance the Bank's procedures for the early detection of risks. Whenever there are indications of specific risks, this Committee has global authority – regardless of exposure size – to classify exposures as "normal" or "subject to intensified handling", and to decide on the measures to be taken as well as the composition of the Deal Team handling the exposure. The transfer of know-how is enhanced through the cross-divisional representation on the Committee.

Extensive IT resources are deployed to identify risk positions, and to monitor and measure risks. Overall, the existing set of tools and methods enable the Bank to adopt suitable risk management measures, where required, at an early stage.

Actively managing client relationships is crucially important in this context: approaching clients in time to jointly develop a solution to any problems which may arise. Where necessary, we muster the support of experts from the independent restructuring and recovery functions.

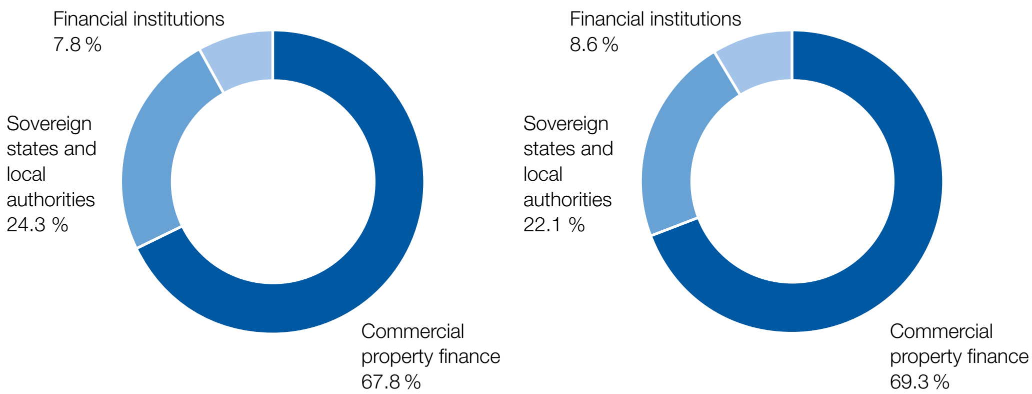
Risk classification procedures

Aareal Bank employs risk classification procedures tailored to the requirements of the respective asset class for the initial, regular, or event-driven assessment of counterparty credit risk. The rating scales and exposure definitions have been customised to match the respective methods. Responsibility for development, quality assurance, and monitoring implementation of risk classification procedures, is outside the Sales units. These units are responsible for the annual validation of the risk classification procedure.

The ratings determined using internal risk classification procedures are an integral element of the Bank's approval, monitoring, and management processes.

Breakdown of exposure by rating procedure

31 Dec 2016 | 31 Dec 2015 100 % = € 43.2 bn | 100 % = € 46.4 bn



Note: The rating procedures for financial institutions also apply to development and promotional banks. Such institutions accounted for 51 % of all rated financial institutions as at 31 December 2016.

Property financing business

The Bank employs a two-level risk classification procedure for large-sized commercial property finance exposures, specifically designed to match the requirements of this type of business.

In a first step, the client's probability of default (PD) is determined using a rating procedure. The method used in this context comprises two main components, a property rating and a corporate rating.

The relative impact of the two components on the rating result is determined by the structure of the exposure concerned. The client's current and future default probability is determined based on specific financial indicators, together with qualitative aspects and expert knowledge.

The second step involves calculating the loss given default (LGD). The LGD estimates the extent of the economic loss in the event of a borrower defaulting. In simple terms, this is the amount of the claim not covered by the proceeds from the realisation of collateral.

When evaluating collateral, haircuts are applied or recovery rates used, depending on the type of collateral involved and specific realisation factors. For financings of domestic properties, recovery rates are taken from a pool of data used across the Bank, whilst recovery rates for international properties are derived using statistical methods, given the low number of realisations.

The expected loss (EL) in the event of default of an exposure is determined as the product of PD and LGD. As a risk parameter related to the financing, EL is used as an input factor for the tools used to manage the property financing business.

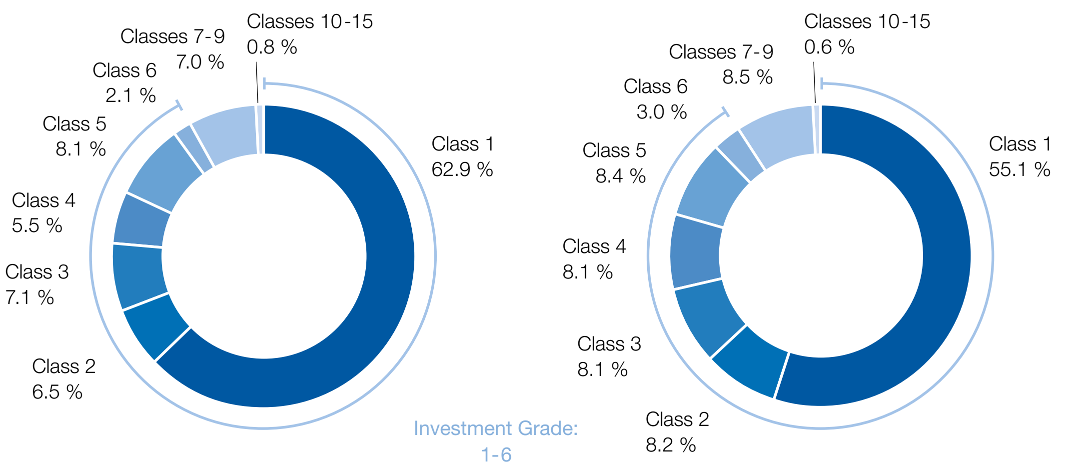
The following diagrams depict the distribution of lending volume by EL classes as at 31 December 2015 and 31 December 2016, based on the maximum current or future drawdown. The distribution excludes exposures for which no rating has been concluded, or which are in default (as defined under the CRR).

Financial institutions

Aareal Bank employs an internal rating procedure for financial institutions, which incorporates qualitative and quantitative factors as well as our client's

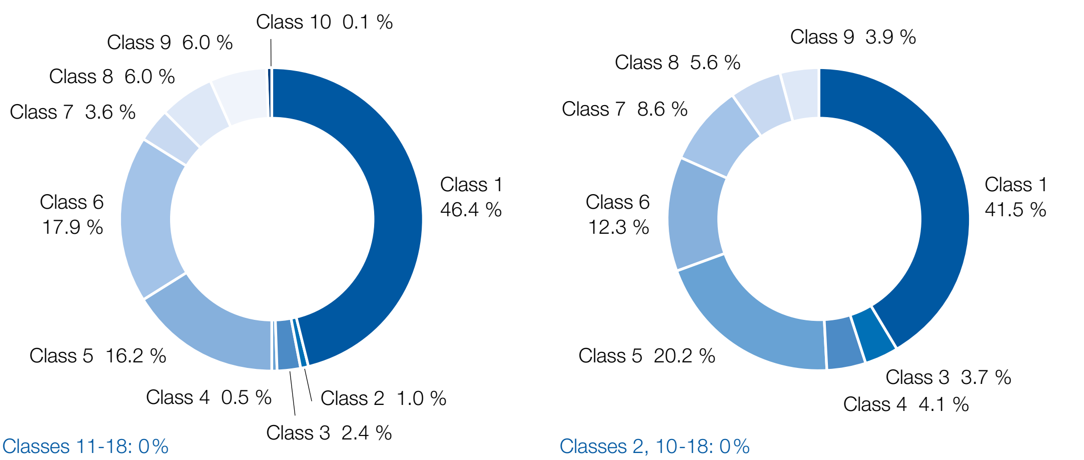
Large-sized commercial property finance

by internal expected loss classes — as at 31 Dec 2016 | as at 31 Dec 2015



Financial institutions

by rating class — as at 31 Dec 2016 | as at 31 Dec 2015



group affiliation, to classify the risk exposure to banks, financial services providers, securities firms, public-sector development banks, and insurance companies. Financial institutions are assigned to a specific rating grade by way of assessing relevant financial indicators and taking into account expert knowledge.

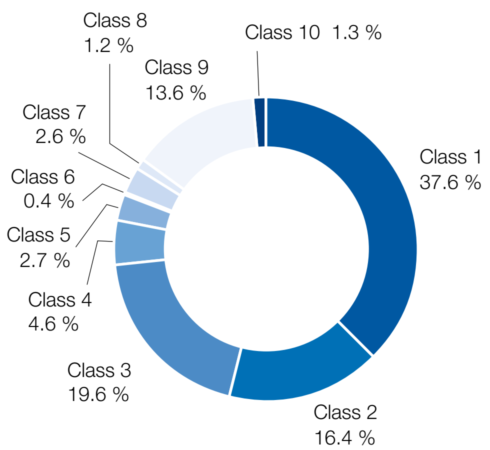
Sovereign states and local authorities

In addition, Aareal Bank Group employs internal rating methods for sovereign borrowers and regional governments, local and other public-sector entities. In this context, rating grades are assigned using clearly-defined risk factors, such as fiscal flexibility or the level of debt. The expert knowledge of our rating analysts is also taken into account for the rating.

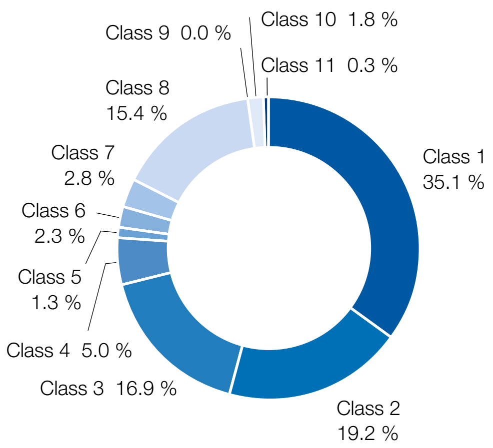
In general, the risk classification procedures employed by the Bank are dynamic methods which are permanently adapted to changing risk structures and market conditions.

Sovereign states and local authorities

by rating class — as at 31 Dec 2016 | as at 31 Dec 2015



Classes 11-20: 0%



Classes 12-20: 0%

Trading activities

Functional separation

We have implemented a consistent functional separation between Sales units and Credit Management for the conclusion, settlement and monitoring of trading transactions, covering the entire processing chain.

On the Sales side, the processing chain comprises the Treasury division, whilst Credit Management tasks are carried out by the independent Operations and Risk Controlling divisions. Beyond this, Finance and Audit are responsible for tasks not directly related to processes.

We have laid down organisational guidelines providing for binding definitions of roles and responsibilities along the processing chain; with clearly defined change processes.

The detailed assignment of responsibilities is outlined below.

Treasury is responsible for risk management and trading activities as defined by the Minimum Requirements for Risk Management ("MaRisk") set out by BaFin. Treasury is also responsible for asset/liability management, and for managing the Bank's market and liquidity risk exposures. In addition, we have established a Transaction Committee, to develop strategies for the Bank's asset/liability management and proposals for their implementation. The Committee, which comprises the Management Board member responsible for Treasury, the Head of Treasury, and other members appointed by the Management Board, meets on a weekly basis.

Operations is responsible for controlling trading activities, confirming trades to counterparties, and for trade settlement. The division is also responsible for verifying that trades entered into are in line with prevailing market conditions, as well as for the legal assessment of non-standard agreements, and of new standard/master agreements.

To assess counterparty credit risk in the trading business, Operations prepares a rating for all counterparties and issuers on a regular or event-driven basis. The rating is a key indicator used to determine the limit for the relevant counterparty or issuer.

Moreover, the RiskExCo is responsible for voting on all limit applications throughout the Bank. The Committe has delegated corresponding authority to the Heads of Risk Controlling, Operations, and Portfolio Management & Controlling, who are also responsible for conducting annual limit reviews, as well as for reducing (or revoking) counterparty or issuer limits whenever required.

The tasks of the Risk Controlling division comprise identifying, quantifying and monitoring market price, liquidity and counterparty credit risk exposure from trading activities, and the timely and independent risk reporting to senior management.

Process requirements

Processes are geared towards ensuring end-to-end risk management, from conclusion of the trade right through to monitoring portfolio risk. The monitoring and reporting function comprises deploying adequate risk measurement systems, deriving limit systems, and ensuring the transparency of Aareal Bank Group's overall risk exposure from trading activities, in terms of scope and structure.

Moreover, processes and systems are designed in a way that allows to incorporate new products into the risk monitoring system swiftly and adequately, in order to ensure the flexibility of the Sales units in their business activities.

A standardised process exists for the intensified handling of counterparties and issuers, and for dealing with problems. This process comprises identifying early warning indicators, applying them for the purposes of risk analysis, and determining further action to be taken. In the event of counterparty or issuer default, the RiskExCo will coordinate an action plan in cooperation with the Bank's divisions involved.

