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

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's strategic business segments comprise commercial property finance as well as services, software products and digital solutions for the property sector and related industries.

Structured Property Financing

In the Structured Property Financing segment, Aareal Bank facilitates property investments 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 finances commercial property investments, especially for office buildings, hotels, retail, logistics and residential properties, with a focus on existing buildings. Its particular strength lies in its success in 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. In particular, the Bank excels with its structuring expertise, as well as in portfolio and cross-border financings.

Aareal Bank manages its sales activities in the individual regions worldwide via a network of sales centres (hubs), some of which have been reorganised since November 2017. In addition to the locally-based experts, the distribution centres for sector specialists covering hotels, shopping centres and logistics properties, as well as those catering to the specific needs of investment fund clients, are located in Wiesbaden.

There are now two regional hubs in Europe: one hub combines sales activities for the euro zone, with a focus on the Benelux countries, France, Germany, Italy and Spain. An additional hub focuses on sales activities outside the euro zone, with a focus on Central and Eastern Europe, Northern Europe, and the UK. As before, the hubs have a network – comprising numerous branches in Brussels, Paris, Rome, London, Stockholm and Warsaw – at their disposal. Representative offices are located in Madrid and Moscow. The Istanbul representative office is allocated to the specialist hub, reflecting the fact that this location is only active in financing hotels and shopping centres.

Aareal Bank Group's activities on the North American market are carried out through the subsidiary Aareal Capital Corporation, operating from New York City. 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.

Funding

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 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

In the Consulting / Services segment, Aareal Bank Group offers its clients from the housing industry and related industries – such as the energy sector – a combination of specialised banking services, software products and digital solutions. With its subsidiary Aareon AG, Aareal Bank can boast the leading international consultancy and IT systems house for the property sector in Europe.

Aareon Group offers its customers consulting, software and services to optimise IT-supported business processes. With its Enterprise Resource Planning (ERP) systems distributed from 36 locations in Austria, Germany, France, the Netherlands, Norway, Sweden and the UK, Aareon generates stable, long-term business volume. In addition, Aareon develops a portfolio of digital solutions with its own research and development team and in cooperation with PropTech enterprises, offering these solutions internationally. "Aareon Smart World", the digital ecosystem, connects these solutions, networking property companies with customers, staff and business partners, as well as connecting technical devices in apartments and buildings. Aareon Group benefits from a transfer of cross-border know-how, leveraging the respective country-specific focal areas of digitalisation to expand its range of products and services. 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.

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 sector forms a second major client group of the Bank's Housing Industry division for the services mentioned above. This enables the offer of further products, facilitating the cross-sector cooperation of client groups and realising synergies via end-to-end digital processes.

In conjunction with payment transactions processed via Aareal Bank's systems, deposits are generated that contribute significantly to Aareal Bank Group's refinancing base.

Within the Consulting / Services segment, Aareon AG and the Bank's Housing Industry division work closely together. The majority of Aareon's clients also do business with the Bank's Housing Industry division.

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.

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

[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

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 in the portfolio, 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 for the Bank's Housing Industry division.

Economic Report

Macro-economic environment

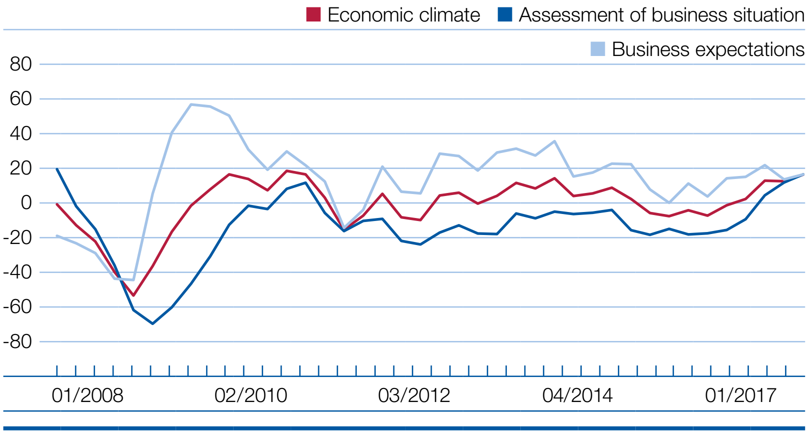
The developed economies reported robust and synchronised growth in 2017. A number of political uncertainties and natural disasters failed to dampen the positive mood. Further focus was on the central banks, some of whom began to, or at least signalled their intention to shift away from extremely expansionary monetary policies.

Economy

Global economic output grew steadily in 2017, and as a result, a synchronous rise was observed in the industrial nations. World trade rose significantly and the economic sentiment indicators reached high levels.

Growth in the euro zone was robust during all four quarters of the year under review, reflecting enhanced trade, greater investments and strong private consumption. Numerous political elections throughout Europe did not impact negatively on the economy. In Germany, the Institute for Economic Research's (ifo) business climate index reached a new record high in November, and this was reflected in strong economic growth. Growth in Germany was slightly above that of the euro zone as a whole in 2017. Economic output in France rose significantly compared with the previous year. From September onwards in Spain, the quest for independence by the autonomous province of Catalonia dominated events. Political and economic uncertainty resulted from the issues concerning independence, and remained unresolved at the end of the year. Growth in Spain was considerably less dynamic in the second half of the year – which meant that overall growth in 2017 remained slightly below the very high rate of the previous year. Growth in Italy was up markedly on the previous year, albeit below the euro zone average. Consolidation in the Italian banking sector continued during the second quarter, with the controlled resolution of two regional institutions. Prior to this development, Fitch Ratings had downgraded Italian government bonds from BBB+ to BBB.

ifo Business Climate World Economy



Source: ifo World Economic Survey (WES) IV/2017.

Growth in the non-euro zone EU nations was mixed. Economic growth in Sweden remained virtually unchanged from the previous year's high level, whilst the Danish economy grew in line with the previous year. In Poland, the economy grew strongly in 2017, driven by strong consumer spending.

The UK's exit from the EU, which was formally requested on 29 March 2017, continued to impact upon British politics and the economy, along with the early parliamentary elections on 8 June 2017. Several terrorist attacks added to the uncertainty. Contrary to the governing Conservative party's hopes, the June election did not produce a strong mandate for the forthcoming Brexit negotiations with the EU. This increased the uncertainty surrounding the planned withdrawal from the EU, even though preliminary agreements were reached in negotiations at the end of 2017. Weak private consumer spending, slower construction activity and only a slight expansion in the service sector slowed economic growth during the course of the year. Moody's responded to this by downgrading the UK's credit rating from Aa1 to Aa2.

Annual rate of change in real gross domestic product

%	2017[1]	2016[2]
Europe		
Euro zone	2.5	1.8
Austria	3.1	1.4
Belgium	1.7	1.5
Finland	3.0	1.9
France	1.9	1.1
Germany	2.5	1.9
Italy	1.5	1.1
Luxembourg	3.3	3.1
Netherlands	3.2	2.1
Portugal	2.7	1.5
Spain	3.1	3.3
Other European countries		
Czech Republic	4.6	2.5
Denmark	2.1	2.0
Poland	4.6	2.9
Russia	1.7	-0.2
Sweden	2.7	3.0
Switzerland	1.0	1.4
Turkey	7.0	3.2
United Kingdom	1.8	1.9
North America		
Canada	2.9	1.4
USA	2.3	1.5
Asia		
China	6.9	6.7
Japan	1.6	0.9
Singapore	3.5	2.0

[1] Preliminary figures; [2] Adjusted to final results

The Turkish economy grew strongly during the year under review, which was mainly due to the weak previous year as well as one-off effects. Economic output increased in Russia again after the decline of the previous year, but the recovery remained fragile.

Economic growth in the US in 2017 was markedly higher than the previous year; the underlying momentum was moderate yet robust, thus taking expansion into its eighth year – only the third such occurrence in history. Both hurricanes "Harvey" and "Irma" had little effect. Growth was sustained by higher investments and already very robust private consumption. The tax reform adopted on 20 December has not yet had any real impact. Growth in Canada increased significantly in 2017.

China's growth in 2017 was slightly above that of the previous year, mainly due to increased world trade and government interventions. Due to high private debt and falling growth prospects, rating agency Moody's downgraded China's rating from A1 to A3 at the end of May, also changing the outlook from "stable" to "negative". However, government-backed measures helped stem the credit-financed boom in residential property slightly.

Unemployment rates declined markedly during the year under review, both in the euro zone and in the EU, to 7.6 % and 9.1 % respectively. Unemployment was also stable to slightly lower when looking at individual countries. In the UK, the rate of unemployment reached a very low level of 2.3 %, and in the US it declined even further, from its already very low level, to 4.4 %.

Financial and capital markets, monetary policy and inflation

Geopolitical events and the realignment of central bank policy were the main focus of attention in financial and capital markets during 2017. This resulted in significant exchange rate fluctuations against the euro, especially versus the US dollar and pound sterling. Due to the overall stabilising effect of the consolidated economy, volatility remained low. A special feature of 2017 was the sharp rise in interest in digital cryptocurrencies over the course of the year, with rates increasing markedly as a result.

The European Central Bank (ECB) maintained its expansionary policy throughout 2017. However, as already announced in December 2016, it reduced the monthly purchase volume within the scope of its asset-buying programme by € 20 billion, to € 60 billion from April 2017. In October, it announced that it was extending its asset-buying programme until September 2018, however, halving asset-buying volumes from January 2018 onwards. Sweden's Riksbank further expanded its monetary policy during the same period, increasing the planned government bond purchase volume by SEK 15 billion for the second half of the year. The Bank of England (BoE) raised its key interest rate by 25 basis points in November 2017, thus reversing its most recent cut – following Brexit – in 2016.

The US Federal Reserve (Fed) raised the target corridor for its key interest rate three times over the course of the year – most recently in December – by 25 basis points, respectively. Thus, at the end of the year, the Fed Funds corridor was between 1.25 % and 1.50 %. It also confirmed at the end of September that it will start to gradually reduce its balance sheet from October onwards, in small steps initially. The reduction is expected to pick up pace over time, according to a fixed schedule. The Fed is therefore the first of the globally important central banks to start reducing its balance sheet. However, it gave no indication of the extent of the reduction.

Long-term interest rates[1] showed no uniform trend in 2017 across the currencies that are important to Aareal Bank. US dollar rates rose slightly year-on-year, following some volatility during the course of 2017. Pound sterling rates fell slightly compared with the end of 2016. Long-term rates increased steadily in the euro area, and at the end of 2017 they were marginally higher than at the end of the previous year.

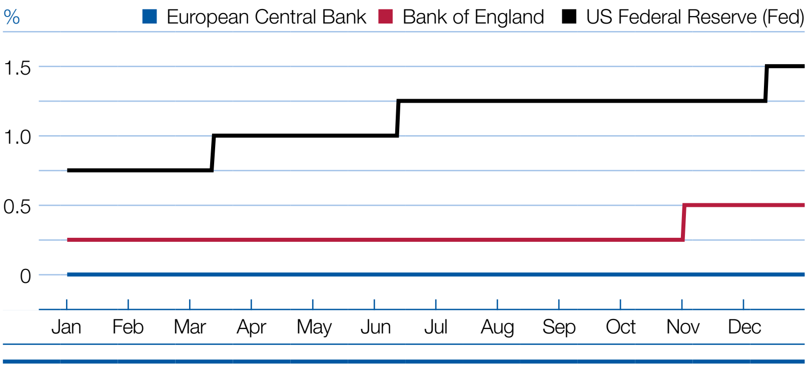
Short-term US dollar rates[2] showed a significant increase over the course of the year compared with the end of 2016. They remained almost unchanged in pound sterling until the third quarter, but rose marginally in line with the interest rate hike at the end of the year. In the euro area, they remained stable in slightly negative territory over the course of the year.

Yields on long-term government bonds showed a mixed trend. The decline in the US was continuous until the third quarter, with yield levels only slightly lower compared with year-end 2016. However, by the end of 2017 they had returned to the previous year's level. Within the euro zone, yields rose in the first quarter but then fell back in most markets during the course of the year. However, by the end of 2017 they had returned to the previous year's level on average. Yields in the UK had initially fallen, but at the end of the year they finished slightly higher than 2016.

Exchange rates in the currency areas that are relevant for Aareal Bank versus the euro were subject to stronger fluctuations, particularly from the second quarter onwards. By the end of the year, the euro had strengthened significantly against the US dollar and the Canadian dollar. Pound sterling lost some of its value against the euro during the course of the year.

[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

Key rate developments in 2017[1)]



1) The upper level of the corridor for the Fed Funds is shown in the chart.

Inflation increased markedly over the course of the year in many economies compared with 2016, reaching a preliminary high in many markets during the first half of the year. At 1.5 %, inflation in the euro zone remained below the ECB's target of just under 2 % in 2017 while it increased significantly over the course of the year in the UK, to reach 2.7 %. This was mainly due to the weaker pound sterling. The inflation rate in the US was at 2.1 % in the year under review. In China, inflation remained at 1.5 % in 2017, thus below the previous year's level.