Escalation and decision-making processes have been set out to deal with limit breaches.

Risk exposure by type of risk

Credit risks

Definition

Aareal Bank defines credit risk – or counterparty credit risk – as the risk of losses being incurred due to (i) a business partner defaulting on contractual obligations; (ii) collateral being impaired; or (iii) a risk arising upon realisation of collateral. Both credit business and trading activities may be subject to counterparty credit risk. Counterparty credit risk exposure from trading activities may refer to risk exposure vis-à-vis counterparties or issuers. Country risk is also defined as a form of counterparty credit risk.

Credit risk strategy

Based on the Bank's overall business strategy, Aareal Bank's credit risk strategy sets out all material aspects of the Group's credit risk management and policies. Proposals for the credit risk strategy are prepared jointly by Sales units and Credit Management, adopted by the entire Management Board, and duly acknowledged by the Supervisory Board. The credit risk strategy will be reviewed, at least once a year, as to its suitability regarding the Bank's risk-bearing capacity and its business environment; amendments will be made as necessary. This process is instigated by management, and implemented by the Sales units and Credit Management, who submit a proposal (on which they both agreed) to management. Designed in principle for a medium-term horizon, the credit risk strategy is adapted when necessary to reflect material changes in the Group's credit risk and business policies, or in the Group's business environment (as in the case of the financial markets crisis).

Aareal Bank's credit risk strategy comprises the Group credit risk strategy (as a general guideline) plus individual sub-strategies called Lending Policies. Given the hierarchical structure of the credit risk strategy, the Group credit risk strategy overrides individual sub-strategies. These rules serve as a guideline for generating new business.

Risk measurement and monitoring

The credit business is subject to a variety of risk measurement and monitoring processes. This includes the application of two different credit risk models incorporating concentration and diversification effects at a portfolio level, from which both the expected and unexpected loss (credit-value-at-risk) are derived. Credit value-at-risk corresponds to the maximum amount by which the actual loss can exceed the anticipated loss, at portfolio level, for a given confidence interval.

Based on the results of these models, the Bank's decision-makers are regularly informed of the performance and risk content of property finance exposures, and of business with financial institutions. The models permit to identify, measure, monitor and manage risks at a portfolio level.

The Bank focuses in particular on the identification, monitoring and management of risk concentrations, where both quantitative and qualitative methods are being used. With regard to counterparty credit risk, these include for example, the regular analysis of our largest borrower units and the analysis of the portfolios by countries, risk classes and categories of collateral. Thresholds are set within this system for individual sub-markets and product groups. Risk Controlling uses a "red-amber-green" indicator system to assess the utilisation of the limits on a monthly basis, which it submits to the Management Board. The thresholds are reviewed annually within the scope of the target portfolio and Group planning.

The model-based review and monitoring of risk concentrations is carried out on the basis of the credit risk models used in the Bank. The models in question allow the Bank to include in particular, rating changes and diversification effects in the model-based assessment of the risk concentrations.

Within the process-oriented monitoring of individual exposures, the Bank uses specific tools to monitor exposures on an ongoing basis: besides the tools already described, this includes rating reviews, monitoring of construction phase loans or residential property developers, the monitoring of payment arrears, and the regular, individual analysis of the largest exposures.

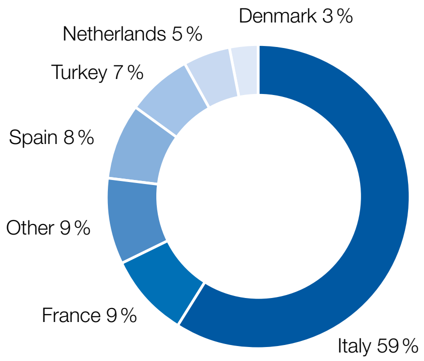
A risk report that complies with the Minimum Requirements for Risk Management (MaRisk) is prepared and submitted to the Bank's senior management and Supervisory Board on a regular basis, at least quarterly. This report contains extensive information on the development of the credit portfolio (covering countries, types of property and product types, risk classes and types of collateral), with a particular focus on risk concentrations.

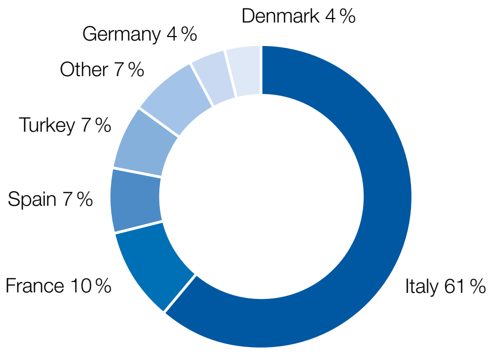
Trading activities are generally restricted to counterparties for whom the requisite limits are in place. Replacement and settlement risks are taken into account when determining counterparty limit usage. Persons holding position responsibility are informed about relevant limits and their current usage without delay. Trading activities also require the establishment of issuer limits.

All trades are immediately taken into account for the purposes of borrower-related limits. Compliance with limits is monitored in real time by Risk Controlling. Any limit breaches are documented, together with action taken in response. Where limit transgressions exceed an amount defined in line with

Individually impaired property financing[1] (amounts drawn)

by country (%) 31 Dec 2016: 100 % = € 1.4 bn | 31 Dec 2015: 100 % = € 1.4 bn





[1] Excluding WestImmo's private client business and local authority lending business.

risk considerations, these are escalated to the responsible members of senior management, using a standardised escalation process.

Credit risk mitigation

The Bank accepts various types of collateral to reduce default risk exposure. This includes impersonal collateral, such as liens on immobile (property) and mobile assets; liens on receivables, such as rents; and third-party undertakings, such as guarantees.

As an international property finance house, Aareal Bank focuses on property when collateralising loans and advances. As a rule, loans are granted and the security interest perfected in accordance with the jurisdiction in which the respective property is located.

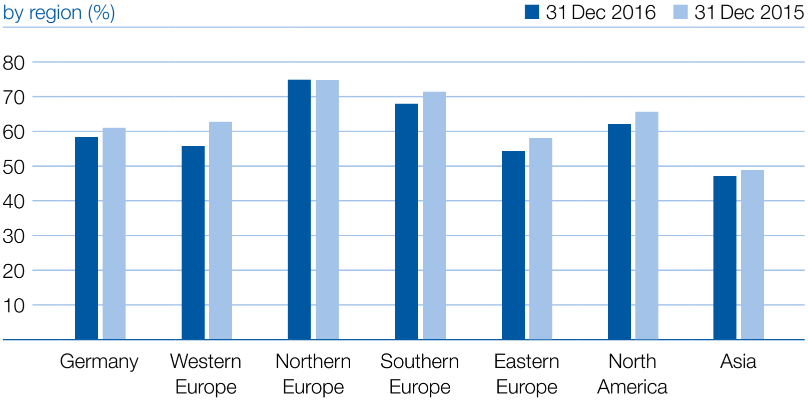
Market values and mortgage lending values are set in accordance with the responsibilities for decision-making on lending, and form an integral part of the lending decision. The values to be determined by the Bank are generally pegged on the valuation prepared by a valuer; any discrepancies must be substantiated in writing. In any case, the market and mortgage lending values determined by the Bank must not exceed the values assessed by independent internal or external valuers.

To mitigate credit risk, the Bank also accepts collateralisation through a pledge of shareholdings in property companies or special-purpose entities not listed on a stock exchange. The Bank has set out detailed provisions governing the valuation of such collateral.

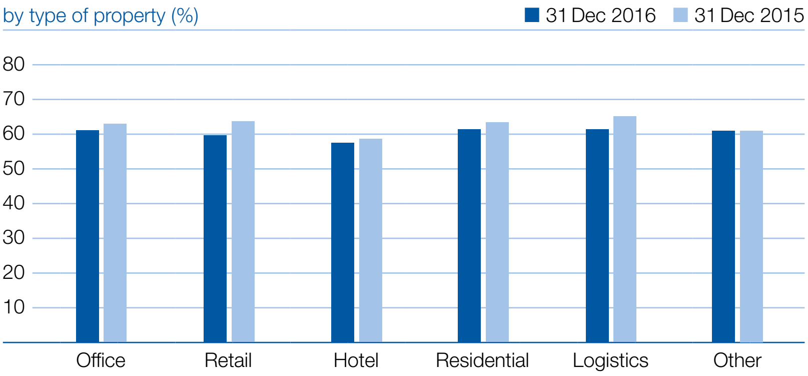
The Bank also accepts guarantees or indemnities as well as financial collateral (such as securities or payment claims) as standard forms of collateral. The collateral value of the indemnity or guarantee is determined by the guarantor's credit quality. For this purpose, the Bank differentiates between banks, public-sector banks, and other guarantors. The value of financial collateral is determined according to the type of collateral. Haircuts are generally applied when determining the value of guarantees / indemnities and financial collateral.

The credit processes provide for the regular review of collateral value. The risk classification is adjusted in the event of material changes in collateral value, and other measures taken as deemed appropriate. An extraordinary review of collateral is carried out where the Bank becomes aware of information indicating a negative change in collateral value. Moreover, the Bank ensures that disbursement is only made after the agreed conditions for payment have been met.

Average LTV of property financing[1)]



Average LTV of property financing[1)]



[1)] Excluding WestImmo's private client business and local authority lending business.
Note that the loan-to-value ratios are calculated on the basis of market values, including supplementary collateral with sustainable value.

Collateral is recorded in the Bank's central credit system, including all material details.

To reduce counterparty credit risk in Aareal Bank's trading business, the master agreements for derivatives and securities repurchase transactions (repos) used by the Bank provide for various credit risk mitigation techniques.

The derivatives master agreements used by the Bank contain mutual netting agreements to reduce prepayment risk at a single transaction level (payment netting), and arrangements for the termination of individual or all transactions under a master agreement (close-out netting). For repo transactions, depending on the counterparty, payment or delivery netting is agreed upon.

To further reduce default risks, the provision of collateral is agreed upon.

Prior to entering into agreements, and on a regular basis following conclusion of an agreement, the responsible legal services unit within the Operations division assesses the legal risks, and the legal effectiveness and enforceability. The Bank uses an internal rating system to assess the credit quality of counterparties. For derivatives transactions entered into with financial institutions, where the Bank is looking for capital adequacy relief in accordance with the CRR, a clause providing for a review of eligibility is added to the netting agreements. This review is carried out in accordance with the CRR, particularly through obtaining regular legal opinions, using a database developed for this purpose.

Operations is responsible for the daily valuation of the Bank's trades, including collateral accepted or pledged, and using validated valuation procedures. Collateral for derivatives transactions is transferred on a regular basis, as provided for in the respective agreements. Margin calls for repo transactions are determined on a daily basis. Haircuts are applied to account for potential fluctuations in collateral value.

Only cash collateral is accepted for derivatives, whereas collateral for repos can be provided in cash or in securities. Some of the collateral agreements the Bank has entered into provide for a higher amount of collateral to be provided in the event of a downgrade of the Bank's external rating.

In principle, Aareal Bank pursues a "buy and manage" strategy in managing its credit portfolio – with the primary objective of holding loans extended on its balance sheet until maturity; at the same time, targeted exit measures are deployed for actively managing the portfolio and the risks involved. Assets acquired upon the realisation of collateral are predominantly properties. The consideration received upon disposal is applied to repay the underlying financing. An immediate sale is generally sought for such properties.

Country risk

Definition

When defining country risk, in addition to the risk of sovereign default or default of state entities, Aareal Bank also considers the risk that a counterparty could become unable to meet its payment obligations as a result of government action, despite being willing and able to pay, due to restrictions being imposed on making payments to creditors (transfer risk). These types of risks arise only if the borrower is located in a different country from the lender, or if the financed property is located in another country.

Country risk measurement and monitoring

Country risk exposure is managed using a cross-divisional process. Countries are assigned to risk classes on the basis of internal ratings and the annual review of country limits. The limits are set by the Management Board. The Risk Controlling division is responsible for the continuous monitoring of country limits and limit utilisation, and for monthly reporting. Country limits defined for the purposes of risk management were always observed during the financial year under review.

The diagram below illustrates the risk exposure by country in the Bank's international business, as at year-end. In the property financing business, country exposures are allocated by location of the property used as collateral. For exposures not collateralised by property, the allocation is based on the borrower's country of domicile. This reflects the exposure of the property finance business, as well as the activities of Treasury.

Market price risks

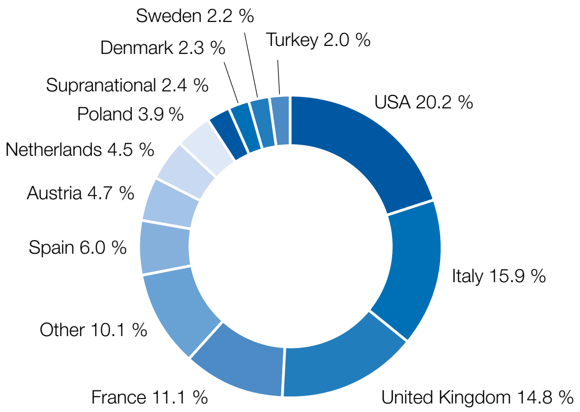
Definition

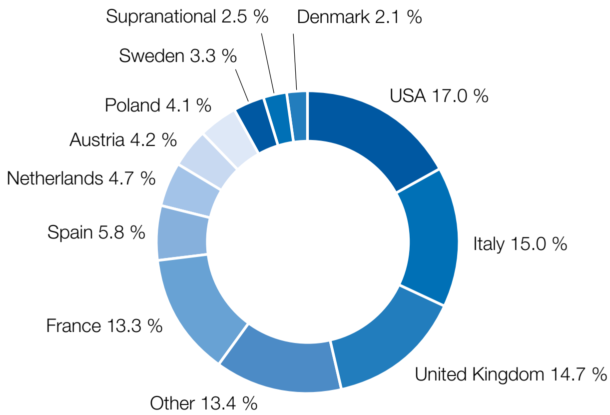
Market price risk is broadly defined as the threat of losses due to changes in market parameters. Aareal Bank Group's market price risk exposure predominantly comprises interest rate risks, whilst currency risks are largely eliminated through hedges. Commodities are irrelevant for the Bank's business. Hence, the primary market price risk exposures are related to the relevant risk parameters of interest rates, equity prices, exchange rates, and implied volatilities. All relevant parameters are covered by our management and monitoring tools.

Derivative financial instruments are primarily used as hedging instruments. Credit spread and basis spread risks between the various yield curves (e.g. government, Pfandbrief and swap curves) are taken into account. The risk exposure from bonds that is not related to market price or interest rate risks is

Breakdown of country exposure in the international business

in % 31 Dec 2016 | 31 Dec 2015





managed as part of "specific risk", in particular, credit and liquidity risk exposure of the bond portfolio.

Risk measurement and monitoring

Risk Controlling informs the members of the Management Board responsible for Treasury and risk monitoring about the risk position and the market price risk exposure on a daily basis. In addition, the entire Management Board is informed on a monthly basis, within the scope of an extensive risk report. A quarterly report is submitted to the Supervisory Board.

Value-at-risk (VaR) has been broadly accepted as the predominant method for measuring general market price risk. The VaR for market price risk quantifies the exposure as a negative divergence from the current aggregate value of the Bank's financial transactions. This absolute amount indicates the potential loss incurred before countermeasures take effect. Since this is a statistical approach, the forecast for the potential loss that may be incurred within a specific period of time is for a given confidence interval only.

A variance-covariance approach (delta-normal method) is used throughout the Group to determine the VaR indicator. Determined on a daily basis for the Group and all its operating units, the VaR figure takes into account the correlation between individual risk types within market price risk. Statistical parameters used in the VaR model are calculated directly from a 250-day historical data pool maintained within the Bank. The loss potential is determined applying a 95 % confidence interval and a 250-day holding period.

By their very nature, VaR calculations are based on numerous assumptions regarding the future development of the business, and the related cash flows. Key assumptions used include current account balances which are factored into calculations for a period of up to five years, using the average residual amount of deposits observed in the past. Loans are taken into account using their fixed-interest period (for fixed-rate exposures), or using their expected maturity (variable-rate exposures). Risks from pension obligations are taken into consideration within the risk model, whereas Aareal Bank Group's consolidated equity is not taken into account as a risk-mitigating item. This tends to overstate VaR, demonstrating the conservative approach adopted in our risk measurement processes.

The limit set for the VaR figure is derived from the analysis of the Bank's risk-bearing capacity, which is carried out at least once a year. Limits are defined at Group level, as well as for the individual Group entities. Being authorised to maintain a trading book, Aareal Bank AG has defined an additional trading book limit, plus a separate value-at-risk limit for fund assets held.

€ mn	MAX	MIN	Mean	Limit
Year-to-date (full previous year), 95 %, 250-day holding period				
Aareal Bank Group – general market price risk	305.0 (422.3)	161.1 (187.5)	224.5 (263.3)	– (–)
Group VaR (interest rates)	211.6 (404.4)	103.0 (119.5)	149.5 (216.5)	– (–)
Group VaR (FX)	185.9 (170.5)	102.2 (61.0)	135.5 (114.7)	– (–)
VaR (funds)	5.8 (4.7)	3.5 (2.8)	4.6 (3.7)	20.0 (20.0)
Aggregate VaR in the trading book (incl. specific VaR)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	5.0 (5.0)
Trading book VaR (interest rates)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	– (–)
Trading book VaR (FX)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	– (–)
VaR (equities)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	– (–)
Group VaR (specific risks)	85.9 (92.0)	62.8 (72.3)	73.3 (83.8)	– (–)
Aggregate VaR – Aareal Bank Group	311.5 (428.7)	174.0 (207.5)	237.5 (277.4)	390.0 (435.0)

When interpreting the VaR figures stated before, it should be taken into account that these refer to the overall portfolio. Hence, the analysis provided represents a very extensive disclosure of market price risks by industry standards.

To ensure that Aareal Bank's figures are comparable to those published by other institutions, the risk parameters shown below were determined for a one-day holding period:

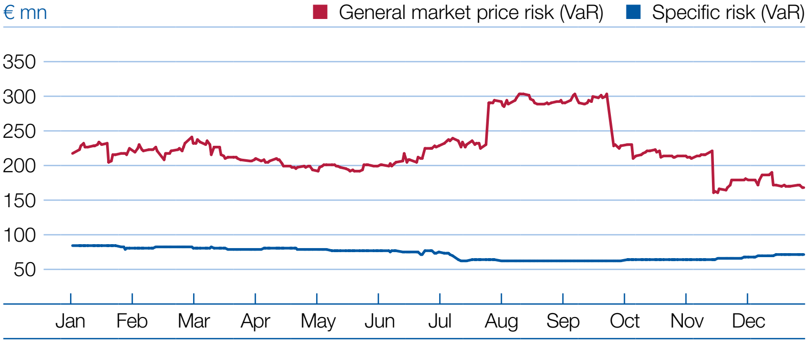
€ mn	MAX	MIN	Mean	Limit
Year-to-date (full previous year), 95 %, 1-day holding period				
Aareal Bank Group – general market price risk	19.3 (26.7)	10.2 (11.9)	14.2 (16.7)	– (–)
Group VaR (interest rates)	13.4 (25.6)	6.5 (7.6)	9.5 (13.7)	– (–)
Group VaR (FX)	11.8 (10.8)	6.5 (3.9)	8.6 (7.3)	– (–)
VaR (funds)	0.4 (0.3)	0.2 (0.2)	0.3 (0.2)	1.3 (1.3)
Aggregate VaR in the trading book (incl. specific VaR)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.3 (0.3)
Trading book VaR (interest rates)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	– (–)
Trading book VaR (FX)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	– (–)
VaR (equities)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	– (–)
Group VaR (specific risks)	5.4 (5.8)	4.0 (4.6)	4.6 (5.3)	– (–)
Aggregate VaR – Aareal Bank Group	19.7 (27.1)	11.0 (13.1)	15.0 (17.5)	24.7 (27.5)

Aggregate VaR – Aareal Bank Group

Group-wide limits are being continuously monitored as part of the analysis of the Bank's risk-bearing capacity. These limits were adjusted in line with the updated risk-bearing capacity during the second quarter of the financial year. No limit breaches were detected even after this re-calibration.

VaR movments in July, September and November resulted from market fluctuations (due to the "Brexit", for example) and related adjustments to statistical model parameters.

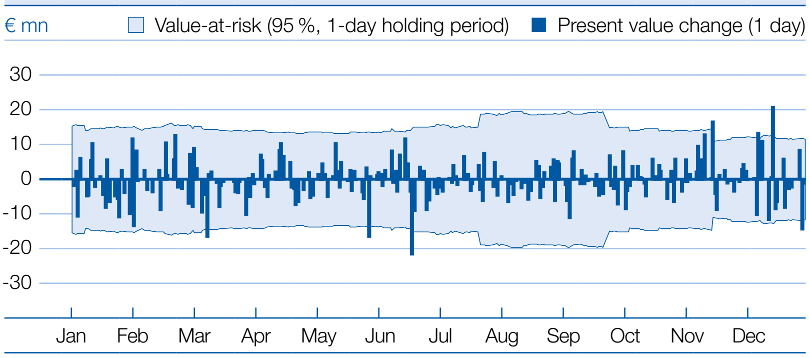
General market price risk and specific risk during 2016



Backtesting

The quality of forecasts made using this statistical model is checked through a weekly backtesting process. The quality of the statistical procedure used to measure risk is checked using a binomial test, whereby daily profits and losses from market fluctuations are compared with the upper projected loss limit (VaR) forecast on the previous day (known as "clean backtesting"). In line with the selected confidence level of 95 %, only a small number of events are expected to break out of the VaR projection (≤ 17 for a 250-day period). Four negative outliers at Group level occurred during the last 250 trading days, affirming the high forecasting quality of the VaR model we use. During the year under review, the statistical model was expanded, in order to better reflect the development of market data – specifically, the low-interest rate environment.

Present values and 1-day VaR during the course of 2016



Stress testing
Although VaR has become a standard tool, the concept may fail to adequately project the actual risk in extreme situations – for example, the end-2008 phase of the financial markets crisis. For this reason, the VaR projection is supplemented by simulating stress scenarios on a monthly basis.

Aareal Bank Group calculates present value fluctuations both on the basis of real extreme market movements over recent years, and also using simulated market movements (parallel shifts, structural changes, steepening of the yield curve). This analysis requires that all positions are revalued fully on the basis of these market scenarios. The resulting impact on present value is compared against a special stress limit within the scope of monthly stress test reporting.

The worst-case scenario used in the financial year under review was a hypothetical scenario, where a deteriorating financial markets crisis caused bond and CDS spreads to widen due to rating downgrades, combined with an appreciation of the euro and unchanged interest rate markets. This scenario implied a present value loss of 26 % of the stressed aggregate risk cover limit as at year-end 2016. No breach of set limits occurred during the year under review.

Interest rate sensitivity
An additional instrument used to quantify interest rate risk exposure is the calculation of interest rate sensitivity, expressed by the so-called "delta" parameter. The first step to determine this parameter requires calculating the present values of all asset and equity / liability items on the statement of financial position. In a second step, the interest rates of yield curves used for this calculation are subjected to a one basis point parallel shift up (a method known as the "key rate method"). Delta is the present value of the profit or loss resulting from this yield curve change.

Interest rate gap analysis
Further, the gap analysis per currency provides information on all of the Bank's positions in respect of which the interest rate has been fixed. In addition to disclosing the net gap positions in the respective maturity bucket, this data allows for specific analyses concerning the risks and returns from the current portfolio.

Trading book
Being authorised to maintain a trading book, Aareal Bank AG is the Group entity that is in a position to assign transactions to the trading portfolio as defined by the German Banking Act. Given that no such trades were concluded during the financial year under review, trading book risks played a negligible role in the overall risk scenario during the period.

Liquidity risks

Definition
Liquidity risk in the narrower sense is defined as the risk that current or future payment obligations cannot be met in full or on time. Aareal Bank Group's liquidity risk management system is designed to ensure that the Bank has sufficient cash and cash equivalents to honour its payment obligations at any future point in time. The risk management and monitoring processes have been designed to cover refinancing and market liquidity risks in addition to liquidity risk in the narrower sense.

Risk measurement and monitoring
Treasury is responsible for managing liquidity risks, whilst Risk Controlling ensures the continuous monitoring, including a daily liquidity report submitted to Treasury, and a contribution to the monthly

risk report to the entire Management Board. The following tools are used for this purpose:

a) Cash flow forecast
We have developed a cash flow forecast, tracking cash flows from all balance sheet items and derivatives, on a daily basis, over a ten-year period. This liquidity risk information helps to assess the Bank's short-term liquidity position, broken down by currency or product. Strategic liquidity is taken into account using this ten-year cash flow profile. We use statistical modelling to incorporate the expected cash flow profile of products without a fixed contractual lifetime.