The Pfandbrief market was once again heavily influenced in 2017 by the ECB, and by developments related to quantitative easing measures. Persistently low interest rates and narrow credit spreads on Pfandbriefe determined the ability to place Pfandbriefe in 2017, too. Notwithstanding the discernible decline in the volume of privately placed Pfandbrief issues, issuing activity of Pfandbrief transactions in benchmark format was only marginally lower than in the previous year. However, positive net issuance was seen again in 2017: by September, issuance had already exceeded maturities by close to € 5 billion.

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. This includes, in particular, implementation of the final draft of the Basel III framework into EU law, which was endorsed by the Basel Committee's Group of Governors and Heads of Supervision (GHOS) on 7 December 2017. In addition, the amendments to BAFin's Minimum Requirements for Risk Management (MaRisk) – including the new German Banking Supervisory Requirements for IT (BAIT), the EU Commission's proposals to revise supervisory regimes (CRR, CRD IV, BRRD and SRMR) as well as the EBA consultation paper "Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures" – will all lead to further regulatory changes.

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, 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. Aareal Bank's Total SREP Capital Requirement (TSCR) has been set at 9.75 % for 2018, comprising the total capital ratio of 8 % for Pillar I and a (Pillar 2) capital requirement of 1.75 % from the ECB's Supervisory Review and Evaluation Process (SREP). In addition, the Bank is required to hold a (phased-in) capital conservation buffer of 1.875 %, plus a countercyclical buffer of 0.113 % forecast for the end of the year. Aareal Bank's pure SREP-CET 1 requirement has been set at 8.24 % for 2018, comprising 4.5 % for Pillar I, the above-mentioned Pillar 2 requirement of 1.75 % as well as the capital conservation buffer (1.875 %) and countercyclical buffer forecast for the end of the year (0.113 %) (also mentioned above). Additional liquidity requirements were not demanded of Aareal Bank.

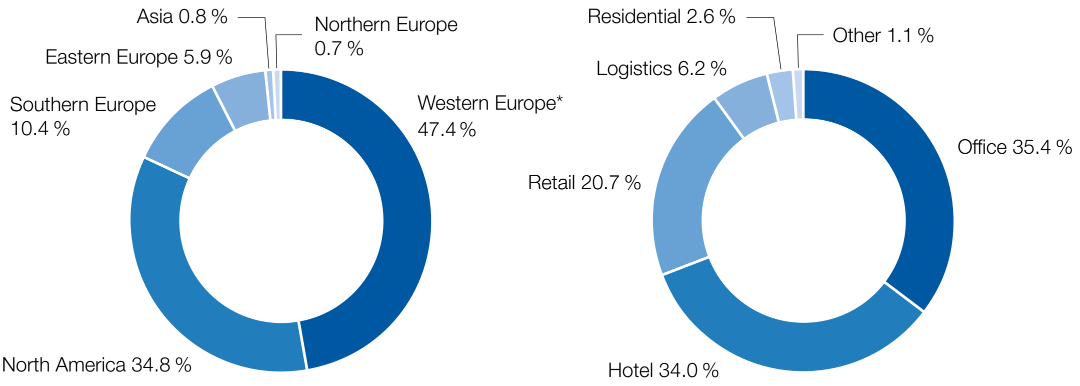
Sector-specific and business developments

Structured Property Financing segment

The transaction volume represents the volume of existing buildings traded on a market and is often

New business 2017

by region | by type of property



* Incl. Germany

viewed as a benchmark or surrogate for the appeal of, and liquidity in, a given market. The development of transaction volumes in the commercial property market[1] was inconsistent across the different regions in 2017. Transaction activity in some European markets rose again over the previous year. In contrast, volumes in North America declined slightly, whilst remaining stable in Asia.

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.

Financing of existing commercial property continued to be subject to considerable competitive pressure in many markets. While margins were under pressure in most European markets and the US in 2017, they remained on a higher level in the US when compared to Europe. Pricing levels on the US market are also influenced by the market for commercial mortgage-backed securities (CMBS). The volume of transactions in this segment remained on a low level in 2017.

In a highly competitive business environment characterised by numerous uncertainty factors, Aareal Bank succeeded in generating € 8.8 billion of new business[2] in 2017. This figure was down slightly on the corresponding figure for the previous year (€ 9.2 billion). The original target was clearly exceeded thanks to high early renewals. With € 6.5 billion, the volume of newly-originated loans was up on the previous year's figure of € 5.8 billion.

At 64.4 % (2016: 73.3 %), Europe accounted for the largest share of new business in 2017, followed by North America with 34.8 % (2016: 24.6 %), and Asia with 0.8 % (2016: 2.1 %). This increase in the North American share over the previous year is in line with the targets of our "Aareal 2020" programme for the future.

[1] Office, retail, logistics and hotel property markets were analysed
[2] New business, excluding former WestImmo's private client business and local authority lending business

With a share of 35.4 %, office properties accounted for the largest share in new business in terms of property type (2016: 45.4 %). This was followed by hotel property, with 34.0 % (2016: 20.7 %), ahead of retail property with 20.7 % (2016: 22.7 %) and logistics property with 6.2 % (2016: 8.5 %). The share of residential property was 2.6 % (2016: 2.1 %) while other property and financing amounted to 1.1 % (2016: 0.6 %).

Europe

The volume transacted in commercial property in Europe was stable in 2017, remaining on a high level overall. Transaction volumes increased slightly in Germany and the UK, and significantly in the Netherlands. In the UK, a few large transactions concluded with Asian investors led to an increase in the volume transacted. Volumes in France remained stable, thanks to a strong fourth quarter, whilst Italy, Poland and Spain saw slight decreases. Transaction volumes in Sweden were down significantly, however. European REIT structures and private investors were largely on the sell side, while investors from outside Europe were clearly on the buy side. Investment by institutional investors was balanced.

Compared to year-end 2016, yields[1] for newly-acquired, first-class commercial properties declined during the course of 2017 in many European economic centres; in part, this was due to the shortage of available top-quality properties. The underlying yield development trend applied to office, retail and logistics properties alike. Yields for UK offices declined slightly in some sub-markets, having risen slightly following the Brexit vote on 23 June 2016. By comparison, retail property yields increased slightly in the UK in 2017, compared to the previous year.

Rents for first-class office properties in the European economic centres mostly reported a slightly positive development in 2017, compared to the end of 2016. Retail and logistics properties were largely stable relative to the end of 2016. Only a few European economic centres witnessed declining rents in the premium segment, for example in a few retail locations in Germany, and office properties in some London locations.

The hotel markets in the European economic centres were largely positive during the year under review. Occupancy ratios rose in most markets, even markedly in some markets, such as Brussels, Milan and Paris. The indicator of average revenues per available room (which is important for hotel markets) also recorded an increase in most markets. Developments in Brussels and Paris should be highlighted: these markets recovered very well, after the burdens of terrorist attacks in recent years. In London, occupancy figures remained stable on a high level at the end of the year, and average revenues per available room picked up significantly.

Aareal Bank originated new business of € 5.6 billion (2016: € 6.7 billion) in Europe during the year under review. As in previous years, Western Europe accounted for the largest share, with € 4.2 billion (2016: € 4.8 billion). Southern Europe followed, with new business of € 0.9 billion (2016: € 1.1 billion), Eastern Europe with € 0.5 billion (2016: € 0.5 billion) and Northern Europe with minor volume (2016: € 0.3 billion).

North America

The volume transacted in commercial property in North America fell slightly compared with the previous year. Nonetheless, it could still be described as high, and the market considered very liquid overall. The declines were concentrated for the most part on office and retail properties, and on hotels. Institutional investors were mainly sellers, while private and cross-border investors were mainly net buyers. Still, cross-border investors were considerably less active than in the previous year. REIT structures had a balanced investment position.

The year 2017 was characterised by largely constant yield developments. On a national average, investment yields in the US hardly moved – compared to the year-end 2016 – for office and retail properties. Slight increases were seen in the metro-

[1] Falling yields are associated with rising property market values, whilst rising yields correspondingly produce falling values, all other things remaining equal.

politan areas of California, for both office and retail properties.

Rents increased marginally on a national average in the US, compared to the final quarter of 2016, for the types of property mentioned. There were marginal differences in the regional centres. The growth in office property rents stagnated for example in Boston, New York, San Francisco and the metropolitan region of Washington. A slight increase was observed on the other hand in Chicago, Dallas and Los Angeles. The scenario was similar for retail properties.

Occupancy rates for hotels in the year under review remained stable in the US on a national average. Average revenue per available hotel room on the other hand climbed slightly. In Canada, occupancy rates rose slightly, whilst average revenue per available hotel room increased significantly.

Aareal Bank originated new business of € 3.1 billion in North America during the year under review (2016: € 2.3 billion). This business was originated in the US and Canada.

Asia

The volume transacted in commercial property during the year under review in the Asia-Pacific region was up slightly on the previous year's figure. Volumes in China failed to match the high levels seen in the previous year, and overall volume was also slightly lower. The considerably lower activity of institutional investors, such as pension funds, insurance companies and sovereign wealth funds, was offset only partially by slightly higher activity amongst private investors.

Investment yields for newly-acquired, high-quality office property was stable in Beijing, whilst a slight decrease was evident in Shanghai. Retail property showed the reverse picture, with a slight decline in Beijing and stable development in Shanghai.

Rents for first-class office and retail properties in these two metropolitan areas were virtually unchanged from year-end 2016.

A slightly positive development of average revenues per available hotel room prevailed on the hotel markets of Beijing and Shanghai during the period under review. Occupancy ratios also rose slightly in the two metropolitan areas.

Aareal Bank Group originated € 0.1 billion in new business in Asia during the year under review (2016: € 0.2 billion).

Consulting/Services segment

Bank division Housing Industry

Business development in the German housing industry proved solid in 2017 as well. Largely constant rental income and long-term funding structures secure a solid foundation and facilitate entrepreneurial investments in conjunction with the very low interest rates. Investments made by the housing enterprises organised in the German Federation of German Housing and Real Estate Enterprises (Bundesverband deutscher Wohnungs- und Immobilienunternehmen – "GdW") increased to around € 16 billion during the year under review, and were therefore 17 % higher than in 2016. The upturn in investments is supported by an expansion of residential construction activity. With more than 28,000 apartments completed, the previous year's level was exceeded by 42 %, thus reaching the highest number of new buildings since the turn of the millennium. In December 2017, rents throughout Germany were some 4.7 % higher than in the previous year.

However, the market developed differently regionally: internal migration and immigration from abroad are responsible for a constantly diverging population development. While the demand for apartments is rising in the metropolitan regions and university cities, rural areas continue to lose inhabitants. The vacancy ratio based on the housing stock managed by GdW enterprises is stable, at 1.9 % in the former West German Federal states and at 8.2 % in the East German states.

The Bank's Housing Industry division further strengthened its market position in 2017, bringing in more business partners from the institutional housing industry and the commercial property sector – managing around 290,000 residential units between them – for the payments and deposit-taking businesses. Moreover, it intensified existing business relationships. We also continuously expanded our client base in the energy and waste disposal industries, especially through interface products (such as BK01 eConnect and BK01 immo-connect) facilitating cross-sector collaboration amongst our client groups. Examples include accounting documentation and invoicing of energy supplies.

At present, more than 3,700 business partners throughout Germany are using our process-optimising products and banking services. The high volume of deposits, averaging € 10 billion (2016: € 9.6 billion) in the year under review, is in line with the "Aareal 2020" programme for the future. Besides the increase in current account deposits, the share of rent deposits and reserves in accordance with the German Residential Property Act in particular also increased. Deposits averaged € 10.4 billion in the fourth quarter of 2017 (Q4 2016: € 10 billion). All in all, this reflects the strong trust that clients place in Aareal Bank.

Aareon

Aareon is the leading international consultancy and IT systems house for the property industry in Europe. It is pursuing a profitable growth strategy and continued to grow in the 2017 financial year. Key factors to its success are the expansion in digital solutions, strengthening of the ERP systems, and exploration of new markets associated with the property industry. The process of internal optimisation to enhance efficiency and profitability also continued.

Overall, Aareon's business developed on schedule in 2017. Strong performance increases in Germany and France offset weaker demand on the UK market and the delay in implementing projects in Sweden. Sales revenue rose from € 211 million to € 221 million, mainly on the back of acquisitions. Aareon matched the previous year's good consolidated operating profit of € 34 million in 2017, despite higher investments.

ERP systems, being the pivot of the Aareon Smart World digital ecosystem, are continuously being developed further: in 2017, the focus was on Wodis Sigma and Blue Eagle in Germany, as well as on Tobias AX in the Netherlands. Additionally, the Scandinavian ERP solution Incit Xpand was expanded with functionality for use in the commercial property sector, and the UK ERP solution QL was migrated to QL.web.