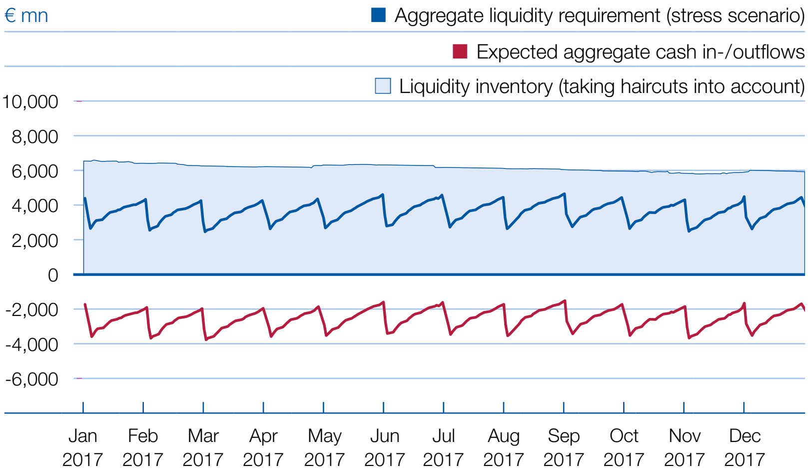
b) Liquidity run-off profile
The appropriateness of the Bank's liquidity is assessed using a liquidity run-off profile: the aggregate of all potential cash inflows and outflows over a three-month period is compared to the liquidity stock. This liquidity stock comprises all assets that can be liquidated at very short notice. The difference of both figures (in absolute terms) indicates excess liquidity, once all claims assumed in the run-off profile have been fulfilled through the liquidity stock. There were no liquidity shortages throughout the period under review.

The chart above shows the planned development of the liquidity stock, expected aggregate cash inflows and outflows, and the total liquidity requirements (based on stressed assumptions) until the end of 2017. This presentation demonstrates that the liquidity stock will always exceed liquidity requirements, even under unfavourable conditions.

Further details are provided in the comments on the Bank's liquidity in the section on "Refinancing and Equity".

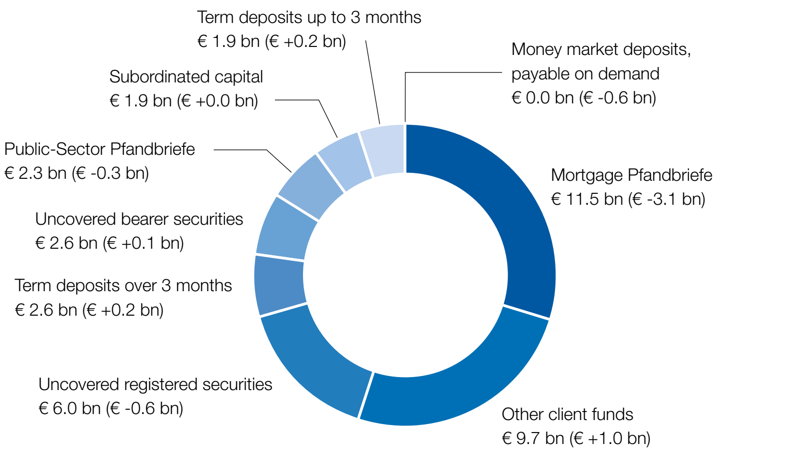
c) Funding profile
Diversifying the Bank's refinancing profile by type of investor, and by product, represents a further key aspect of our approach to liquidity risk management. Core sources of funding such as customer deposits and funds invested by institutional clients – alongside covered and uncovered bond issues – constitute the foundation of our liability profile.

Liquidity



Refinancing portfolio diversification by product

as at 31 Dec 2016 versus 31 Dec 2015 Total: € 38.6 bn



Stress testing
Moreover, we employ stress tests and scenario analyses to assess the impact of sudden stress events onto the Bank's liquidity situation. The various standardised scenarios used are evaluated on the basis of the liquidity run-off profile.

From our point of view, the most significant scenario is the institution-specific "idiosyncratic stress" scenario, which simulates a withdrawal of funds deposited by public-sector entities and banks, as well as a 30 % reduction in current account balances. Even in this stress scenario, liquidity is sufficient to cover the expected liquidity needs under stress conditions.

Operational risks

Definition

The Bank defines operational risk as the threat of losses caused by inappropriate internal procedures, human resources and systems (or their failure), or through external events. This definition also includes legal risks. To the extent that they are caused by operational risks, model, strategic and reputational risks are also taken into consideration within this type of risk. Systemic risks (or their impact on operational risks) are not affected by this.

Risk measurement and monitoring

It is the objective of the policy pursued by Aareal Bank to achieve a risk-minimising or loss-limiting effect at an early stage by employing a pro-active approach.

The Bank currently uses the following tools to manage operational risks:

- Self-assessments: analysis thereof can provide management with indicators of any potential risks within the organisational structure.
- Risk inventories that include a periodic systematic identification and compilation of all relevant risks.
- A loss database, in which relevant damages incurred are reported, and in which they can be monitored until they are officially closed.

By means of this control toolkit, decentralised data capture as well as centralised and timely compilation of all material operational risks across the Group are ensured.

The three tools described above are used to prepare the regular risk reporting to the Bank's senior management. The responsibility for implementing operative risk-reducing measures rests with those responsible for the Bank's risk management. The utilisation of freely available funds for operational risks – as part of the Bank's risk-bearing capacity – are determined using the regulatory standardised approach.

In addition to the reports prepared from the tools stated above, suitable and plausible stress tests are conducted every quarter. These are hypothetical scenarios and sensitivity analyses on the risk inventories. The results of the stress tests are reported regularly to the Management Board and serve as an indicator for potential developments within the operational risks that could jeopardise the continued existence of the Group.

Aareal Bank's legal department deals with any litigation the Bank is involved in, as well as with any legal issues of fundamental importance – where necessary, using the support of external lawyers.

Legal also compiles all information concerning any legal disputes involving Aareal Bank Group, whether in or out of court. To this extent, the involvement of the legal department is based on corresponding Group-wide guidelines. The Bank's decentralised operating legal entities, as well as the legal departments of subsidiaries submit quarterly reports on legal risks identified to Aareal Bank's legal department; where particular risks have occurred, such reports are submitted on an event-driven basis. When required, Aareal Bank's legal department discusses and coordinates any concrete measures with the reporting unit.

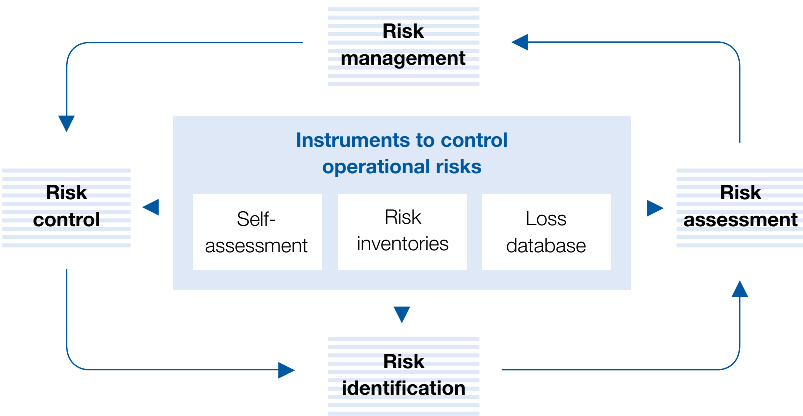
The legal department reports to the Management Board, (at least) on a quarterly basis, as well as on an event-driven basis. Moreover, information about legal risks is included in operational risk reporting.

Analyses conducted using the instruments employed have shown that the Bank is not exposed to disproportionate operational risks; nor did they indicate any material risk concentration. Even though loss cases were recorded in the loss database during the financial year under review, the aggregate impact of such losses amounted to less than 10 % of the regulatory capital to be maintained for operational risks.

Further to these tools, the Bank reviews relevant individual scenarios, and implements any measures required, on the basis of external data. Taken together, these tools for managing operational risks result in an integrated control circuit which leads to risk identification, evaluation, and management – through to risk control.

Tools to control operational risk are supplemented by a system to manage and monitor outsourced activities and processes (outsourcing), whereby the relevant organisational units regularly assess the performance of outsourcing providers, using defined criteria. The results of this process, and actions taken, are communicated to the Bank's senior management within the scope of operational risk reporting, thus allowing for risk-mitigating steps to be taken where needed.

Management of operational risks



Investment risks

Aareal Bank Group's risk exposure is largely concentrated on risks generally associated with banking, such as credit risk, market price risk, liquidity risk, and operational risk. Some Group subsidiaries, however, are exposed to a variety of other types of risk outside typical banking risk, which we include in our centralised risk management system through an Investment Risk Control concept.

Aareal Bank Group acquires equity investments strictly for the purpose of positioning the Group as an international property financing specialist and provider of property-related services.

Definition

Aareal Bank defines investment risk as the threat of unexpected losses incurred due to an impairment of the investment's carrying amount, or a default of loans extended to investees. The concept of investment risk also encompasses additional risks arising from contingencies vis-à-vis the relevant Group entities.

Risk measurement and monitoring

All relevant Group entities are subject to regular audits, including a review and assessment of their risk situation within the framework of risk measurement and monitoring. Due to the special character of some exposures (e.g. marketing risks), special methods and procedures are employed to deal with investment risk. The Bank uses an internal valuation method to quantify investment risk, and to include it in the calculations of the Bank's ability to carry and sustain risk, and for the purpose of limitation. The limit defined for investment risk was always complied with during the financial year under review.

The existing procedures used to measure and monitor risk exposure are supplemented by subjecting the equity portfolio to regular stress testing.

The Acquisitions & Subsidiaries and Risk Controlling divisions are jointly responsible for measuring and monitoring investment risk exposure.

Risk Controlling is responsible for submitting a quarterly equity investment risk report to the Bank's Management Board.

Aareon AG

Aareon AG has introduced a Group risk management system (which includes early-warning features on the basis of the R2C_risk to chance standard software) in order to monitor and control company risk. This risk management system requires the regular recording and assessment of risks (but not opportunities) by those individuals holding responsibility for divisions, shareholdings and projects, and provides for the conception of active risk management measures. In this context, risks are assessed separately in terms of their impact and their probability. Specifically, risk is viewed on a net basis, using the residual risk after taking into account adequate measures taken. The risk reports prepared in this manner are consolidated by the Group Legal and Risk Management divisions and by the Compliance Office; they form the basis for quarterly risk reporting which is regularly discussed during meetings of the Bank's corporate bodies and committees. The reports are also incorporated into the quarterly reporting package submitted to Aareon AG's Supervisory Board. Aareon's risk reporting system creates transparency regarding the company's risk situation, providing a basis for decisions regarding any measures to be taken by senior management.

The measures, proposed by those individuals responsible for risk, regarding the top ten risks perceived during the current quarter are documented within the scope of risk reporting, provided that the expected value of such risks (calculated as a function of impact and probability of occurrence) exceeds a defined threshold of currently € 100,000. In the fourth-quarter reporting, which is relevant for the reporting date, six risks fulfilled this criterion on a single-exposure level. In addition to measures taken during the current quarter, risk-related measures are also documented if they related to the risks involving the ten highest expected values during one of the preceding three quarters. This juxtaposition of risks and related measures serves both to enhance transparency of risk assessments as well as to verify the effectiveness of the measures taken. Furthermore, Aareon AG's International Board as well as the senior management of Aareon Deutschland GmbH take action with respect to any risks the expected value of which exceeds a further defined threshold.

Aareon's Internal Audit carries out checks of the risk management system. This includes an oversight of compliance with legal requirements and Group-wide guidelines, and of the effectiveness of internal controls established.

Aareon's risk categories include financial and market risks, management and organisational risks, environmental/business risks, and production risks. The financial risk category includes liquidity, cost and revenue risks. Market risks comprise client risks, competition risks, as well as the risks emanating from the views of opinion leaders in industry associations and advisory boards, as well as supplier risks. Management and organisational risks include risks related to human resources as well as risks from internal processes. The environmental/business risk category covers legal risks, political and regulatory risks as well as compliance risks. Production risks comprise product-specific risks, project risks, and IT security risks. Cross-relationships exist between individual risks. On a risk category level, Aareon does not determine an aggregate risk value. The time horizon on this level is one year.

In a first step, categories and sub-categories are introduced to create a uniform risk atlas – and hence, a uniform risk view. The risk atlas provides an overview of the risks and indicators monitored by the individual divisions or entities.

Central risk management will adapt the risk atlas in the event of any material changes to the organisation, strategy or business policy resolved during meetings of corporate bodies and committees.

Based on the average of quarterly risk assessments, risk exposure during 2016 was assessed at a slightly higher overall level compared to the previous year. Overall, there were no risks which would have jeopardised the continued existence, or which would have had a material impact on the financial position and performance of Aareon.

Aareal First Financial Solutions AG

Aareal First Financial Solutions AG develops innovative products and services for account maintenance and payments for the housing sector and operates the respective systems. The material risks resulting from this business consist of operational risks regarding the further development and the operation of systems, as well as an indirect market risk, which is due in particular to the close relationship with Aareal Bank AG, which is responsible for the distribution of banking products.

The risk arising from developing software with respect to the initial and continued development of BK 01 software solutions largely relates to the potential inability to complete such developments with the required quality, within the planned timeframe, or within budgeted costs. Internally, Aareal First Financial Solutions AG counters such risks by deploying a uniform development process and regular management reporting. This is complemented by a uniform, high-quality process for licensing BK 01 products, established vis-à-vis development cooperation partners; this is designed to satisfy our quality requirements on a sustained basis, and to ensure a high degree of transparency.

The stand-alone "Aareal Account Rent Deposits" solution, which is independent of specific systems environments, has been in production and fully migrated since 2015. At present, rent deposits of approximately € 25 million (and rising) are being managed using this software.

Development partnerships with providers of institutional housing or utility software are being continuously monitored; such partnerships will not be extended, or will be terminated, if the partners fail to comply with the stringent quality requirements placed upon them.

Aareal First Financial Solutions AG has offered Aareal Bank's clients a browser-based online access since 2015, via the Aareal EBICS platform. Aareal First Financial Solutions AG complies with regulatory requirements for this new risk class (in accordance with BaFin's Minimum Requirements for the Security of Internet Payments – "MaSI"): strong client authentication and multi-level security procedures are strictly adhered to; external risk analyses were commissioned and application-related access tests carried out.

The further development of the BK@1 accounting system is based on Release 21.01 – the version which is currently in productive use – and therefore does not represent any material risk.The currently valid SEPA procedures have been fully implemented. Risk exposure resulting from the operation of the BK@1 and PTS software solutions is sufficiently covered through the regular operational processes.

Within the framework of a project scheduled to run until April 2017, Aareal First Financial Solutions AG is currently working on the technical infrastructure required to adequately meet the strategic, functional and technical requirements for a future banking portal: all current access rights for customers and account managers have been reviewed, island applications and systems are being gradually replaced, migrated or integrated; in addition, value-added functionality such as an electronic mailbox is being implemented.

The company's Management Board applies a standardised project risk management methodology, whereby risks are assessed monthly on a qualitative level, in order to identify any risks at an early stage and take appropriate counter-measures. Monthly project status reports are assessed by the management bodies identified within the framework of Aareal First Financial Solutions AG's project management system. This allows for continuous monitoring, facilitating swift counteraction if necessary.

Company management receives comprehensive monthly reports covering the level of rendered and responsible production, which includes the provision and maintenance of applications and products, the hotline, and the provision of support services for operations.

A standardised procedure for the management of operational risks is being consistently applied. The results of regular risk inventory surveys and self-assessments regarding operational risks yielded no indication of risks or threats which are material or would jeopardise the continued existence of the business.

Aareal First Financial Solutions AG acts on behalf of Aareal Bank, within the scope of agency agreements in place. Aareal First Financial Solutions AG has outsourced its print server system, as well as host and server platform operations, to Aareon AG. Regular discussions are held with both contracting parties on the topics of request management, change management, and active control of outsourced activities.

Aareal First Financial Solutions AG regularly reviews the emergency scenarios it considers relevant; contingency plans are verified using BCP testing.

The market risk regarding utilisation of BK 01 solutions was mitigated by developing interfaces to relevant third-party systems on the market, such as SAP or platforms developed by other software providers to the commercial housing sector, alongside connectivity to Aareon' AG's systems. These interfaces are refined on an ongoing basis.

Deutsche Bau- und Grundstücks-Aktiengesellschaft

Deutsche Bau- und Grundstücks Aktiengesellschaft ("BauGrund") looks back on a track record – either directly or through its subsidiaries – covering more than eight decades in the property management sector. The business focus is on commercial and technical property management, primarily for residential property, but also for commercial and special property. BauGrund also manages properties on behalf of third parties according to the Residential Property Act (Wohnungseigentumsgesetz – "WEG").

BauGrund manages properties on behalf of the German federal government, institutional investors and companies, and for private investors including home owners' associations. The company's key risk factors are developments in the German property market, particularly regarding residential property investments, which in turn influence the behaviour of BauGrund's private, institutional and public-sector clients. In light of the low interest rate environment and the greater interest shown in tangible assets as a result of the sovereign debt crisis, it is fair to expect stronger construction activity on the German residential property market for the foreseeable future. Accordingly, the demand for property management services is likely to be stable or to slightly rise. Given the increasingly systematic workflows employed by the majority of market participants and the ongoing efficiency enhancements of all process steps (in an industrial business environment), service quality demands are set to rise further. However, clients are not expected to accept corresponding price increases.

To counter the risk of shrinkage in the managed portfolio, the activities were focused on stabilising and securing these portfolios. In addition, the company has revised its sales concept in order to originate further attractive follow-up orders from existing clients, targeting both institutional investors as well as private customers. BauGrund plans further investments, especially to enhance efficiency, in order to sharpen the company's profile as a quality provider with nationwide coverage.

Going forward however, there is a distinct expectation that property managers who fail to deliver the service standards demanded by clients stand to be replaced in the near future. This offers BauGrund potential for acquisitions, which has been reflected in the steady acquisition of new orders: the company was able to acquire new business of approximately € 1.6 million during 2015, which impacted income in 2016. The majority of BauGrund's existing contracts were largely secured. As a result, revenues for 2016 continued to rise year-on-year.

Other risks

Definition

Aareal Bank uses the category of "other risks" to aggregate those types of risk that cannot be quantified exactly: primarily, this includes reputational and strategic risks.

Reputational risk is defined as the risk of events that negatively affect the Bank's reputation with investors, analysts, or clients.

Strategic risk is typically associated with the threat of incorrect assumptions regarding market developments, burdening a bank's performance as a result.

Risk measurement and monitoring

The Bank has defined a suitable early-warning system – focusing on media observation/social media, client/staff and investors/analysts – that is designed to assess reputational risks. By analysing the early-warning indicators and deploying experiences already gained by the Bank, the Management Board can take a proactive stance in relation to potential reputational risks.

Other risks are predominantly managed and monitored through qualitative measures. A Group-wide Code of Conduct sets the framework regarding integrity and professional conduct for all activities. The Code provides a standard that is binding for all employees of Aareal Bank Group – regardless of position, and hence, including members of the Management Board or supervisory bodies. Accordingly, the Code defines the fundamental standards for the conduct of each individual employee. Each employee or member of an executive body is personally responsible for complying with this Code of Conduct. Aareal Bank Group ensures compliance with these standards, employing its internal facilities and organisational units (including, in particular, Internal Audit and Compliance/Anti-Money Laundering/Data Protection). Managers are responsible for raising staff awareness within their area of responsibility.

Aareal Bank's Management Board is responsible for managing strategic risk; it coordinates its actions with the Supervisory Board. The Management Board is supported in this task by the various divisions, for instance, via the continuous monitoring of trends which may be relevant to business policy.

Accounting-related Internal Control and Risk Management System

Tasks of the accounting-related Internal Control System (ICS) and the Risk Management System (RMS)

The accounting-related Internal Control and Risk Management System includes principles, procedures and measures to ensure the effectiveness and the efficiency of internal and external accounting, in accordance with applicable legal provisions. The tasks of the accounting-related Internal Control System mainly include ensuring proper conduct of business activities, guaranteeing proper internal and external accounting, as well as ensuring compliance with relevant statutory and legal requirements applicable to the Company.

The objective of the accounting-related Risk Management System is to identify, assess and limit risks which may impede the compliance of the financial statements with applicable rules and regulations. As with any other Internal Control System, the accounting-related ICS and RMS may only provide reasonable – but not absolute – assurance with regard to achieving this objective, regardless of how much care is used to design and operate this system.

Organisation of the accounting-related ICS and RMS

The Internal Control System of Aareal Bank takes into account the principles established by the Minimum Requirements for Risk Management (MaRisk) related to company-specific design of the ICS. The design of this Internal Control System comprises organisational and technical measures to control and monitor the Company's activities, covering all entities of Aareal Bank Group. The Management Board of Aareal Bank AG is responsible for designing, implementing, applying, developing and reviewing an appropriate accounting-related Internal Control System. The Management Board makes decisions as regards the scope and the design of specific requirements; it has defined the responsibilities for the individual process steps in connection with accounting by means of organisational guidelines, and has delegated these responsibilities to individual organisational units.

Aareal Bank prepares its consolidated financial statements in accordance with International Financial Reporting Standards (IFRSs). The Finance division controls Group accounting processes and is responsible for ensuring compliance of Group accounting with legal requirements, as well as with any further internal and external provisions. Based on the IFRSs, the Finance division establishes accounting-related requirements that have to be applied consistently throughout the Group. These requirements are set out in the IFRS Group Accounting Manual.

Aareal Bank Group entities prepare an IFRS package as at the relevant balance sheet date. This includes financial statements prepared under IFRSs and in accordance with the IFRS Group Accounting Manual, as well as the Notes and consolidation information (intercompany balances). All packages are recorded by the Finance division in a consolidation software and aggregated for the purpose of preparing the consolidated financial statements. The number of employees within Aareal Bank's Finance division is adequate, as are their qualifications. Furthermore, they possess the necessary knowledge and experience relevant for their functions.

The Supervisory Board is responsible for monitoring the Management Board. It approves both the single-entity financial statements of Aareal Bank AG and the consolidated financial statements. Measures taken by the Supervisory Board to ensure an efficient performance of its control functions include the establishment of an Audit Committee, which is primarily responsible for financial reporting issues and monitors the effectiveness of Aareal Bank's Internal Control System. The committee analyses and assesses the financial statements submitted to it, the internal risk reports, and the annual Internal Audit report. In addition, the Audit Committee is responsible for determining the focal points of the audit, as well as for evaluating the auditors' findings. The Audit Committee includes an independent finance expert, pursuant to section 100 (5) of the German Public Limited Companies Act (Aktiengesetz – "AktG").

Internal Audit also has a process-independent monitoring function. It reports directly to the Management Board, and provides auditing and consulting services which are designed to optimise Aareal Bank's business processes with regard to accuracy, safety and efficiency. The Internal Audit division supports the Management Board by evaluating the effectiveness and appropriateness of the process-dependent Internal Control System and of the Risk Management System in general. Any detected weaknesses regarding the identification, evaluation and reduction of risks are reported and addressed within the context of specific action plans.

Internal Audit also performs Group audit functions for Aareal Bank's subsidiaries, within the context of the Group's risk management. The audit activities of Internal Audit comprise all of the Group's operational and business processes, and are carried out using a risk-based approach. The review of the risk management's effectiveness and appropriateness covers the risk management and risk control systems, reporting, information systems, and the accounting process. To perform its tasks, Internal Audit has full and unrestricted information rights with respect to activities, processes and IT systems of Aareal Bank AG and its subsidiaries. Internal Audit is informed on a regular basis about material changes related to the Internal Control and Risk Management System.

The review of process-integrated controls conducted by Internal Audit is based on a set of internal regulations, procedural instructions and guidelines of Aareal Bank Group. The audit activities of Internal Audit comprise all of the Group's operational and business processes, and are carried out using a risk-based approach.

Components of the accounting-related ICS and RMS

Within Aareal Bank, various measures related to the Bank's organisational structures and workflows help to fulfil the monitoring duties within the framework of its Internal Control System.

A prerequisite for the monitoring system to work efficiently is a written set of procedural rules governing the distribution of tasks between the individual divisions and the scope of the respective activities. The organisational structure of the Finance division is set out in the Bank's organisational guidelines. Aareal Bank's accounting system is structured observing the principle of separation of functions. The functional separation makes for a split between operative and administrative roles, and is designed to ensure a sufficient level of control. In addition, the preparation of the consolidated and the single-entity financial statements is carried out in distinct units.

Various guidelines exist for activities and processes. These guidelines are set out in the Written Set of Procedural Rules of Aareal Bank and available for inspection to all employees. There are requirements as regards data entry and control – as well as data storage – which have to be observed in general by all of the Bank's posting units. If necessary, results are reconciled across divisions or companies. Uniform accounting methods and measurement techniques are guaranteed through guidelines applicable throughout the Group. The requirements of these Group-wide guidelines substantiate legal provisions, and are adjusted on an ongoing basis to take current standards into account. The valuation techniques used, as well as the underlying parameters, are controlled regularly, and adjusted if necessary. For further information on measurement, please refer to the relevant Notes to the consolidated financial statements.

In addition, the Bank's Risk Manual summarises the material elements of Aareal Bank Group's Risk Management System. Specifically, the Manual describes the organisational workflows as well as methods and instruments used in the context of risk management. In this context, reference is made to our explanations in the Risk Report.