As expected, numerous additional customers opted for Wodis Sigma in Germany during the course of 2017, bringing the total number to 945. Among these new customers, there are still many previous GES customers who opted to change to Wodis Sigma within the framework of Aareon's migration campaign. As expected, the favoured version is the one that uses Wodis Sigma as a service from the exclusive Aareon Cloud. Aareon is still realising a large number of migration projects, all of which are developing on schedule. Systems for 109 customers were rolled out in 2017. Capacity utilisation in the Aareon consulting business thus remained high. The business volume of SAP® solutions and Blue Eagle developed as planned. Maintenance revenues in the Netherlands were increased through a large number of production roll-outs. Additional customers were acquired for the Tobias AX ERP solution. The acquisition of Kalshoven Groep B.V., effective 1 April 2017, also made a contribution to growth in the business with ERP products. Sustainable growth was also generated in France by increasing the maintenance business, especially through acquiring more customers for an extended range of maintenance services. Despite intensive competition, additional customers were won in the UK for QL.net. Furthermore, a major Swedish company has opted for Incit Xpand, including a digital customer portal. A big Norwegian customer rolled out Incit Xpand. All in all, however, growth in the ERP business fell short of expectations, owing to intense competition in the UK and the delay in implementing projects in Sweden.

The digital solutions of Aareon Smart World will be expanded throughout the Group, as part of the digital transformation process. On the one hand, this will be effected through Aareon's own research and development team, and the associated transfer of knowledge throughout the Group – on the other hand, through cooperations with PropTech companies that have developed solutions providing added value to Aareon Smart World stakeholders. The digital solutions involved boosting the cross-border development of Aareon CRM in particular. Having been available in France for quite some time, the Aareon CRM app was rolled out in Germany in 2017 for a pilot customer. The app, which simplifies the customer relationship management between housing enterprises and tenants, will be systematically rolled out on the market.

Business volumes with digital solutions in Germany developed as planned, with the Mareon service portal, Aareon Archiv kompakt, Aareon CRM (tenant portal) and Aareon Immoblue Pro (management of tenant prospects) solutions being in particular demand. These offers benefit from migration activities involving ERP products. In Aareon's international business, sales revenues generated with digital solutions continued to grow, especially in France and the Netherlands. Aareon Nederland rolled out Mareon and a customer portal (for tenants and owners) for several customers. Customers in France signed agreements for the digital Aareon solutions, such as the digital customer relationship management system Aareon CRM. Several customers have rolled out digital solutions, predominantly for mobile property inspection purposes. The regulatory requirements for digital invoicing in France in particular also led to an increase in digital sales revenues. Moreover, initial customers for the digital platform were acquired, within the scope of the new Platform as a Service (PaaS) business model. With this digital development platform, Aareon offers its customers the possibility of developing their own digital solutions, building on pre-programmed components. In the UK, more customers have opted for the Aareon 360° solutions, and for the mobile solutions. Effective 1 December 2017, Aareon Nederland acquired 60 % of the shares in FIRE B.V., Utrecht. Aareon Nederland thus offers its customers an integrated solution that allows both the valuation and financial management of properties. Facilitor, the facility management solution already established in the Netherlands, was prepared for the Swedish market and Aareon Sverige has already succeeded in acquiring its first customer for this.

The 100 % acquisition of Incit Nederland B.V. from Swedish Incit AB (now Aareon Sverige AB) with effect from 1 January 2017 – and the subsequent merger of this company with Aareon Nederland B.V. – brought together Aareon's activities in the Netherlands under one roof. Incit AB in Sweden and Incit AS in Norway have traded as Aareon Sverige AB and Aareon Norge AS, respectively, since October 2017.

Aareon also cooperates with PropTech companies, in order to expand the integrated offer of Aareon Smart World for its clients – for example, with KIWI.KI GmbH, which offers the keyless entry system KIWI. This was integrated via an interface in the Mareon service portal. Furthermore, Aareon entered into a cooperation agreement with, and invested in Immomio GmbH, which offers a web-based customer acquisition management solution and is expected to develop into a comprehensive service platform covering digital renting. In France, Aareon France and Intent Technologies agreed upon a partnership for Aareon Group. Integration of the Intent platform will support the increased connectivity of Aareon Smart World solutions with software offers provided by other suppliers to Aareon's customers.

Within the area of add-on products, Aareon was able to considerably extend its outsourcing business in Germany, in particular. Turnover at the BauSecura insurance business was slightly higher than the previous year's level. The increase in sales revenues, with add-on products in the international business, was mainly attributable to the full acquisition of the Dutch company SG2ALL B.V. with its outsourcing business in 2016.

Aareon is now targeting new markets, such as utilities and the commercial property market, and is currently developing a solution for utilities, housing enterprises and metering service providers, which will digitalise the processes involved in moving house. With regard to the commercial property market, Aareon Nederland B.V. acquired 100 % of Kalshoven Groep B.V., Amsterdam, effective 1 April 2017. It strengthened its presence in this market segment in Germany with the acquisition of the mse companies as at 1 October 2017; this move also enables Aareon to explore the Austrian market.

Financial Position and Financial Performance

Financial performance

Group

Consolidated operating profit for the 2017 financial year amounted to € 328 million (including a non-recurring effect of € 50 million, related to net other operating income / expenses), and was thus within the increased guidance of between € 310 million and € 350 million. The previous year's figure of € 366 million was influenced by € 61 million in sales proceeds, reported in the result from non-trading assets.

Net interest income declined to € 634 million (2016: € 701 million) and was thus in line with our expectations (€ 620 million to € 660 million). This was largely due to the scheduled reduction of the former WestImmo and Corealcredit portfolios. In addition, exchange rate fluctuations led to lower net interest income.

Allowance for credit losses fell to € 82 million in the 2017 financial year (2016: € 97 million) and therefore remained within the forecast range of € 75 million to € 100 million for the full year. Net commission income increased to € 206 million (2016: € 193 million), which was mainly due to higher sales revenue at Aareon. The net figure was within the forecast range of € 195 million to € 210 million for the year.

The € 7 million aggregate of net trading income/ expenses, the net result from non-trading assets, and the net result on hedge accounting, resulted largely from the measurement of derivatives used to hedge interest rate and currency risk. The previous year's figure of € 86 million included € 61 million from the disposal of wholly-owned subsidiary Aqvatrium, which is the owner of a commercial property located in Stockholm.

Consolidated net income of Aareal Bank Group

€ mn	1 Jan-31 Dec 2017	1 Jan-31 Dec 2016
Net interest income	634	701
Allowance for credit losses	82	97
Net interest income after allowance for credit losses	**552**	**604**
Net commission income	206	193
Net result on hedge accounting	-7	0
Net trading income/expenses	14	19
Result from non-trading assets	0	67
Results from investments accounted for using the equity method	–	0
Administrative expenses	511	547
Net other operating income/expenses	74	30
Operating profit	**328**	**366**
Income taxes	115	132
Consolidated net income	**213**	**234**
Consolidated net income attributable to non-controlling interests	6	19
Consolidated net income attributable to shareholders of Aareal Bank AG	207	215

Administrative expenses amounted to € 511 million (2016: € 547 million), and were thus at the top end of the € 470 million to € 510 million range projected for the financial year. The decline reflected lower integration and current costs related to former WestImmo; the total figure includes provisions for personnel measures resulting from the optimisation of processes and structures, within the scope of the "Aareal 2020" programme for the future, as well as costs for strategic projects.

Net other operating income/expenses of € 74 million (2016: € 30 million) includes a positive non-recurring item in the amount of € 50 million, from a subsidiary's reversal of provisions against income. Aareal Bank Group disclosed a corresponding income tax expense of € 26 million.

All in all, consolidated operating profit for the 2017 financial year totalled € 328 million, after € 366 million in 2016. Taking into consideration income tax expenses of € 115 million and non-controlling interest income of € 6 million, consolidated net income attributable to shareholders of Aareal Bank AG amounted to € 207 million (2016: € 215 million). Assuming the pro rata temporis accrual of net interest payments on the AT1 bond, consolidated net income allocated to ordinary shareholders stood at € 191 million (2016: € 199 million). Earnings per ordinary share amounted to € 3.20 (2016: € 3.33) and return on equity (RoE) before taxes stood at 11.9 % (2016: 13.2 %).

Structured Property Financing segment

Operating profit for the Structured Property Financing segment totalled € 351 million; when a non-recurring effect of € 50 million in net other operating income/expenses is taken into account, the figure fell short of the previous year's € 395 million. However, the previous year's figure was influenced by € 61 million in sales proceeds, reported in the result from non-trading assets.

Net interest income declined to € 646 million (2016: € 716 million). This was largely due to the scheduled reduction of the former WestImmo and Corealcredit portfolios. In addition, exchange rate fluctuations led to lower net interest income.

Allowance for credit losses fell to € 82 million in the 2017 financial year (2016: € 97 million). The € 7 million aggregate of net trading income/

Structured Property Financing segment result

€ mn	1 Jan-31 Dec 2017	1 Jan-31 Dec 2016
Net interest income	646	716
Allowance for credit losses	82	97
Net interest income after allowance for credit losses	**564**	**619**
Net commission income	7	10
Net result on hedge accounting	-7	0
Net trading income/expenses	14	19
Result from non-trading assets	0	66
Results from investments accounted for using the equity method	–	0
Administrative expenses	296	346
Net other operating income/expenses	69	27
Operating profit	**351**	**395**
Income taxes	123	143
Segment result	**228**	**252**

expenses, the net result from non-trading assets, and the net result on hedge accounting, resulted largely from the measurement of derivatives used to hedge interest rate and currency risk. The previous year's figure of € 85 million included € 61 million from the disposal of wholly-owned subsidiary Aqvatrium, which is the owner of a commercial property located in Stockholm.

Administrative expenses amounted to € 296 million in the 2017 financial year (2016: € 346 million). The decline reflected lower integration and current costs related to former WestImmo; the total figure includes provisions for personnel measures resulting from the optimisation of processes and structures, within the scope of the "Aareal 2020" programme for the future, as well as costs for strategic projects.

Net other operating income/expenses of € 69 million (2016: € 27 million) included a positive non-recurring item in the amount of € 50 million, from a subsidiary's reversal of provisions against income. Aareal Bank Group disclosed a corresponding income tax expense of € 26 million.

Operating profit in the Structured Property Financing segment totalled € 351 million. After inclusion of € 123 million in income taxes, the segment result amounted to € 228 million (2016: € 252 million).

Consulting/Services segment

Operating profit in the Consulting/Services segment remained negative, at € -23 million (2016: € -29 million). At € 34 million, Aareon matched its good result from the previous year. 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 revenue increased to € 226 million (2016: € 206 million), mainly due to increased sales revenue at Aareon and at the Bank's Housing Industry division.

Staff expenses of € 151 million rose from the previous year's level, reflecting higher staffing levels and Aareon's acquisitions, amongst other factors. On balance, the Consulting/Services segment generated operating profit of € -23 million (2016: € -29 million). After inclusion of tax effects of € 8 million, the segment result amounted to € -15 million (2016: € -18 million).

Consulting/Services segment result

€ mn	1 Jan-31 Dec 2017	1 Jan-31 Dec 2016
Sales revenue	226	206
Own work capitalised	4	6
Changes in inventory	–	0
Other operating income	7	7
Cost of materials purchased	35	35
Staff expenses	151	144
Depreciation, amortisation and impairment losses	12	11
Results from investments accounted for using the equity method	–	0
Other operating expenses	62	58
Interest and similar income/expenses	0	0
Operating profit	**-23**	**-29**
Income taxes	-8	-11
Segment result	**-15**	**-18**

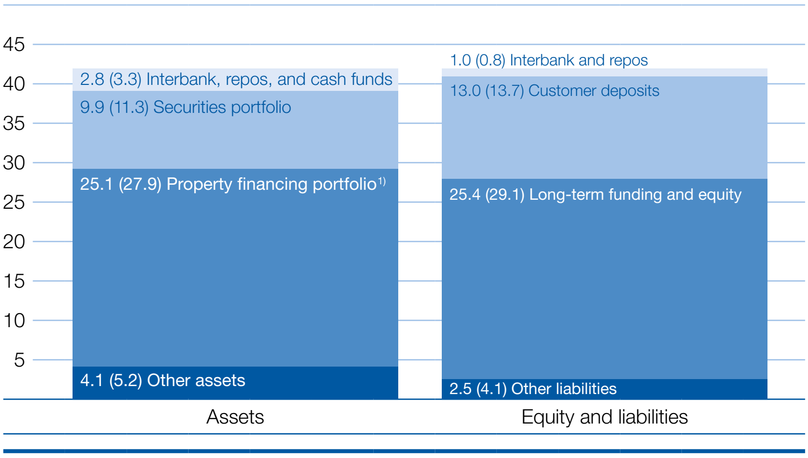
Financial position

Consolidated total assets of Aareal Bank Group as at 31 December 2017 amounted to € 41.9 billion, after € 47.7 billion as at 31 December 2016.