Clearly-defined rules as regards delegation of authorities facilitating the allocation of professional responsibilities also contribute to reliable financial reporting. Any decisions taken are always based on relevant authorities. Internal controls defined on the basis of risk considerations are embedded in the accounting process. Compliance with the principle of dual control in all material processes is one of the principles for ensuring accurate accounting. Where no integrated approval system/ dual control feature has been implemented in the Group accounting IT systems for material transactions, this has been integrated and documented in the manual process workflows.

Adherence of Group accounting to generally accepted accounting principles is ensured by both preventive and detective controls within the accounting process itself, as well as through a comprehensive review of processed data. The preparation of the consolidated financial statements is characterised by multiple analyses and plausibility checks. Besides the evaluation of individual accounting issues, these include comparisons of periods, and between plan and actual data. Adequate control processes have been implemented for both manual and automated accounting transactions.

In order to increase the level of control quality, all relevant divisions are involved in the reconciliation process. An example of cross-divisional reconciliation is the process for the preparation of annual and interim reports. All divisions involved must ensure and (prior to preparation by the Management Board) confirm the quality of the sections of the reports they are responsible for. This represents an additional control level for the data to be disclosed.

In terms of organisational workflows, the accounting-related Internal Control and Risk Management System is based on a comprehensive standardisation of processes and software. Aareal Bank Group uses both standard and customised software. The consolidation software provides technical support to the reconciliation of Group-internal relationships, in a clearly-defined process. The data of the units included is reported using a uniform standardised chart of accounts. The Group's accounting-related IT systems were designed in such a way that both manual controls and automatic plausibility checks are performed for material technical and procedural system steps of the applications used. The controls in relation to processing within the IT systems are also integrated in the processes, as well as being independently performed. Process-integrated controls comprise, for example, the review of error and exception reports or the regular analysis of internal service quality. In contrast, IT reviews are conducted independently from processes, by Internal Audit.

Data and IT systems must be protected from unauthorised access. A differentiated access authorisation concept is in place for the systems used for finance and accounting, preventing manipulation of data by unauthorised parties. Authorisations are allocated to responsible employees, reviewed regularly, and adjusted if necessary in accordance with internal criteria.

Aareal Bank reviews its accounting-related Internal Control and Risk Management System on an ongoing basis. Necessary adjustments are made with respect to the accounting process based on the Bank's reviews. Adjustments may have to be made, for example, in connection with changes in the Group structure, to the business model, or new legal requirements.

Aareal Bank has to comply with legal requirements. If these requirements change, for example in the form of new laws or changes in accounting standards, the processes or IT systems will be adjusted as required in separate projects across divisions – based on a clearly-defined allocation of functions, and the accounting-related Risk Management System will be adjusted to take the amended rules into account. Current developments of statutory and legal provisions applicable for Aareal Bank AG are constantly monitored and reported, not only by the responsible division, but also by a steering committee established by the Bank. This committee also initiates any required adjustments to be made to systems and processes, and reports the results to the Management Board.

Report on Expected Developments

In the Report on Expected Developments, we present the macro-economic environment as well as sector-specific and business developments, including Group targets, considering the resulting opportunities.

Macro-economic environment

The macro-economic environment continues to be exposed to high risks and uncertainties. These also impact on the commercial property markets and can influence their development in the future. Besides economic components such as weak investment and stagnating global trade, we also see the threat of geopolitical danger – especially due to terrorism. Overall, there is a risk of global political stances shifting towards protectionism and demarcation.

The focal point continues to be the low interest rate environment, which harbours risks for financial stability of a systemic dimension. Low interest rates can lead to a misallocation of investment capital, possibly resulting in asset-price bubbles. Moreover, market participants might be encouraged to take on higher levels of risk. Sudden changes in interest rates may trigger a revaluation and changes in investor behaviour, potentially leading to a collapse in asset prices. A longer-lasting period of low interest rates may delay an exit from such an environment, heightening the risks for the financial and capital markets. Low interest rates may also entice a scaling back of reform and consolidation efforts in various sectors.

A sharp increase in interest rates entails considerable risk: an excessively quick rise can hamper investments, have negative implications for asset prices, and impact other regions. The latter concerns in particular the emerging economies that need to face capital outflows, and which may have to raise their own interest rates. Although financial market players have been expecting interest rates to rise further in the US for some time now, the extent – and possible resulting financial market volatility – is still an unknown factor. Turmoil in the financial and capital markets may still hurt the global economy.

A major risk factor in Europe is the UK's exit from the EU (Brexit). Despite the minimal economic impact this had in 2016, we continue to see a high level of economic risk for the UK, as well as for the EU. Besides the possibility of a split of the UK itself, another risk factor is the breakup of the EU. The referendum on reforming the Italian senate that was rejected in December 2016, and the forthcoming presidential or parliamentary elections in some European countries are both fuelling uncertainty.

The sovereign debt crisis might potentially raise its head again in Europe: the problem of high levels of indebtedness is still there, and has not been resolved once and for all. The diverging monetary policy between the US and the euro zone could heighten the risk.

There is a danger that the residential property boom in China and the sharp increase in levels of private debt could lead to a pronounced market correction. Overall, there is a threat of substantial capital withdrawal from the emerging markets, with far-reaching negative consequences for the global economy.

Economy

Global economic development shows a mixed picture. We predict that economic development will be weaker in Europe compared with North America and the Asia-Pacific region. Taking into account the aforementioned threats and risks, economic development might turn out to be weaker across all regions, or even lead to a recession. The threat of protectionist measures in some regions might – through the trade channels - influence the entire global economy.

We forecast stable growth for the euro zone in 2017, that will be down slightly on 2016. Despite weak global trade and uncertainty factors as well as risks, we anticipate robust growth. Political risk will be a key issue for the euro zone in 2017, with elections to be held in several of the big euro zone countries. Stable fundamental data is expected to lead to a further slight decline in unemployment. In this environment, we expect economic growth in France to pick up slightly compared with 2016, while growth in Italy should remain weak, and slightly below 2016's levels. We forecast growth in Germany, the Netherlands and Spain to be slightly weaker than in 2016.

We envisage slightly higher growth for the EU overall than in the euro zone. The uncertainty about the specifications and negotiations surrounding the planned Brexit is determining the economic outlook in the UK. The sharp depreciation of pound sterling vis-à-vis the euro and the US dollar as a consequence of the Brexit vote will support exports this year. Higher inflation and ongoing uncertainty make it likely that the support provided by private consumption to date will ease. The economy will therefore grow at a slower pace than in 2016, and the labour market could slow down due to the uncertainty factors. We expect a distinct strengthening of the Danish economy in 2017. With domestic demand remaining the sole driver of growth in Poland, the growth rate will remain in line with the previous years' levels. After several particularly strong years in Sweden, growth momentum is expected to slow down, on robust fundamental data.

In light of the political uncertainty, we expect weak growth for Turkey at the level seen in 2016. A fragile recovery, with slightly positive growth, can be expected for Russia – following two years of recession.

We anticipate the newly-elected US administration to pursue a more expansionary fiscal policy, embarking upon a series of structural reforms in 2017, including tax cuts. Economic growth will rise moderately compared with 2016. As in 2016, growth will be supported mainly by private consumption, so that additional investment will be expected from the private sector this year. Owing to the uncertainty about protectionist plans, and the new administration's further political measures, the outlook is clouded by a high degree of uncertainty.

The economy will remain weak in Japan, and will grow at the same low level that was seen in 2016. It will be supported by a current economic programme.

We anticipate a slight fall in the growth rate in China in the course of reducing excess capacity this year. The outlook is slightly uncertain in light of future trade relations with the US.

Financial and capital markets, monetary policy and inflation

We anticipate moderate volatility on the financial and capital markets this year, as well as a steeper euro zone yield curve compared with the previous year. However, the markets will remain liquid and receptive.

As far as monetary policy is concerned, we predict further divergence in polical trends in the relevant currency areas. We expect a moderate rise in the key interest rate in the US, and therefore a continuation of the moderate shift away from the expansionary monetary policy. In the euro zone, quantitative measures will remain in place, given the extension of the securities purchasing programme at least until the end of December 2017. An increase in the key interest rate for the euro zone is not expected this year, so that monetary policy will remain extremely expansionary. However, developments in the US and a reduction in the volume of securities purchased by the ECB might nonetheless drive up government bond yields. The Bank of England (BoE) will take its cue from the consequences of the Brexit vote. We do not anticipate any further expansionary measures, as the BoE will be faced with higher inflation and a weaker currency – as expected. The positive economic development in the UK supports the cautious attitude of the BoE.

The US dollar is expected to make further moderate gains over the euro in the medium term, owing to the expansionary fiscal policy and expectation of rising key interest rates in the US. On the other hand, any appreciation should be stemmed by the higher expected US budget deficit.

The pound sterling will remain weaker against the euro than in the past years as a result of the UK's Brexit vote. Besides political uncertainty, the very negative current account balance will also be felt here. On the other hand, the currency is being supported by the surprisingly good economic situation.

The Danish krone remained in a fixed exchange rate regime relative to the euro with very little change in the exchange rate. We do not anticipate any appreciable volatility for the current year.

The Swedish krona has depreciated considerably against the euro in the past year. We expect the currency to stabilise in the current year, and to appreciate slightly versus the euro. The krona is supported by stable and strong economic growth, which is countered by the expansionary monetary policy.

Yields could rise moderately due to the developments described above; in this context, we see the long end of the euro zone yield curve being especially affected. The ECB's purchase programmes for various securities will continue to influence interest rates in the current year. Rising inflation expectations and the robust economy on the other hand might strengthen the upside pressure on interest rates, countered by the ECB's securities purchases. However, any upside pressure is expected to remain moderate. The covered bond market will be influenced significantly. Overall, the combination of low yields, growing ECB purchases and stricter regulatory requirements have increasingly curbed trading activity on the covered bond market over the last two years. This is unlikely to change much in the near future.

Basis effects and the dwindling effect of lower energy prices will drive up inflation significantly in the euro zone, to levels that significantly exceed the previous year. However, weak wage increases are likely to prevent the central bank's target of inflation at just under two per cent from being reached. Core inflation will remain low.

Thanks to healthy labour market data and a positive wage development, we anticipate significantly higher inflation in the US during the current year, compared with previous years. The announcement of a more expansionary fiscal policy also drove up inflation expectations sharply in the US.[1)]

[1)] Measured in terms of the US 5Y5Y forward swap (inflation expectation)

Inflation in Japan remains close to zero and is therefore well below the target of two per cent stated by the central bank in January 2013.

Regulatory environment

The trend towards a tighter regulatory framework in the banking business is set to persist during the coming years. Numerous initiatives, such as the revision of the Credit Risk Standard Approach (CRSA), the Internal Ratings-based Approaches (IRBA) and the basic approaches for operational risk and the capital floor rules are currently being discussed, for example. EBA has also finalised its Guidelines on the collection of information related to the Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP).

The ECB will also review the internal model of Pillar I (Targeted Review of Internal Models) in 2017, whose exact impacts on banks – and the consequences – cannot be fully assessed at present.

Regulators have yet to come up with final details for some of these additional regulatory requirements; hence, various technical standards, guidelines and regulations still have to be finalised. In addition, EBA published a consultation paper in November 2016 on "Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures". The EU Commission made proposals to revise supervisory regimes (CRR, CRD IV, BRRD and SRMR) that implement in particular international banking supervision rules of the Basel Committee and the FSB (Financial Stability Board) in Europe.

To facilitate the timely implementation, we have already continued to pursue the individual issues in numerous projects – devoting considerable resources to this task.

Moreover, the increasing volatility of requirements presents an additional challenge for institutions: besides the new requirements mentioned by way of example, this volatility is particularly a function of the concrete specifications for instruments implemented by the ECB and/or the national supervisory authorities. For instance, the capital buffers to be set on a national level (the anticyclical buffer and especially the buffer for systemic risks), or the annual results of the Supervisory Review and Evaluation Process (SREP) for individual banks can only be planned to a certain extent. Moreover, these instruments may lead to changes in a bank's individual capital requirements, at short notice.

Sector-specific and business developments

Structured Property Financing segment

Commercial property continued to be a sought-after asset class in 2016, despite the different appetites for risk amongst investors. We expect this trend to continue, and to be reflected in transaction volumes.

Transaction activity worldwide will, in our view, decline further in the current year. The quest for yield will not ease much, despite the growing attraction of alternative investments, as commercial property will largely continue to offer a strong yield pick-up over comparable investments.

Several factors will impact on the value of commercial property in the current year. Whilst the low interest rate environment will continue to prevail, alongside a stable economy with gradually improving labour market figures, the market faces greater uncertainty factors, both political and otherwise.