Interbank deposits, repos, and cash funds

Interbank deposits, repos, and cash funds comprise short-term investments of surplus liquidity. As at 31 December 2017, this comprised predominantly cash funds and deposits with central banks and money-market receivables from banks.

Asset/liability structure as at 31 Dec 2017 (31 Dec 2016)



1) Excluding € 0.8 billion in private client business (31 December 2016: € 1.1 billion) and € 0.5 billion in local authority lending business by former WestImmo (31 December 2016: € 0.6 billion)

Property financing portfolio

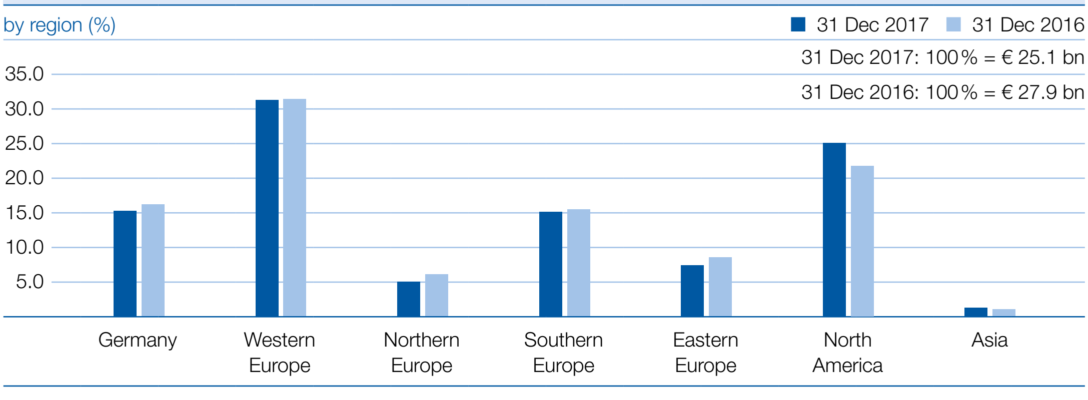
Portfolio structure

The volume of Aareal Bank Group's property financing portfolio stood at € 25.1 billion as at 31 December 2017, down by 10 % from the year-end level 2016 (€ 27.9 billion). This was particularly attributable to the planned portfolio reduction at former WestImmo and Corealcredit, high early loan repayments, and exchange rate fluctuations. The international share of the portfolio increased to 84.8 % (31 December 2016: 83.9 %).

At the reporting date (31 December 2017), Aareal Bank Group's property financing portfolio was composed as shown below, compared with year-end 2016.

Portfolio allocation by region and continent changed in line with the Bank's strategy, compared with the end of the previous year: whilst the portfolio share of exposures in North America rose by about 3.3 percentage points, it was down by around one percentage point each for Germany, Northern Europe and Eastern Europe – remaining relatively stable for all other regions.

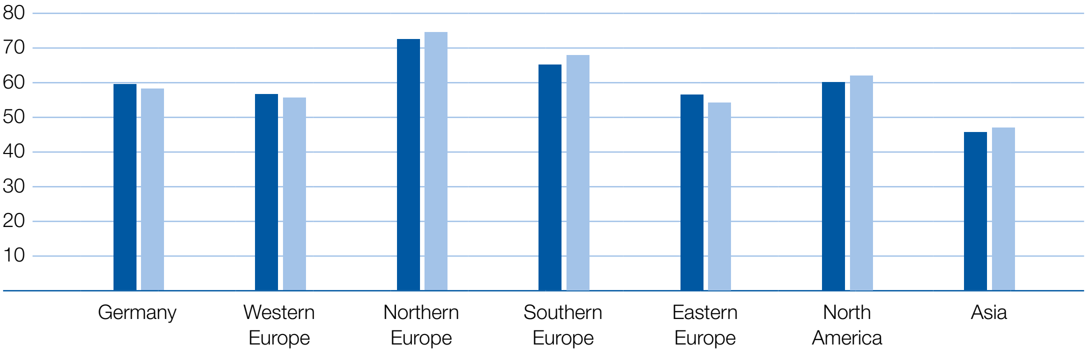
Property financing volume[1] (amounts drawn)



1) Excluding former WestImmo's private client business and local authority lending business

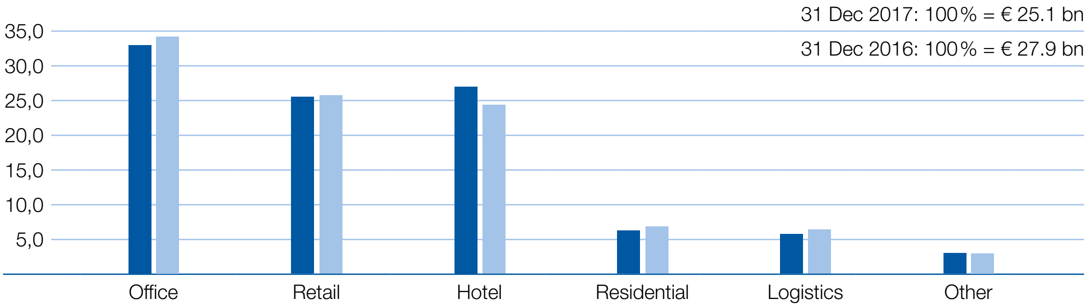
Property finance portfolio by ltv range (quarterly comparison)[1)]

by region (%)



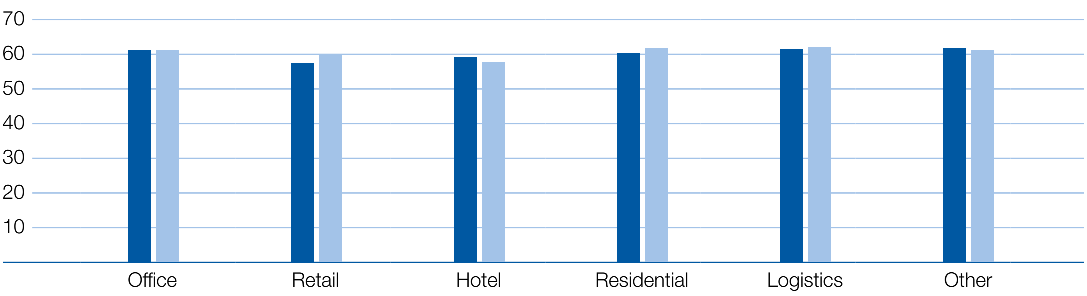
Property financing volume[1)] (amounts drawn)

by type of property (%)



Property finance portfolio by ltv range (quarterly comparison)[1)]

by type of property (%)



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

The breakdown of the portfolio by property type changed during the reporting period: the share of hotel property increased by 2.6 percentage points compared to year-end 2016, whilst the share of office property was reduced by 1.2 percentage points. The share of financings for residential, logistics, and retail property as well as other financings in the overall portfolio showed only minor changes compared to the year-end 2016.

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-pool management of Pfandbriefe.

As at 31 December 2017, the nominal volume of the consolidated securities portfolio[1] was € 8.3 billion (31 December 2016: € 9.3 billion).

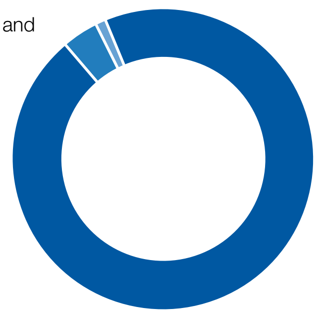
Key aspects taken into account for portfolio management are good credit quality and the related value stability, as well as a high degree of liquidity, particularly with regard to Basel III criteria. The securities portfolio comprises three asset classes: public-sector borrowers, covered bonds and Pfandbriefe, as well as bank bonds.

99 % of the overall portfolio is denominated in euro. 99 % of the portfolio has an investment grade rating.[2] More than 75 % of the portfolio fulfils the requirements for "High Quality Liquid Assets" (as defined in the Liquidity Coverage Ratio (LCR)).

Public-sector borrowers are the largest asset class held, accounting for a share of approx. 95 %. These include securities and promissory note loans that are eligible cover-pool assets for Public Sector Pfandbriefe. 99 % of these issuers are headquartered in the EU. Some 79 % are rated AAA or AA, and a further 4 % are rated single-A. Overall, 99.5 % have an investment grade rating.

Securities portfolio as at 31 December 2017

% Total volume (nominal): € 8.3 bn



The share of Pfandbriefe and covered bonds at year-end was 4 %. 86 % consist of European covered bonds, with the remainder invested in Canadian covered bonds. All Pfandbriefe and covered bonds were rated AAA.

Due to 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 1 % as at year-end.

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 2017.

[1] As at 31 December 2017, the securities portfolio was carried at € 9.9 billion (31 December 2016: € 11.3 billion).
[2] The rating details are based on the composite ratings.

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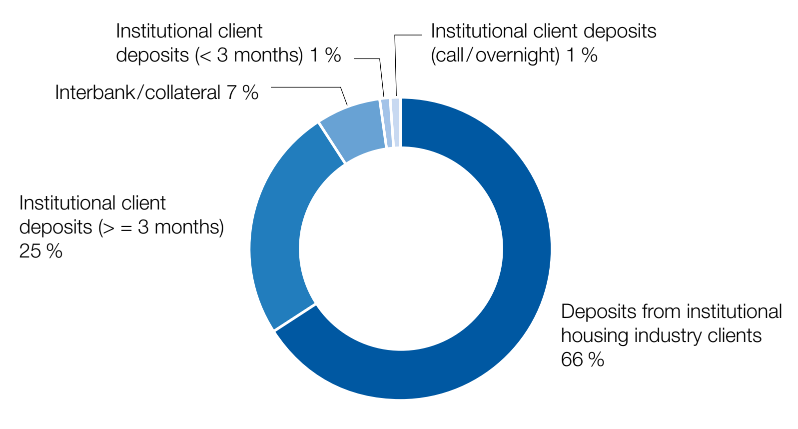
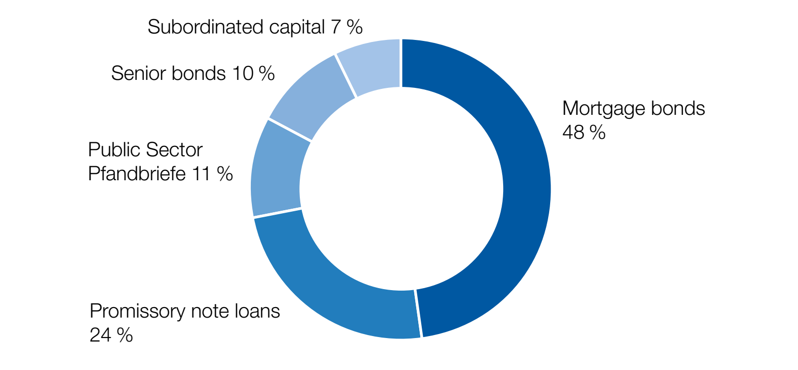
Money market funding mix as at 31 December 2017

% Total volume: € 14.0 bn



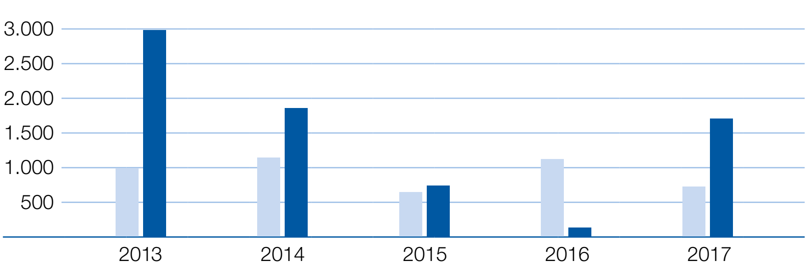
Capital market funding mix as at 31 December 2017

% Total volume: € 22.8 bn



Issuing activities – 2013 to 2017

Issue volume, € mn Uncovered[1] Mortgage Pfandbriefe



[1] excluding SoFFin-guaranteed issues and subordinated capital

Customer deposits

As part of our business activities, we generate deposits from housing industry customers, and from institutional investors. As at 31 December 2017, housing industry deposits amounted to € 9.2 billion (31 December 2016: € 9.2 billion). Deposits from institutional investors amounted to € 3.8 billion as at 31 December 2017 (31 December 2016: € 4.5 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-term notes, other bonds and subordinated issues. The latter include subordinated liabilities, profit-participation certificates, silent participations, and Additional Tier I (AT I) issues.

As at 31 December 2017, the long-term refinancing portfolio amounted to € 22.8 billion. Of this amount, Mortgage Pfandbriefe accounted for € 11.1 billion, public-sector Pfandbriefe for € 2.6 billion, uncovered long-term refinancing for € 7.6 billion and subordinated long-term refinancing for € 1.5 billion.

Thus, Mortgage Pfandbriefe accounted for a total share of 48 % of long-term refinancing.

The Liquidity Coverage Ratio (LCR) exceeded 150 % on the reporting days of the period under review.

Refinancing activities

A total of € 1.7 billion in Mortgage Pfandbriefe plus senior unsecured issues in the amount of € 0.7 billion were very satisfactorily placed by Aareal Bank on the capital markets during the financial year 2017. In addition to the very successful issue of a € 500 million Mortgage Pfandbrief, the Bank also placed non-euro issues of £ 250 million and an additional USD 625 million issue on the capital markets. Of Aareal Bank's senior unsecured issues, a USD 250 million bond deserves particular mention: this bond was Aareal Bank's first syndicated senior unsecured bond denominated in US dollars.

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 € 2,924 million as at the 31 December 2017 reporting date (31 December 2016: € 3,129 million), comprising € 300 million for the Additional Tier 1 (AT 1) bond. Due to the repayment of the Capital Funding Trust in the first quarter of the year, non-controlling interests were reduced to € 2 million (31 December 2016: € 242 million).

Regulatory capital [1]

	31 Dec 2017[2]	31 Dec 2016
€ mn		
Common Equity Tier 1 (CET 1)	2,305	2,351
Tier 1 (T1)	2,600	2,896
Total capital (TC)	3,536	3,994
%		
Common Equity Tier 1 ratio (CET 1 ratio)	19.6	16.2
Tier 1 ratio (T1 ratio)	22.1	19.9
Total capital ratio (TC ratio)	30.0	27.5

[1] 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.

[2] After confirmation of Aareal Bank AG's financial statements for 2017. The calculation of regulatory capital takes into account the Management Board's proposal for the appropriation of profits for the financial year 2017. The appropriation of profits is subject to approval by the Annual General Meeting.

Our Employees

Qualification and training programmes

Qualified and motivated employees make a decisive contribution to our Company's economic performance and are thus a key factor in its success – as well as a competitive advantage. 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 human resources policy is continuously developed in a targeted way. Aareal Bank Group supports employees in change processes and promotes lifelong professional learning.

The Group consistently pursued this strategy throughout the year under review. The Bank thus focused its activities on further developing skills in project management methodologies, in particular, the agile project management method. Aareon's activities focused on the SAP HANA application environment and online English language training.

Employee data as at 31 December 2017

	31 Dec 2017	31 Dec 2016	Change
Number of employees of Aareal Bank Group	2,800	2,728	2.6%
No. of years' service[3]	12.9 years	13.9 years	-1.0 years
Staff turnover rate	4.0%	3.9%	

[3] The previous year's figure refers to Aareal Bank AG.

The overview of employee key indicators in the "Responsibility" section of the Company's website (www.aareal-bank.com/en/responsibility/reporting-on-our-progress/) provides more information, including the breakdown by gender, age and region.

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Promoting the next generation

Promoting the next generation through training is a central element of Human Resources work at 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.

The Bank's "Junior Training Programmes" once again provided support for young people in terms of training in 2016, including trainees for office management (within training courses at the Chamber of Commerce and Industry), students in the fields of business administration, banking, and business information systems from the Baden-Württemberg Cooperative State University (Duale Hochschule Baden-Württemberg/DHBW), Mannheim, as well as business administration students from the University of Applied Sciences Mainz (Hochschule Mainz). Alongside the trainee programmes, Aareon also offers vocational training for specialist jobs in office management and IT application development and system integration. It also offers the dual courses of study "Business Information Systems/ Software Engineering" and "Business Information Systems/Application Management", in partnership with the DHBW Mannheim.

Remuneration system

In addition to the fixed remuneration that is paid in twelve monthly instalments, all employees receive a performance-related variable remuneration. 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. This is emphasised by a broad range of dedicated support services such as partnerships with childcare institutions or service providers for the provision of private childcare, holiday programmes for employees' children, the availability of parent-child workrooms, flexible working policies, part-time positions and the option of working remotely or alternating teleworking for all employees. Another component of improving the work-life balance of the employees consists of services that make it easier to combine working life with the care of those who require it. This includes, among other things, the offer of counselling and support in the event of illness as well as nursing care for close relatives (available throughout Germany) and the option of participating in various training courses for better compatibility of family, care and work.

Health

In order to verify the effectiveness and continuous improvement of occupational safety management, implemented occupational safety committees meet quarterly, which include the respective company doctor and occupational safety specialists in addition to various company officers.

In order to protect and promote the health of its employees in a targeted manner, Aareal Bank Group offers a comprehensive range of health-promoting measures in the areas of information, prophylaxis, exercise and ergonomics, nutrition, mental health and relaxation that are always based on employees' current needs. In the year under review, these included speeches on various topics, workshops on topics such as nutrition, exercise and back health as well as ageing at work, stress prevention and management measures (attention training, resilience support programme, stress management seminars), health checks, preventive individual health consultations, skin screenings and flu vaccinations.

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. This economic motivation for a highly-developed risk management system is continuously increased by extensive regulatory requirements for risk management. 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 material 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. The adjacent diagram provides an overview of the responsibilities assigned to the respective organisational units.

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

Type of risk		Risk management	Risk monitoring
Market price risks		Treasury, Transaction 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, Project & Credit Portfolio Management	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		Strategy Development	Risk Controlling, Finance & Controlling, Controlling bodies

Process-independent monitoring: Audit

The Management Board formulates the business strategy and the so-called Risk Appetite Framework. For this purpose, 'risk appetite' means the maximum risk exposure where the Bank's continued existence is not threatened, even in the event of risks materialising (the "going-concern" approach). For individual business units (the "First Line of Defence"), the Risk Appetite Framework defines guidelines for the independent and responsible handling of risks.

The risk monitoring function (the "Second Line of Defence") regularly measures utilisation of risk limits, and reports on the risk situation. In this context, the Management Board is supported by the Risk Executive Committee (RiskExCo). The RiskExCo develops proposals for resolutions in line with delegated tasks, and promotes risk communications and a risk culture within the Bank.

On top of this, Group Internal Audit (as the "Third Line of Defence") reviews the organisational structure and procedures, as well as risk processes – including the Risk Appetite Framework – and assesses their appropriateness. Moreover, internal processes provide for the involvement of the Compliance function whenever there are facts which are compliance-relevant.

In order to efficiently perform its control duties, amongst other measures, the Supervisory Board has established a Risk Committee, whose responsibility includes the risk strategies as well as the management and monitoring of all types of risk.

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 material types of risk. Taken together, these represent the Group's risk strategy. 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.

The business strategy and the risk strategies are subject to review on an ongoing basis, and are updated if necessary. Besides the regular review (and, if appropriate, adjustment) of the business strategy (and consequently, the Group risk strategy), the Bank's risk-bearing capacity is validated at least once a year. For this purpose, the appropriateness of risk measurement methods, processes, and risk limits is examined in particular. During the financial year under review, the strategies were adopted by the Management Board, duly noted, and approved by the Supervisory Board.

The Bank has defined escalation and decision-making processes to deal with limit breaches. Risk Controlling ensures the timely and independent risk monitoring to the Management Board.

Aareal Bank Group maintains a decentralised Internal Control System (ICS), with control activities and results being outlined in the Written Set of Procedural Rules. These describe individual processes of divisions, subsidiaries, or other units. Internal controls may run upstream, downstream, or in parallel to workflows; this applies both to automatic control and monitoring functions as well as to the respective manual steps. Accordingly, the ICS comprises the entire universe of control activities; its objective is to ensure that qualitative and quantitative standards are adhered to (compliance with legal or regulatory requirements, with limits, etc.).

The appropriateness of controls is reviewed on an event-driven basis; in any case, at least once a year. The results are discussed with the corresponding units within the Second and Third Lines of Defense (Risk Controlling, Compliance and Internal Audit), and reported to the Management Board and the Supervisory Board. In the event of any irregularities or violations, depending on the severity of the event, the Management Board must be notified without delay, so that adequate measures or audit activities can be initiated at an early stage.

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). Freely available funds increased significantly during the period under review. Firstly, this was due to portfolio planning; secondly, Aareal Bank further refined its procedures, defining Tier I (T1) capital (as defined by the CRR) at a level of 7.75 % of forecast risk-weighted assets (RWA) as a deductible, in accordance with regulatory requirements. Only free own funds exceeding this level are applied as potential risk cover, of which a further 10 % is deducted. This deduction is not applied to risk limits, but retained for risk types that cannot be quantified (for example, business or strategic risks). Migration or FX lending risks are no longer deducted as a buffer, but are now included as credit risk exposure.

Likewise, the Bank adopts a 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 7.75 % 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 table below summarises the Group's overall risk-bearing capacity as at 31 December 2017.

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 the crisis

Risk-bearing capacity of Aareal Bank Group as at 31 December 2017
– Going concern approach –

€ mn	31 Dec 2017	31 Dec 2016
Own funds for risk cover potential	2,623	2,598
less 7.75 % (31 Dec 2016: 8 %) of RWA (Tier 1 capital (T1))	870	1,477
Freely available funds	**1,753**	**1,121**
Utilisation of freely available funds		
Credit risks	265	317
Market risks	145	207
Operational risks	86	106
Investment risks	21	24
Other risks [1]	173	–
Total utilisation	**690**	**654**
Utilisation as a percentage of freely available funds	**39 %**	**58 %**

[1] Other risks such as business or strategic risks

affecting financial markets and the economy, which broke out in 2007, on individual types of risk and aggregate risk is analysed within the scope of a historical scenario. In the hypothetical scenario, current potential developments are derived from factors such as political developments, and are combined with significant macroeconomic deterioration. 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 results 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 procedures

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 organisational structure and procedures 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 Project & Credit Portfolio Management (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.

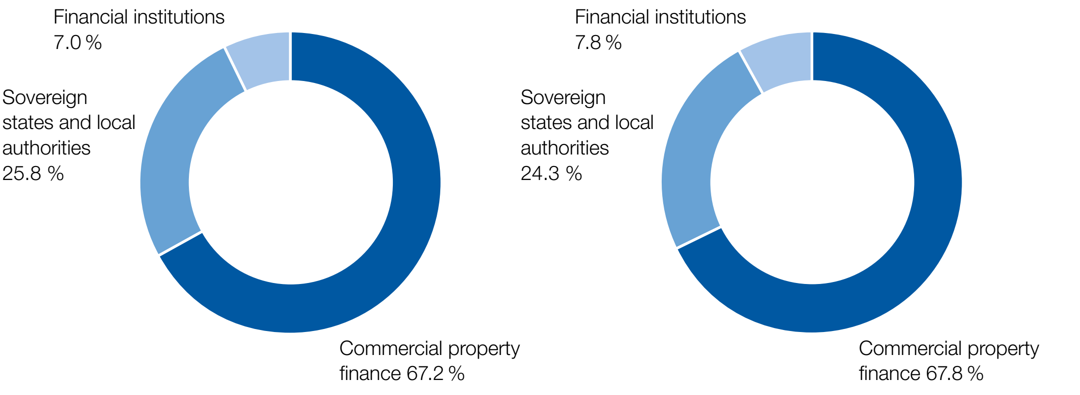
Actively managing client relationships is crucially important in this context: approaching clients in time to jointly develop a solution to any problems which may arise. Where necessary, we muster the support of experts from the independent restructuring and recovery functions.

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

Breakdown of exposure by rating procedure

31 Dec 2017 | 31 Dec 2016 100 % = € 40.0 bn | 100 % = € 43.2 bn



Note that the exposure includes claims against the borrower plus off-balance sheet obligations. The following distributions of ratings and Expected Loss classes exclude exposures for which no rating has been concluded, or which are in default (as defined under the CRR).
The rating procedures for financial institutions also apply to development and promotional banks. Such institutions accounted for 56 % of all rated financial institutions as at 31 December 2017.

implementation of risk classification procedures, and for annual validation, lies with two separate divisions outside the Sales units.

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

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.

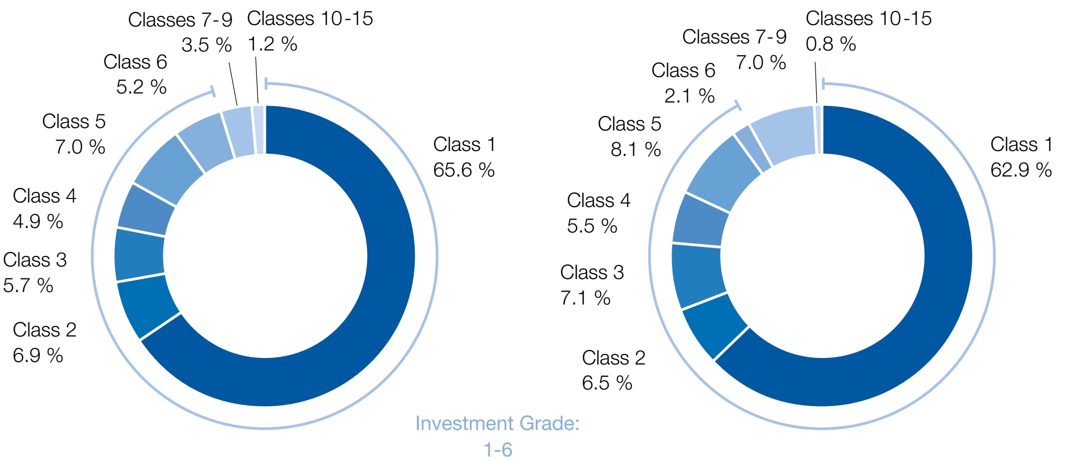
The expected loss (EL) in the event of default of an exposure is determined as the product of PD and LGD. As a risk parameter related to the financing, EL is used as an input factor for the tools used to manage the property financing business.