We therefore anticipate a largely stable development in the market values of commercial property in many markets this year. However, the combination of the existing low interest rate environment and adjustments to the (often very low) returns on investment, given potential interest rate hikes, pose the risk of a correction to the market values of commercial property.

We expect a stable performance in most European countries in 2017. Deviating from this, we expect a slightly positive development owing to the good economic situation in Denmark and Spain. The situation in the UK is subject to uncertainty because of the Brexit vote. Values could fall in some sub-markets although we anticipate a stable development overall. Property values in some sub-markets in Turkey might be negatively influenced by political uncertainty and the tense security situation.

We forecast a stable performance for example in Germany, France, Italy, the Netherlands and Poland.

Following the sharp decline in property values in Russia in recent years, we believe these will stabilise in the current year due to the slight economic recovery. Ongoing difficult international relationships and uncertainties arising from the Syrian and Ukrainian conflicts could continue to burden the situation.

Property values in the US are expected to develop slightly positively, thanks to the relatively favourable economic outlook. Rising interest rates pose a certain risk for this development, while the property markets should benefit from the expansionary fiscal policy the new administration is expected to pursue. We expect a stable performance in Canada.

Developments in commercial property values are likely to vary in Asia. Stable values are expected in China and Singapore, while prime commercial property values could continue to rise further in Japan as interest rates remain low.

The trends described above are expected to apply to office, retail and logistics properties.

We expect varied developments in 2017 on the hotel markets of Europe's most significant economic centres. Brussels and Paris should see a slight increase in the occupancy ratios and average revenues per available room. As we see it, occupancy ratios should be stable in the other big European cities with slightly higher average revenues per available room. The difficult political situation in Turkey will continue to have negative implications for the hotel markets: hence, we do not anticipate any substantial recovery in the current year.

We believe a slight improvement on average in revenues per available room is likely in North America, with stable or slightly lower occupancy ratios.

We see the hotel markets in the large Asian cities as being stable. Seasonal volatility is highly likely in all markets in 2017.

The intense competition of previous years is also likely to persist in many markets during the current year, with less of an incentive to lower the margins. We do not anticipate any notable increases in loan-to-value ratios.

Interest amongst financiers to provide finance for first-class properties in top locations will remain high. However, the limited supply of these kinds of property in some markets will restrict the financing options.

Aareal Bank takes property market developments into account for its ongoing risk monitoring. Within the framework of orienting its lending policies, Aareal Bank monitors expected diverging developments in different countries. It also performs regional analyses within these countries.

We are planning our new business for the coming financial year on the basis of various market aspects. In the Structured Property Financing segment, we aim to generate aggregate new business of between € 7 billion and € 8 billion. Aareal Bank Group's property financing portfolio is expected to be in the region of € 25 billion to € 28 billion, subject to currency fluctuations. The Bank plans to expand its US portfolio, within the scope of the "Aareal 2020" programme for the future, increasingly managing this portfolio (and the associated risks) by way of syndication. Syndication is a suitable tool, which also offers scope for providing larger-scale financing solutions.

The forecasts are based on the assumption that the macro-economic risks and uncertainty factors described above will not materialise to a significant extent, or only in a manageable manner: otherwise, they might influence business development, for example, in terms of new business.

Consulting / Services segment

Bank division Housing Industry

We expect the stable development of the German housing and commercial property industries to prevail throughout 2017. This stability is largely due to the mainly constant rental income and the high stability of property values.

In addition to implementing the energy turnaround in buildings, the impact of demographic change and immigration requires the industry to make additional investment. Additionally, new construction projects, above all in the conurbations, will come under scrutiny.

The industry's future investment activities will be closely connected with the political environment and its impact on the profitability of any projects undertaken. Increased requirements of energy measures or changes to the modernisation levy could have a dampening effect on investment.

Given the stable German economic framework, we assume that developments on the German housing market are likely to remain stable. Rental growth will continue to be highest in cities with growing populations and high economic output. This trend will be beneficial to property investors and potential sellers within the housing and commercial property industries.

We see good opportunities during 2017 to acquire new clients and to intensify the business relationships with our existing client base. We will also benefit from the product innovations in 2016, such as BK 01 eConnect, which facilitates the total automation of invoicing and settlement, as well as internet applications that can further streamline and speed up our client's processes.

Looking at the volume of deposits taken, we expect the positive trend to continue, particularly in relation to current account balances and rent deposits, in line with the Aareal 2020 strategic agenda. The persistent low interest rate environment, which is relevant for the results from our deposit-taking business, will continue to place a significant burden on segment results. However, the importance of this business goes way beyond the interest margin generated from the deposits, which is under pressure in the current market environment. This is because the deposits from the housing industry represent a strategically important additional source of funding for Aareal Bank.

Aareon

Aareon will continue in 2017 to pursue the growth strategy based on its strategy programme integrated in the "Aareal 2020" programme for the future. Consolidated sales revenues are expected to rise slightly, accompanied by an almost steady contribution to Group results. The expansion of the digital solutions of the Aareon Smart World portfolio of products, strengthening the ERP business and tapping new areas of business will be the key growth factors. We will continue to invest in the expansion of Aareon Smart World as well as in measures to enhance performance and efficiency.

Aareon anticipates its advisory business to expand in Germany as the migration of GES clients to the Wodis Sigma ERP solution proceeds as planned. We also believe that sales revenues with digital solutions will continue to grow in 2017 as the topic has considerably gained in importance in the housing industry alongside customer interest.

Aareon expects to increase its advisory business in the Netherlands by further penetrating the market for digital solutions, in particular. For Aareon France, we expect the positive trend in maintenance will continue together with a decline in the licensing business due to the cyclical release planning. Very strong growth in sales revenue is also expected of the digital solutions on the back of further market penetration. A sharp increase in the advisory and licensing business for the ERP solution QL is expected in the UK for 2017, while the new ERP product generation QL.net should also be established further in the market. The demand for digital solutions – including the 1st Touch mobile solution, 360° Tenant Portal and the tenant portal – is expected to increase further here too. The Swedish Incit Group is expected to increase sales revenues stemming from Incit Xpand, in particular through a rise in business with new clients in the Scandinavian markets and, as a consequence, a more dynamic advisory business.

In view of the aforesaid, Aareon expects a slight increase in sales revenues for 2017, together with a contribution to consolidated operating profit of between € 34 million and € 35 million.

Group targets

We expect the competitive environment to remain challenging during the current financial year 2017, with a continuation of diverging developments in the key economic regions. The low interest rate environment is likely to persist during 2017. Whilst financial markets participants expect further interest rate increases in the US, as well as a steepening of the yield curve in the euro area, the scope of such changes – and the resulting volatility on the financial markets – remain difficult to predict. In a highly competitive environment, commercial property is likely to remain a sought-after asset class during the current financial year.

We will adhere to our selective strategy in originating new business, with active portfolio management, in 2017. As in the previous year, the Bank will expand in growing markets with attractive margins, in a targeted manner.

Consolidated net interest income is expected to decline to between € 620 million and € 660 million, largely due to the continued, scheduled reduction of non-strategic portfolios in the entities acquired over the past two years. Allowance for credit losses is expected to be in a range between € 75 million and € 100 million during 2017, once again reaping the benefits of a prudent risk policy over recent years. Net commission income is projected to be in a range between € 195 million and € 210 million, slightly above the previous year's level. Administrative expenses are expected to fall, to a range between € 470 million and € 510 million, in spite of expected project costs and substantial forward-looking investments, such as for realigning the Bank's IT infrastructure.

We therefore expect to generate a good consolidated operating profit during the current year, in a range between € 260 million and € 300 million – in a demanding environment. We anticipate Return on Equity (RoE) before taxes of between 9.0 % and 10.5 % for the current financial year, with earnings per share (EpS) between € 2.45 and € 2.90. We affirm our medium-term target RoE of at around 12 % before taxes.

In the Structured Property Financing segment, the credit portfolio is projected at between € 25 billion and € 28 billion by the end of 2017, subject to currency fluctuations. We are targeting new business between € 7 billion and € 8 billion in the current year. In the Consulting / Services segment, we expect our IT subsidiary Aareon to contribute between € 34 million and € 35 million to consolidated operating profit.

Given prevailing uncertainty with regard to future regulatory requirements as well as any potential deterioration to economic developments, and considering our dividend policy, we project the fully-phased in Common Equity Tier 1 ratio (CET 1 – assuming full implementation of Basel III) by the end of 2017 to be moderately higher than the current level of 15.7 %. Further, we expect the Liquidity Coverage Ratio (LCR), which should be at least 100 %, to largely remain at a very high level.

Corporate Governance Statement pursuant to Section 315 (5) in conjunction with Section 289a of the HGB

Given the implementation of the EU Accounting Directive (2013/34/EU), a Corporate Governance Statement is required to be included in the Group Management Report for the 2016 financial year for the first time. The existing obligation to issue a Corporate Governance Statement, as part of Aareal Bank AG's Management Report, pursuant to section 289a of the German Commercial Code (HGB) remains in place. Pursuant to section 315 (5) sentence 2 of the HGB, the requirements of section 289a of the HGB must be applied, mutatis mutandis, to the Corporate Governance Statement at

Group level. Since Aareal Bank AG is the only listed Group entity, and also the Group's parent undertaking, only one Corporate Governance Statement will be issued.

The Corporate Governance Statement is available to the public on the Company's website on http://www.aareal-bank.com/en/about-us/corporate-governance/. Please refer also to the "Transparency" section.

Principles of Remuneration of Members of the Management Board and the Supervisory Board

The Supervisory Board determines the structure and amount of remuneration for members of the Management Board.

The Remuneration Control Committee (Vergütungskontrollausschuss) fulfils the requirements according to section 25d (12) of the German Banking Act (Kreditwesengesetz – KWG) and section 15 of the InstitutsVergV, and held six meetings throughout the 2016 financial year.

The Supervisory Board defines before the beginning, but no later than immediately after the beginning of every financial year, the Management Board members' targets regarding the performance-based remuneration components. The Supervisory Board assesses Management Board members' success and performance after the end of every financial year.

Aareal Bank AG has entered into fixed-term service contracts with the members of its Management Board. Besides their fixed annual salary, Management Board members receive a performance-related remuneration that is determined using an assessment basis extending over several years.

The level of this performance-related remuneration is determined by reference to the personal performance of each Management Board member, which is measured by the degree to which targets set in advance by the Supervisory Board are achieved, based on contractually agreed initial values for a 100 % target achievement. The targets which are relevant for performance-related remuneration include annual targets and multiple-year targets. The measurement of the multiple-year target is now undertaken retrospectively over a time period of three years. The weighting of annual to multiple-year targets is fixed for each financial year, with a weighting of 45 % (annual target) to 55 % (multiple-year target) taken as a guideline. Until now, the target system envisaged a weighting of 60 % for the annual target and 40 % for the preceding three-year target period.

For each financial year, the Supervisory Board sets a target level for the Common Equity Tier 1 ratio (CET 1 ratio) as the measurement threshold in order to secure adherence of the regulatory capital adequacy and a suitable liquidity measure (Liquidity Coverage Ratio – LCR). No variable remuneration will be determined for any financial year where these two targets have not been achieved. The Supervisory Board also defines the sectional and individual targets for every member of the Management Board, for each financial year.

Annual targets and multiple-year targets are integrated into the Bank's overall strategy and are geared towards achieving the objectives set out in the Bank's business and risk strategies. The targets comprise quantitative components and qualitative components, which are also related to non-financial parameters. In this context, the Group's overall performance, the performance of the section the Management Board member is responsible for, and the individual performance contributions of the Management Board member concerned, are all taken into consideration, with a weighting of one-third for every component towards the annual target. Aareal Bank Group's overall performance is determined using the categories of consolidated operating profit/loss before taxes and risk-weighted assets.

The initial value of the performance-related remuneration may increase – depending on the Management Board member's degree of target achievement – up to a maximum of 150 % of the target value. If the overall target achievement level exceeds 150 %, the initial value of the performance-related remuneration will not increase any further (cap). If the overall target achievement level is 0 %, no performance-related remuneration will be awarded for the financial year concerned. Unconscionable behaviour or behaviour in breach of duties cannot be balanced out by positive performance contributions in other areas and will automatically lead to an appropriate reduction in the variable remuneration. The variable remuneration generally depends on the Supervisory Board's decision to provide for the applicable financial year an amount (mathematically) sufficient for all variable remuneration components to be paid out accordance with section 45 (2) sentence 1 no. 5a of the KWG and section 7 of the InstitutsVergV.