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

classified by internal expected loss classes as at 31 Dec 2017 | as at 31 Dec 2016



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.

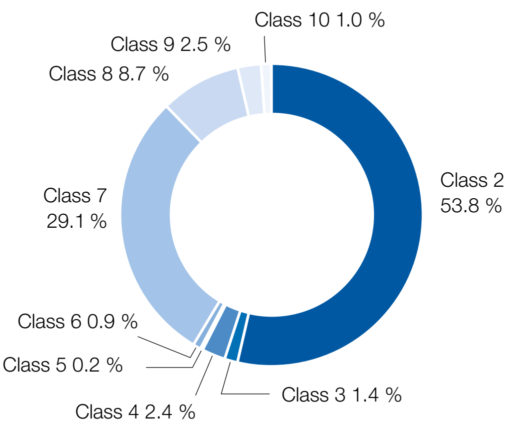
Sovereign states and local authorities

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

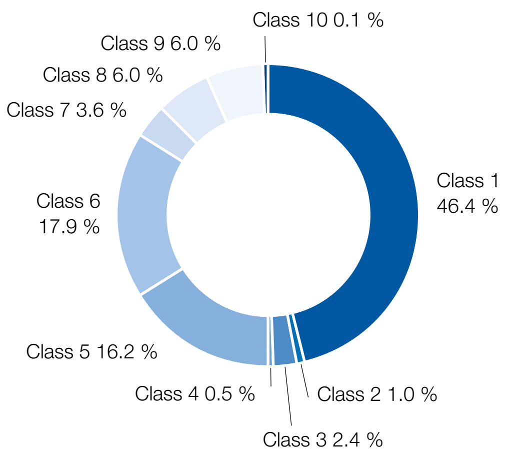
Financial institutions

by rating class

as at 31 Dec 2017 | as at 31 Dec 2016



Classes 1, 11-18: 0%

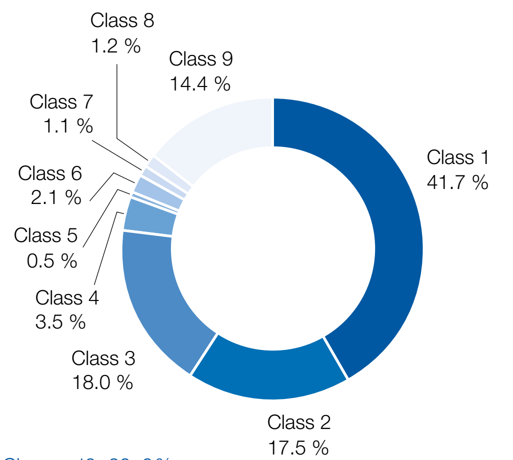


Classes 11-18: 0%

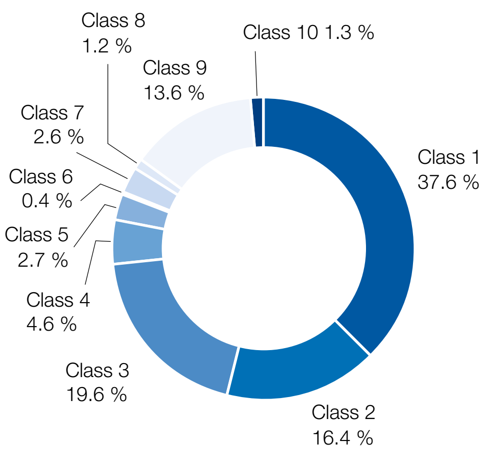
Sovereign states and local authorities

by rating class

as at 31 Dec 2017 | as at 31 Dec 2016



Classes 10-20: 0%



Classes 11-20: 0%

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.

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 & Controlling 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"). 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.

The RiskExCo is responsible for voting on all limit applications. The Committee has delegated corresponding authority to the Heads of Risk Controlling, Operations, and Project & Portfolio Management, who are 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 be involved in devising 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. The associated 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 Guidelines. 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.

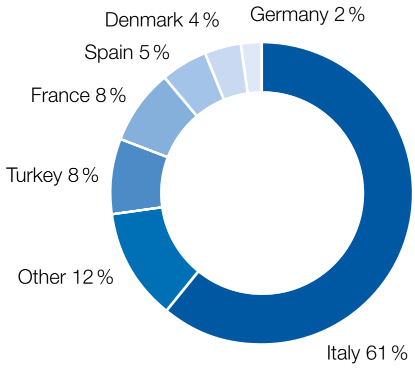
Based on the results of these models, the Bank's decision-makers are regularly informed of the performance and risk content of property finance exposures, and of business with financial institutions. The models permit to identify, measure, monitor and manage risks at a portfolio level.

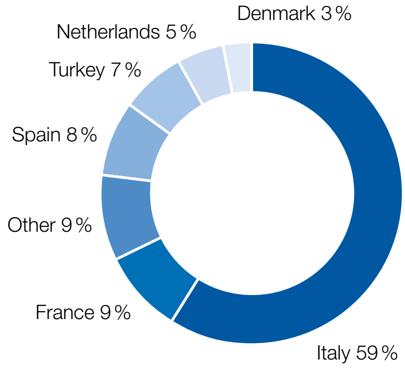
The Bank focuses in particular on the identification, monitoring and management of risk concentrations, where both quantitative and qualitative methods are being used. With regard to counterparty credit risk, these include for example, the regular analysis of our largest borrower units and the analysis 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

Individually impaired property financings[1] (carrying amount)

by country (%) 31 Dec 2017: 100 % = € 1.2 bn | 31 Dec 2016: 100 % = € 1.4 bn





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

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, 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 or issuers for whom the requisite limits are in place. Replacement and settlement risks are taken into account when determining counterparty/issuer limit usage. Persons holding position responsibility are informed about relevant limits and their current usage without delay.

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 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.

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

Credit risk mitigation for trading activities

To reduce counterparty risk in Aareal Bank's trading business, the master agreements for financial derivatives[1)] and master agreements for securities repurchase transactions (repos) used by the Bank provide for various credit risk mitigation techniques, via mutual netting framework agreements.

The master agreements for financial derivatives used by the Bank contain framework netting agreements at a single transaction level (so-called "payment netting"), and arrangements for the termination of individual transactions under a master agreement (so-called "close-out netting").

In general, all master agreements are based on the principle of a common agreement. This means that, in the case of a termination, the individual claims are netted, and that only such net amount can and may be claimed with regard to the defaulted counterparty. This claim must not be affected by any insolvency, i.e. it must be legally valid and enforceable. This, in turn, means that the jurisdictions concerned must recognise the concept of a common agreement which protects the net amount of the claim from imminent access by the insolvency administrator.

Above all, the close-out netting is subject to international) legal risks. The Bank reviews these legal risks by reference to legal opinions regarding the validity and enforceability of mutual netting framework agreements in the case of a counterparty's insolvency. These legal opinions are evaluated based on various criteria such as product type, jurisdiction of the registered office and branch office of the counterparty, individual contract supplements and other criteria, and using a database developed for this purpose. In doing so, the Bank decides for each individual transaction whether or not netting is possible. The Bank uses eligible bilateral netting framework agreements within the meaning of the CRR for all transactions with

[1)] Any comments below referring to the German Master Agreement on Financial Derivatives (Deutscher Rahmenvertrag für Finanztermingeschäfte – "DRV") also pertain to the master agreement issued by the International Swaps and Derivatives Association Inc. (ISDA) (the "ISDA Master Agreement"). Both agreements are standardised agreements recommended by leading associations – among others, by the Association of German Banks (Bundesverband deutscher Banken – "BdB").

financial institutions; in many cases there are additional collateral agreements which further reduce the relevant credit risk.

The Bank enters into repo transactions both on a bilateral basis and via Eurex Clearing AG as a central counterparty. For repo transactions, depending on the counterparty, payment or delivery netting is agreed upon. Master agreements for repo transactions generally contain provisions on close-out netting. The Bank does not use the option permitted by regulatory authorities to reduce capital requirements for repo transactions.

Furthermore, counterparty risk is reduced through derivatives settlement via central counterparties (CCPs): Aareal Bank uses Eurex Clearing AG and LCH.Clearnet Limited.

The Bank uses an internal rating system to assess the credit quality of counterparties. Operations is responsible for the daily valuation of the Bank's trades, including collateral accepted or pledged, and using validated valuation procedures.

Cash collateral only is accepted for derivatives transactions; such collateral is pledged in regular intervals, as set out in the individual agreements. Repo transactions are usually collateralised through securities, pledged on a daily basis.

Some collateral agreements provide for higher collateral levels in the event of material downgrade to a contracting party's rating.

In principle, Aareal Bank pursues a "buy and manage" strategy in managing its credit portfolio – with the primary objective of holding the majority of 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. A rapid 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.

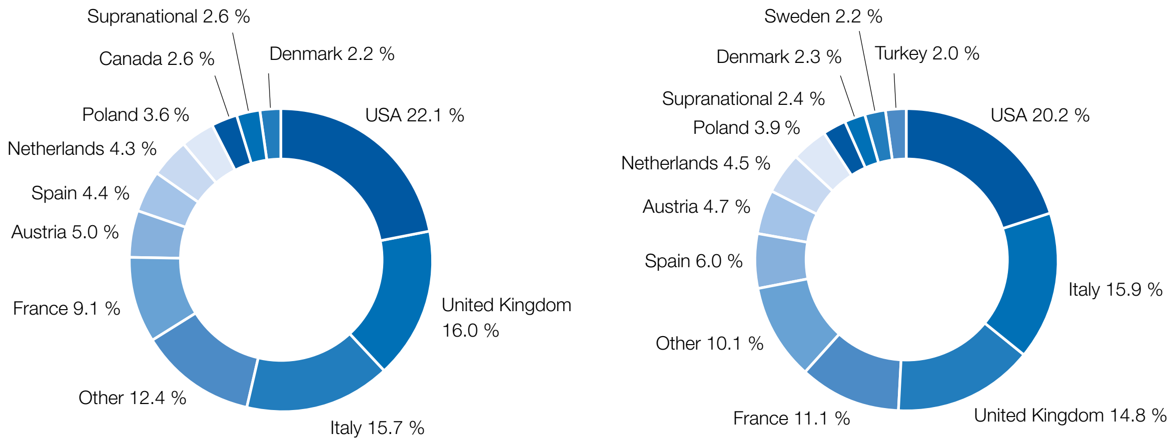
Country risk measurement and monitoring

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 on the following page illustrates the risk exposure by country (comprising receivables and off-balance sheet obligations) in the Bank's international business, 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.

Breakdown of country exposure in the international business

% 31 Dec 2017 | 31 Dec 2016



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 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.

When interpreting the VaR figures stated below, 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.

€ mn	MAX	MIN	Mean	Limit
Year-to-date (full previous year), 95 %, 250-day holding period				
Aareal Bank Group – general market price risk	173.6 (305.0)	119.6 (161.1)	143.3 (224.5)	– (–)
Group VaR (interest rates)	127.6 (211.6)	71.6 (103.0)	97.1 (149.5)	– (–)
Group VaR (FX)	98.8 (185.9)	68.9 (102.2)	84.3 (135.5)	– (–)
VaR (investment fund and equities)	4.8 (5.8)	2.1 (3.5)	3.8 (4.6)	20.0 (20.0)
Aggregate VaR in the trading book	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	5.0 (5.0)
Group VaR (specific risks)	79.8 (85.9)	62.0 (62.8)	73.0 (73.3)	– (–)
Group funding risk	26.2 (23.0)	3.0 (17.2)	14.7 (19.4)	– (–)
Aggregate VaR – Aareal Bank Group	204.6 (311.5)	141.2 (174.0)	175.6 (237.5)	390.0 (390.0)

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	11.0 (19.3)	7.6 (10.2)	9.1 (14.2)	– (–)
Group VaR (interest rates)	8.1 (13.4)	4.5 (6.5)	6.1 (9.5)	– (–)
Group VaR (FX)	6.3 (11.8)	4.4 (6.5)	5.3 (8.6)	– (–)
VaR (investment fund and equities)	0.3 (0.4)	0.1 (0.2)	0.2 (0.3)	1.3 (1.3)
Aggregate VaR in the trading book	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)	0.3 (0.3)
Group VaR (specific risks)	5.0 (5.4)	3.9 (4.0)	4.6 (4.6)	– (–)
Group funding risk	1.7 (1.5)	0.2 (1.1)	0.9 (1.2)	– (–)
Aggregate VaR – Aareal Bank Group	12.9 (19.7)	8.9 (11.0)	11.1 (15.0)	24.7 (24.7)

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.

Both general and specific market risk were relatively stable during the course of the year – overall, they declined.

Backtesting

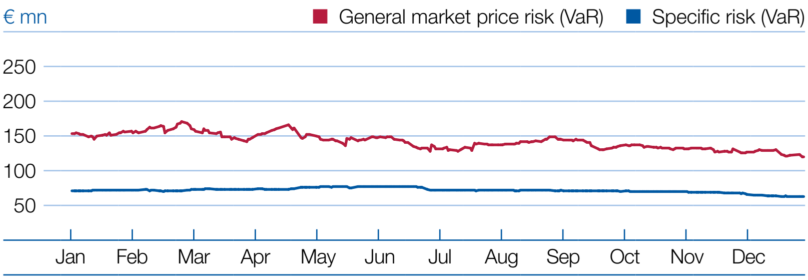
The quality of forecasts made using this statistical model is checked through a weekly backtesting process. The quality of the statistical procedure used to measure risk is checked using a binomial test, whereby daily profits and losses from market fluctuations are compared with the upper projected loss 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.

Stress testing

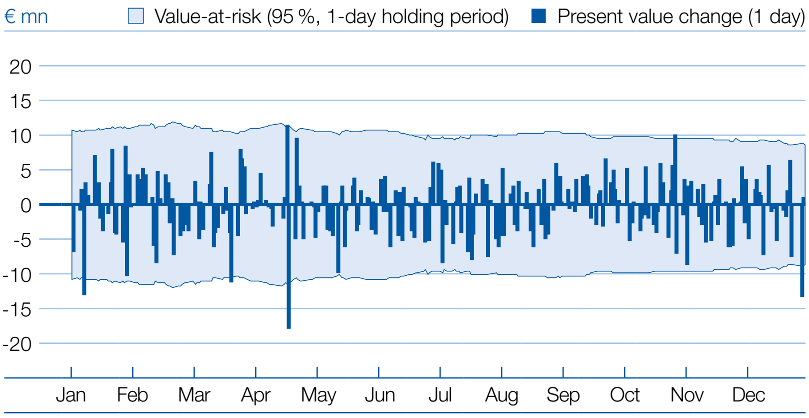
Although VaR has become a standard tool, the concept may fail to adequately project the actual risk in extreme situations – for example, the end-2008 phase of the financial markets crisis. For this reason, the VaR projection is supplemented by simulating stress scenarios on a monthly basis.

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

General market price risk and specific risk during 2017



Present values and 1-day VaR during the course of 2017



special stress limit within the scope of weekly and monthly stress test reporting.

The hypothetical scenario implied a present value loss of approximately 15 % of the stressed aggregate risk cover limit as at year-end 2017. 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 metho"). 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

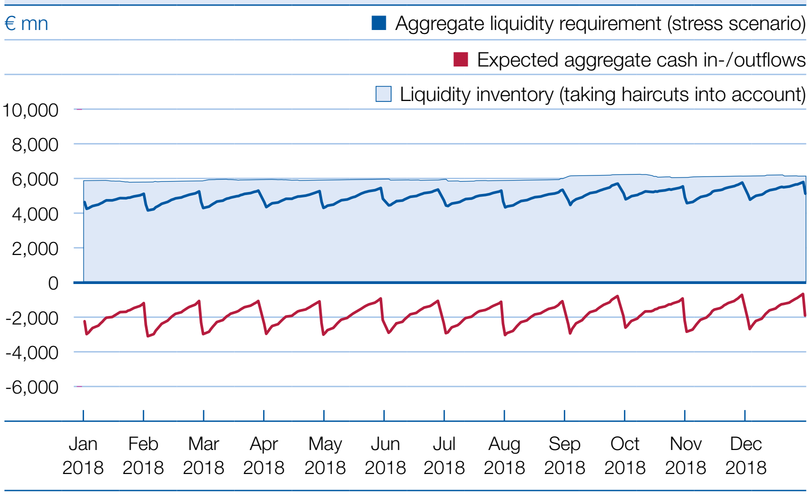
We have developed a cash flow forecast, tracking cash flows from all balance sheet items and derivatives, on a daily basis, over a ten-year period. This liquidity risk information helps to assess the Bank's short-term liquidity position, broken down by currency or product. Strategic liquidity is taken 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 beside 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 2018. This presentation demonstrates that the liquidity stock will always exceed liquidity requirements, even under unfavourable conditions.

Liquidity



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.

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.

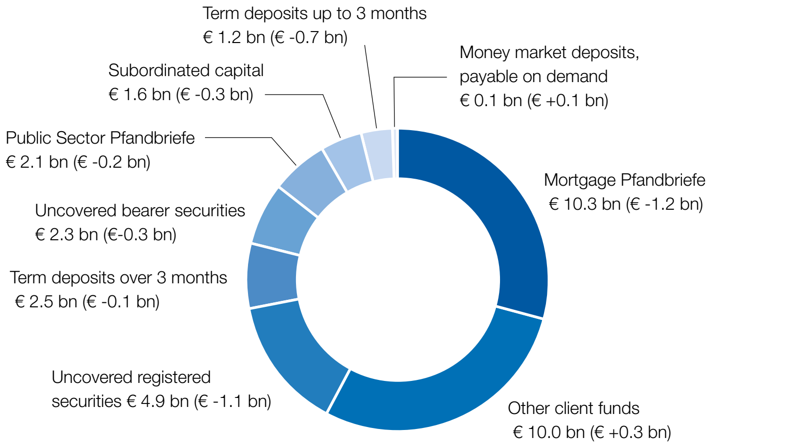
Operational risks

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.

Refinancing portfolio diversification by product

as at 31 Dec 2017 versus 31 Dec 2016 Total volume (nominal): € 35.0 bn



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 as well as historical 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.

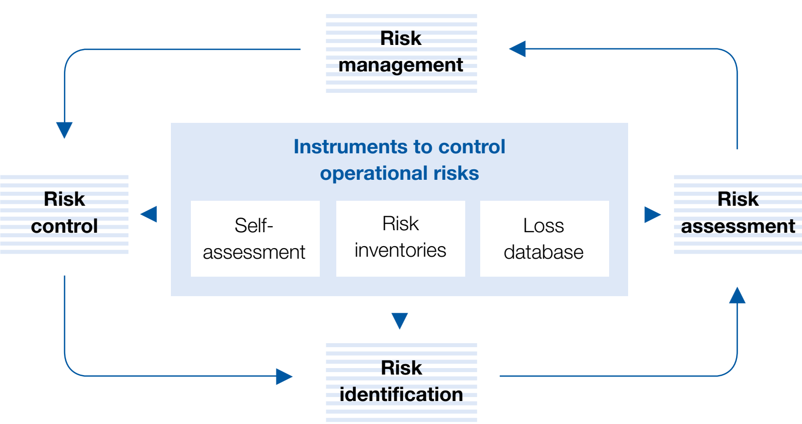
The legal department reports to the Management Board, (at least) on a quarterly basis, as well as on an event-driven basis. Moreover, information about legal risks is included in operational risk reporting.

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.

Strategy Development, as well as Finance & Controlling and Risk Controlling, are 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.

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. To protect and enhance the reputation of Aareal Bank Group, and to ensure the Group's uniform strategic position, the Group Communication Policy sets out procedures for (and the approach to be taken in) external media relations, internal communications, governmental affairs, financial reporting, as well as marketing, under the central responsibility of Corporate Communications.

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 & Controlling 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 & Controlling 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 & Controlling division in consolidation software and aggregated for the purpose of preparing the consolidated financial statements. The number of employees within Aareal Bank's Finance & Controlling 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 and the management report of Aareal Bank AG as well as the consolidated financial statements and group management report. 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 expert in the fields of accounting or auditing, 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 procedures 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 & Controlling 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.

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. 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 and Opportunities

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

Macro-economic environment

Developments for the economy, as well as for financial and capital markets, are exposed to diverse risks and threats – which also have an impact on the commercial property markets. The economic forecast as at the end of December 2017 was characterised by significant uncertainty, such as geopolitical risks, protectionist economic policies, and changing monetary policy.

The low interest rate environment – combined with expected low inflation – continues to be a risk factor in many markets, as it harbours risks for financial stability of a systemic dimension, should it persist for a longer period. Low interest rates can lead to a misallocation of investment capital, possibly resulting in asset-price bubbles. Moreover, market participants are encouraged to take on higher levels of risk. Sudden or excessive changes in interest rates may trigger a revaluation and changes in investor behaviour, potentially leading to a collapse in asset prices. Emerging economies in particular will have to face capital outflows, and may have to raise their own interest rates. Although financial market players are expecting interest rates to rise further in the US, the impact – in parallel with a decline in the Federal Reserve's balance sheet – is as yet unclear. Turmoil in the financial and capital markets may still hurt the global economy. A longer-lasting period of low interest rates complicates an exit from such an environment, heightening the risks for the financial and capital markets. In this context, traditional central bank policy may lose its impact. Low interest rates may also entice a scaling back of reform and consolidation efforts in various sectors.

In the US, we see increased political uncertainty, which might prevent or delay measures to stimulate growth. If this was to materialise, it could tip the economy into recession. Therefore, simultaneous corrections could occur on those financial and capital markets where expectations of such growth stimulus had led to currency or price increases.

A major risk factor in Europe is the impact of the UK's exit from the EU (Brexit). We continue to see significant economic risks from this – both for the UK and for the EU. Differences about the EU's future orientation might cause further uncertainty; in this context, political uncertainty in Spain also needs to be mentioned. A separation of the Autonomous Community of Catalonia from the Kingdom of Spain might have negative economic consequences, which are as yet difficult to assess. The tense political situation in Turkey is a risk burdening the country's economy.

The sovereign debt crisis might still raise its head again in Europe: the problem of high levels of indebtedness continues to exist. Diverging monetary policy between the US and the euro zone, as well as political reorientation, could also heighten that risk.

In China, there is continued danger that the sharp increase in levels of private debt could lead to a pronounced market correction. Despite a slight easing of price pressure on the residential property market, the danger of a far-reaching market correction still exists.

Economy

Despite the numerous uncertainty factors and burdens, economic momentum – which already prevailed in 2017, driven by strong consumer spending and robust investment – is set to continue this year. The growth rate of real global economic output is expected to slightly exceed the levels seen during 2017. In this context, global trade is expected to grow further – which will especially benefit emerging market economies. Moderate inflation in the industrial countries is likely to provide additional support for purchasing power.

Group Management Report
Consolidated Financial Statements
Transparency

Still, developments will differ across the regions. Moreover, risks and uncertainty factors, were they to materialise to a substantial extent, could mute the economic development, or even cause recessive tendencies in certain regions.

We anticipate growth in the euro zone in 2018 to be slightly weaker than in 2017. In line with our projections for the region as a whole, most of the euro zone countries relevant to Aareal Bank should show moderate to good economic development. In this connection, we must assume that growth rates in the Netherlands and in Spain will remain high, albeit short of the previous year's levels. We expect stable and robust growth in Germany and France. The Italian economy is likely to continue its recovery, with growth in line with the previous year.

In 2018, the economic development of the EU as a whole is anticipated to be similar to that of the euro zone countries. For the UK, we expect economic growth in line with last year's levels. Brexit will continue to be a burden. The Polish economy is expected to continue growing strongly, albeit at a slightly weaker rate than in the previous year. Economic growth in Denmark and Sweden is forecast to be markedly weaker than in 2017, but still at a good level.

The Turkish economy is expected to show a significantly lower growth rate than in the previous year. Due to the political situation, the outlook is clouded by a high degree of uncertainty. We expect the economy in Russia to grow at a comparable level than in the previous year.

In the US, economic growth is anticipated to be slightly more dynamic than the year before, thanks to strong exports and high levels of investment, alongside robust consumption. Whilst uncertainty remains concerning the direction of economic policy, the tax reform adopted in December 2017 is nonetheless likely to provide clearly positive impulses. In Canada, we anticipate robust, yet slightly lower growth in real economic output, compared to the previous year.

Following a year influenced by non-recurring effects in China, we expect the trend of slowing real GDP growth rates to continue. Factors influencing economic development in China are the targeted reduction of over-capacity in heavy industry and the transition to an overall lower investment ratio. We are still witnessing uncertainty with regard to the increase of macro-economic debt.

Against a background of a positive economic development, we expect most labour markets across the euro zone as well as in other European countries to register slowly decreasing or virtually stagnating unemployment rates for 2018. The US unemployment rate is also likely to decline slightly.