To ensure that the remuneration system provides long-term incentives, variable remuneration is awarded at the end of the financial year, according to the following principles:

20 % of the variable remuneration is paid out in cash (cash bonus) after the Supervisory Board has determined the overall target achievement level. A further 20 % of the variable remuneration is awarded as a share bonus subject to a holding period (and forms part of the share-based bonus plan), in the form of virtual shares, also after the Supervisory Board has determined the overall target achievement level. 30 % of the variable remuneration is retained (cash deferral) and disbursed in equal proportions over a three-year period. The remaining 30 % of variable remuneration is credited, as a cash amount, to a virtual account maintained on behalf of each Management Board member, and forms part of the share deferral plan.

With regard to the portion of the variable remuneration that is deferred initially as a cash deferral or a share deferral, the Supervisory Board makes a decision regarding the granting of one third of the amount, as well as the associated interest, in the three years following the determination of the performance-related remuneration (retention period). Until the end of the retention period, there is no right to the relevant remuneration components. Once the deferred remuneration components for Management Board members are vested, the cash deferral is paid out in cash and the share deferral is converted into phantom shares, subject to a two-year holding period.

In making its determination about the amount to be awarded, the Supervisory Board particularly takes into account any negative aspects of the Management Board member's performance, that of his section, as well as any weakness in the performance of Aareal Bank Group (backtesting). The existence of a negative aspect in the performance of a Management Board member is to be assumed, in particular, if serious breaches of duty and/or performance deficiencies are discovered, which lead to the performance contributions – which were initially assumed to be positive – being later shown to have not been sustained. A negative performance contribution on the part of the section within the respective Management Board member's responsibility, or of Aareal Bank Group, is to be assumed if significant assumptions which formed the basis of the calculation of the variable remuneration are later proven to be incorrect or unsustainable. The Supervisory Board may award the deferred variable remuneration components in full, partially, or not at all. If the full amount of the bonus is not awarded, the remaining sum is forfeited, i.e. it is not carried forward into subsequent years. An award of the deferred variable remuneration components will not be made insofar and for so long as the German Federal Financial Supervisory Authority ("BaFin") forbids this according to section 45 (2) sentence 1 nos. 5a and 6 of the KWG. The entitlement no longer exists if BaFin so orders by way of a final and conclusive decision pursuant to section 45 (5) sentences 5 to 8 of the KWG.

A variable remuneration component may not be vested (share deferral) or disbursed (cash deferral) if the Supervisory Board believes that the Management Board member's performance on the whole was so poor that it would make awarding performance-related remuneration inappropriate. In particular, this is to be assumed if significant breaches of the duty of care have been determined, which would give rise to an extraordinary termination of the appointment to the Management Board contract. Further, this is to be assumed if the member of the Management Board was causally and negligently actively involved in behaviour which has led to considerable losses, or for which losses the Management Board member was causally and negligently responsible.

The contracts of Management Board members prohibit them from undertaking to limit or override the risk orientation of their remuneration by initiating personal protection or countermeasures (hedging ban).

Remuneration for the services of the Supervisory Board members is specified in Article 9 of the Memorandum and Articles of Association of Aareal Bank AG.

The remuneration system for the Supervisory Board only comprises a fixed remuneration, supplemented by a compensation for attending meetings. In addition, the Supervisory Board members will be reimbursed for their expenses. Where membership in the Supervisory Board falls short of an entire financial year, said remuneration shall be paid on a pro rata temporis basis. Any value-added tax invoiced will also be deemed to be a refundable expense.

The fixed remuneration is € 50,000.00 p.a. for each Supervisory Board member. The Chairman of the Supervisory Board shall receive three times this amount, while the deputy shall receive one and a half times as much as a normal member. The fixed remuneration is increased for each membership in a committee (with the exception of the Committee for Urgent Decisions, which is part of the Risk Committee). This additional fixed remuneration amounts to € 20,000 p.a. for membership of the Risk Committee and the Audit Committee; fixed remuneration is increased by € 40,000 p.a. for the chairmanship of one of these committees.

Additional fixed remuneration for membership of the other committees amounts to € 15,000 p.a.; or € 30,000 p.a. for the chairmanship of such other committee. The meeting attendance compensation amounts to € 1,000.00 for each meeting attended (except for the Committee for Urgent Decisions).

The remuneration for any financial year shall be due and payable one month after the end of the respective financial year.

Please refer to the Notes to the financial statements (Remuneration Report) for further details about the remuneration system for members of the Management Board and the Supervisory Board of Aareal Bank AG as well as on the existing change-of-control regulations.

Explanatory Report of the Management Board on Takeover Disclosures in Accordance with Section 315 (4) of the German Commercial Code (Handelsgesetzbuch – HGB)

Composition of subscribed capital, and rights and obligations attached to shares

The composition of Aareal Bank AG's subscribed capital is shown in Note 60 ("Equity") to the consolidated financial statements. Each share casts one vote at a General Meeting. There are no shares with special rights granting supervisory powers to any shareholder or shareholder group. The Company currently does not hold any treasury shares, which would not be entitled to vote.

Restrictions affecting voting rights or the transfer of shares

The transfer and exercise of voting rights is governed exclusively by the legal restrictions. Voting rights are not limited to a certain number of shares, or of votes. All shareholders who have registered to attend a General Meeting in good time, and who have provided the Company with evidence of their shareholding and their right to vote, are entitled to attend the General Meeting, and to exercise their voting rights from all shares held and so registered. The exercise of voting rights from the shares concerned is precluded by law in the cases where section 136 of the AktG applies. Where the Company holds treasury shares, section 71b of the AktG prohibits the exercise of rights vested in such shares. We are not aware of any other restrictions affecting voting rights or the transfer of shares.

Shareholdings exceeding 10 % of voting rights

Details regarding any shareholdings exceeding 10 % of voting rights are provided in Note 94 to the consolidated financial statements.

Shares with special rights granting the holder supervisory powers

Aareal Bank AG's Memorandum and Articles of Association do not grant any shareholder the right to nominate members to the Supervisory Board, nor are there any other shares with special rights granting the holder supervisory powers.

Type of control of voting rights regarding shares held by employees with their rights of control not being directly exercised

There are no Aareal Bank AG shares held by employees where the rights of control cannot be directly exercised.

Statutory provisions, and provisions in the Memorandum and Articles of Association regarding the appointment and removal of members of the Management Board, and regarding amendments to the Memorandum and Articles of Association

The appointment and removal of members of the Management Board of Aareal Bank AG is carried out in accordance with sections 84 and 85 of the AktG and Article 7 of the Memorandum and Articles of Association, according to which the Management Board must have a minimum of two members. The Supervisory Board shall appoint the Members of the Management Board and determine their number. The Supervisory Board may appoint deputy members, and may appoint one member of the Management Board to be the Chairman of the Management Board. The members of the Management Board are appointed for a maximum term of five years. This term of office may be renewed or extended for a maximum of five years in each case.

Pursuant to section 179 of the AktG, the Memorandum and Articles of Association may be amended by way of resolution passed by the General Meeting. Resolutions of the General Meeting regarding amendments to the Memorandum and Articles of Association are passed by a simple majority of the votes cast, or – to the extent permitted by law – by the majority of the issued share capital present at the Meeting. In accordance with section 181 (3) of the AktG, such amendments become effective upon their entry in the Commercial Register. In the event of a capital change, the Supervisory Board is authorised to modify the wording of the Articles of Association in line with the amount of the capital change (Article 5 (7) of the Memorandum and Articles of Association).

Authorisation of the Management Board to issue or repurchase shares

Authorised capital

The Annual General Meeting held on 23 May 2012 resolved to authorise the Management Board to increase, on one or more occasions, the Company's share capital, subject to the approval of the Supervisory Board, by up to a maximum total amount of € 89,785,830 by issuance of new shares for contribution in cash or in kind; the Management Board is also authorised, within defined limits, to disapply pre-emptive rights, given the fulfilment of certain conditions. This authorisation will expire on 22 May 2017. When exercising this authorisation, the Management Board will restrict any exclusion of shareholders' pre-emptive rights to a total of 20 % of the Company's share capital. The authorised capital has not been utilised to date.

Conditional capital

Based on a resolution passed by the General Meeting on 21 May 2014, the Management Board was authorised to issue, on one or more occasions until 20 May 2019, profit-participation rights with a limited or unlimited term for contribution in cash or in kind in a total nominal amount of € 1,000,000,000. Holder or creditor conversion rights may be attached to such profit-participation rights, provided they are not issued against contribution in kind. Conversion rights may be attached exclusively to no-par value bearer shares and are limited to a maximum amount of € 89,785,830 of the Company's share capital. Issuance of profit-participation rights may also be effected by domestic or foreign enterprises in which the Company either directly or indirectly holds a majority interest. In such cases, the Company may itself assume guarantees and offer shares of Aareal Bank AG, subject to the approval of the Supervisory Board, in order to meet the resulting conversion rights. Subject to the approval of the Supervisory Board, the Management Board may exclude shareholders' pre-emptive rights for profit-participation rights in certain cases.

The issued share capital is subject to a conditional capital increase not exceeding € 89,785,830 by issuance of up to 29,928,610 new no-par value bearer shares ("Conditional Capital 2014"). The conditional capital increase shall be implemented only insofar as (i) the holders or creditors of conversion rights from convertible profit-participation rights issued by the Company (or by an enterprise in which the Company either directly or indirectly holds a majority interest) until 20 May 2019 on the basis of the Annual General Meeting's authorisation resolution of 21 May 2014 exercise their conversion rights or (ii) the holders or creditors of convertible profit-participation rights issued by the Company (or by an enterprise in which the Company either directly or indirectly holds a majority interest) until 20 May 2019 on the basis of the Annual General Meeting's authorisation resolution of 21 May 2014 and who are obliged to exercise those rights fulfil their obligation or (iii) the Company makes use of alternative performance; insofar as treasury shares are not used to service the rights or, in the aforementioned cases (i) and (ii), no cash compensation is granted. The new shares shall be entitled to a share in the profits from the beginning of the financial year in which they come into existence through the exercise of conversion rights or the fulfilment of conversion obligations. The Management Board is authorised to determine the details of the conditional capital increase.

Authorisation to purchase treasury shares

The General Meeting held on 20 May 2015 authorised the Management Board, pursuant to section 71 (1) no. 7 of the AktG, to purchase and sell treasury shares for the purposes of securities trading, at a price not falling below or exceeding the average closing price of the Company's share in Xetra trading (or a comparable successor system) during the three trading days on the Frankfurt Stock Exchange prior to the relevant transaction by more than 10%. This authorisation expires on 19 May 2020. The volume of shares acquired for this purpose must not exceed 5 % of the issued share capital of Aareal Bank AG at the end of any given day.

Furthermore, the General Meeting held on 20 May 2015 authorised the Management Board, pursuant to section 71 (1) no. 8 of the AktG, to purchase treasury shares with a volume of up to 10% of the issued share capital for purposes other than securities trading. This authorisation expires on 19 May 2020. Such purchases may be effected via stock exchanges or public purchase offers made to all shareholders, taking into account the prices as specified in the respective Annual General Meeting's resolution, which are in turn based on the Company's stock exchange share price. The authorisation may be exercised on one or more occasions, covering partial amounts or the total amount.

Subject to the approval of the Supervisory Board, the shares acquired under this or an earlier authorisation may be sold outside stock exchanges and without an offer to all shareholders, thereby excluding shareholders' pre-emptive rights, provided that the shares sold do not exceed the threshold value of 10 % of the Company's share capital and that the issue price is not significantly lower than the stock exchange price, or if the sale of such shares is made against contribution in kind, or if the shares are given to the holders of conversion or option rights, even if they had been issued by subsidiaries. The treasury shares may also be given to the holders of conversion or option rights in lieu of new shares from a contingent capital increase. The shares can be withdrawn, without this withdrawal or its implementation requiring a further resolution by the Annual General Meeting.

In addition, the Management Board was authorised to purchase treasury shares using put or call options. However, any and all share purchases involving the use of derivatives shall be limited to a maximum threshold value of 5 % of the Company's share capital. Moreover, such share purchases shall be taken into account with the 10% threshold value for the purchase of treasury shares as specified in the Annual General Meeting's resolution. Where treasury shares are acquired using equity derivatives, the shareholders' right to enter into any option transactions with the Company is excluded in analogous application of section 186 (3) sentence 4 of the AktG.

Material agreements which are subject to change of control clauses triggered in the event of a takeover offer

There are no material agreements which are subject to change of control clauses triggered in the event of a takeover offer. Any public offers to acquire the Company's shares are governed exclusively by the law (including the provisions of the German Securities Acquisition and Takeover Act), and the Memorandum and Articles of Association.

Compensation agreements entered into with members of the Management Board or employees in the event of a takeover offer

For details regarding compensation agreements entered into with members of the Management Board or employees in the event of a takeover bid, please refer to the Remuneration Report, which forms part of the Notes to the consolidated financial statements.