Financial and capital markets, monetary policy and inflation

The risks and uncertainty factors we have listed so far also apply to the financial and capital markets this year. Likewise, any of the aforementioned risks could, were they to materialise to a substantial extent, cause turbulence on the financial and capital markets. In the current environment, we assume volatility will remain moderate overall. We continue to expect that financial and capital markets will remain receptive towards securities issues and refinancings.

The ECB's decision – taken in the previous year – to expand its asset-buying programme, as well as further measures, underscored our expectation that the very expansive monetary policy pursued in the euro zone would remain intact. In this context, there is a possibility that the ECB will terminate its asset-buying programme in the autumn. In contrast, further interest rate hikes are expected in the US, whilst the Fed will likely continue the reduction of its balance sheet in 2018. Given the prospect of interest rate adjustments, as indicated by the Bank of England, the likelihood of an increase in UK key interest rates during 2018 has risen. Given the UK's exit from the EU and forecast economic developments, any change is expected to be moderate.

The continued normalisation of monetary policy in the US suggests that further gradual interest rate hikes are on the horizon for this year. Although this may place upside pressure on interest levels in the euro zone and other EU countries, European interest rate levels are expected to remain very low during the remainder of the year given the ECB's very loose monetary policy stance.

Euro zone inflation is expected to be roughly in line with the levels seen in 2017 – accordingly, we assume the euro zone inflation rate to remain clearly below 2 % for the full year 2018. The average inflation rate in the US for the full year is anticipated to be slightly higher than in the euro zone, but likely to remain at the previous year's level. In China, inflation is likely to return to a rate just over 2%.

Regulatory environment

The trend towards a tighter regulatory framework in the banking business is set to persist during the coming years. For instance, the finalisation of the Basel III framework, adopted by the Basel Committee's Group of Governors and Heads of Supervision (GHOS), will bring about extensive changes to the approaches used for determining risk-weighted capital requirements (a concept known as "Basel IV"). Aareal Bank would already fulfil these future requirements, bearing in mind that these have as yet to be transposed into European law.

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). In addition, the Single Supervisory Mechanism (SSM) has developed expectations regarding the structure of ICAAP and ILAAP based on a multi-year plan. These expectations are set to be specified in more detail in 2018.

Furthermore, the Target Review of Internal Models within Pillar I has not yet been completed.

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. Moreover, EBA has published guidelines for PD and LGD estimates, and on the treatment of defaulted exposures, which must be implemented by the end of 2020.

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

The 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 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

During the year 2018, commercial property will continue to be a sought-after asset class in many markets. Global transaction volumes are therefore expected to remain high. Given the shortage of available first-class properties on offer, and rising total revenue requirements, investor interest in properties outside the top segment will likely increase compared to previous years. Investor demand is thus expected to continue to support performance this year. Nonetheless, commercial property markets are also exposed to major risks and threats. An excessively sharp interest rate hike – originating from the US – may have a negative effect on performance. Moreover, other uncertainty factors and risks in the macro-economic environment are also relevant for commercial property markets.

Several factors will impact the market value[1] of commercial property during the remainder of the year. Whilst the stable economy and the prevailing low interest rate environment will support property values, political uncertainty and a potentially significant interest rate increase can reduce values. Expansive monetary policy in numerous currency areas supports the upward trend in market values, which has now been intact for a very long time. Still, market cycles have not been invalidated. This means that cyclical downturns are possible as well.

We anticipate a largely stable development in the market values of commercial property in many markets this year.

We expect a stable development of market values in most European countries in 2018, including Italy, the Netherlands, Poland and Sweden. For Germany, France and Spain, we expect slightly positive growth. The situation in the UK is subject to uncertainty because of the Brexit vote. Market values could fall in some sub-markets, although we anticipate a stable development overall. Political unknowns in Turkey lead to uncertainty, which may have a negative impact on the market values of commercial property. We believe property values in Russia will stabilise in the current year due to the slight economic recovery.

In the US, backed by the relatively positive economic outlook, values are expected to show a slightly positive trend. Increasing interest rates pose certain risks for this development. We expect a stable performance in Canada.

In China, market values for commercial property are expected to remain stable.

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

We expect a slightly positive development overall in 2018 on the hotel markets of Europe's most significant economic centres. Looking at occupancy ratios, we see potential for further slight increases in numerous markets, including in Berlin and Paris. Likewise, we expect average revenues per available hotel room to further improve in most markets – in Paris and Madrid, for example. The difficult political situation in Turkey will continue to have negative implications for the hotel markets.

We believe a slight improvement on average in revenues per available room is likely in the US, with stable or slightly lower occupancy ratios. In Canada, we anticipate increases for both indicators – albeit short of the momentum seen in the previous year, which was driven by the 150th anniversary celebrations of the foundation of the Canadian Confederation.

In Asia, we anticipate occupancy ratios and average revenues per available room to remain stable throughout 2018 in the hotel markets of many metropolitan areas.

The intense competition in commercial property financing is also likely to persist in many markets during the current year, so that we assume that lenders will be willing to lower margins. We anticipate a virtually stable development in loan-to-value ratios across the various regions. Banks are expected to continue adhering to their preference for financing first-class properties in top locations. Investors' readiness to finance properties outside top locations will increase.

We have incorporated various market aspects and our "Aareal 2020" programme for the future, amongst other factors, in our assessment of anticipated new business volumes for the current year. For the Structured Property Financing segment, we are targeting new business of between € 7 billion and € 8 billion for the 2018 financial year, whereby the focus is set to remain on the high-margin US market. Aareal Bank Group's property financing portfolio should amount to between € 25 billion and € 28 billion at the end of 2018, subject to currency fluctuations. Within the framework of our "Aareal 2020" programme for the future, syn-

[1] Assessments of individual sub-markets and properties may deviate from the general description of developments on commercial property markets outlined below.

dication is set to be one of the instruments for managing the portfolio, and managing risk. Syndication is a suitable tool here, 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

The German housing and commercial property industries are expected to continue showing solid development in 2018, on the back of stable rents and a high degree of stability in property values. Companies in this sector will continue to pursue sustainable portfolio optimisation. Energy-efficient renovation, deployment of technical assistance systems, expanding the digital infrastructure and serial construction are the trends currently shaping investment trends.

Political developments and their impact on the profitability of individual measures may be affecting future corporate investment activities. Stricter regulations regarding energy efficiency measures to be incorporated during renovations, and rising requirements for new construction, might restrict the volume of investments.

The stable development on the residential property market is expected to prevail in 2018. Regional differences are expected to further increase, as a consequence of migration driven by education and labour market factors. Due to the ongoing urbanisation trend, we expect demand for apartments to rise further, especially in economically strong conurbations. Property investors and potential sellers within the housing and commercial property industries should continue to be able to benefit from these market developments.

We see good opportunities during 2018 to acquire new clients and to intensify the business relationships with our existing client base. This also applies to utilities and the waste disposal industry. In addition, in line with our "Aareal 2020" programme for the future, we are investing into the expansion of the "Housing Industry Ecosystem", the cross-sector development of interface products, and the expansion to adjacent ecosystems. We will also examine cooperations with Fintech and Proptech companies.

We expect the volume of deposits taken to remain on a high level. The persistent low interest rate environment, which is relevant for the results from our deposit-taking business, will continue to burden 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 2018 to pursue the growth strategy based on its strategy programme integrated in the "Aareal 2020" programme for the future. Both sales revenue and Aareon's contribution to consolidated operating profit are expected to rise significantly. Key success factors are the expansion of digital solutions within the Aareon Smart World portfolio, strengthening the ERP business, and growing activities targeting the commercial property markets in the Netherlands and in Germany. Furthermore, the structural organisation in the UK and Sweden are set to be optimised, with a view to more intensively exploiting the inherent potential regarding the existing customer base in these countries.

In Germany, Aareon anticipates higher sales revenues in the ERP business, especially from the acquisition of mse companies and the continued migration of GES customers to Wodis Sigma. Likewise, stronger demand is seen for digital solutions such as Immoblue Pro, Aareon CRM in conjunction with the tenant app, as well as for mobile services.

Sales revenue generated from ERP products in the international business will be slightly above the previous year's levels, whilst they are expected to remain unchanged year-on-year in France, the Netherlands and the UK. Incit Xpand, the solution for the Scandinavian markets, will be a growth driver. Following the acquisition of Kalshoven Groep, effective 1 April 2017, sales revenues are expected to increase in the Netherlands.

Sales revenues from digital solutions will also be significantly up year-on-year in the international business: in the UK, the CRM solution 360° Tenant Portal and a new release of the mobile solution are expected to generate additional demand. In the Netherlands, besides CRM solutions, growth is envisaged in the digital solutions Facilitor (for facility management), Trace & Treasury (for the management of assets), and ShareWorX (for case management). In France, the Building Relationship Management (BRM) and Supplier Relationship Management (SRM) solutions – newly-developed in 2017 – are expected to generate growth.

Based on the explanations outlined above, Aareon envisages a marked overall increase in sales revenue, as well as profits, for 2018. Aareon's contribution to consolidated operating profit is expected to amount to approximately € 40 million.

Business strategy

Aareal Bank Group's strategy focuses on sustainable business success. With its Group-wide "Aareal 2020" programme for the future, the Bank is addressing the challenges of the future. In an environment characterised by technological change, altered client needs and fiercer competition, this programme allows us to secure our strong foundation while also leveraging new revenue potential. Aareal Bank developed an extensive strategic roadmap for the implementation of Aareal 2020, including various initiatives and projects for the further development of the Group. One of the top priorities is unlocking new revenue potential in both segments; another is to adapt structures and processes to its stakeholders' requirements in a digital world.

Group targets

We anticipate the challenging business environment to prevail during the current financial year – with continued low interest rates in Europe, and strong competitive and margin pressure on key target markets. Against this background, we will continue to adhere to our business policy with a strict focus on risks and returns. We will further accelerate our strategic development, within the framework of the "Aareal 2020" programme for the future, in order to safeguard the Group's long-term success – in a business environment that is set to remain highly challenging in the future.

We anticipate consolidated net interest income for the full year 2018 between € 570 million and € 610 million, including the net result from the derecognition of financial assets and liabilities not measured at fair value through profit or loss – which will be reported separately, in accordance with IFRS 9, in the future. Allowance for credit losses is expected in a range between € 50 million and € 80 million. Net commission income, whose importance for the Group is continuously rising due to the expansion of business activities in the Consulting / Services segment, is anticipated to rise further, to between € 215 million and € 235 million. Administrative expenses are expected to decline to between € 470 million and € 500 million.

Against this background, we expect consolidated operating profit for the current year to be in a range between € 260 million and € 300 million; this is in line with the previous year's figure, adjusted for the positive non-recurring effect related to Corealcredit. We envisage RoE before taxes of between 9.5 % and 11.0 % for the current financial year, with earnings per share between € 2.60 and € 3.00. We affirm our medium-term target RoE of around 12% before taxes.

We will continue the reduction of non-strategic portfolios in the Structured Property Financing segment during 2018. At the same time, our core credit portfolio is planned to grow in line with respective market conditions: overall, subject to exchange rate fluctuations, the aggregate credit portfolio is expected to remain stable year-on-year, in a range between € 25 billion and € 28 billion. We are targeting new business between € 7 billion and € 8 billion for the current year, with a continued focus on the high-margin US market. In the Consulting/Services segment, we expect our IT subsidiary Aareon to provide a markedly higher contribution of approximately € 40 million to consolidated operating profit.

Subject to further regulatory changes, Aareal Bank considers a target CET1 ratio (post-finalisation of Basel III – so-called "Basel IV") of around 12.5 % to be appropriate. The Liquidity Coverage Ratio (LCR) is expected to be at least 150 %.

Corporate Governance Statement

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 full Corporate Governance Statement pursuant to sections 289f and 315d of the HGB is publicly available on the Company's website (www.aareal-bank.com/en/about-us/corporate-governance/), and in the "Transparency" section.

Consolidated Non-Financial Report

The German Act implementing the CRS Directive has transposed the EU CSR Directive (2014/95/EU) into national law. With effect from 1 January 2017, Aareal Bank AG is obliged to report on material non-financial aspects (environmental, employee and social matters, respect for human rights and anti-corruption matters), to the extent necessary for an understanding of the Company's development, performance, position and impact of its activity.

The required disclosure is published not later than four months after the reporting date, within the scope of a condensed separate non-financial report, on the Company's website (www.aareal-bank.com/en/responsibility/reporting-on-our-progress/).

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

The Supervisory Board determines the remuneration system, and the amount of remuneration for members of Aareal Bank AG's 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. It held eight meetings throughout the 2017 financial year. The Supervisory Board of Aareal Bank AG discussed remuneration issues at five meetings during the 2017 financial year.

The Supervisory Board defines – no later than immediately after the beginning of every financial year – the Management Board members' targets with respect to performance-related remuneration components. The Supervisory Board assesses Management Board members' target achievement and performance after the end of every financial year.

Members of the Management Board receive a fixed basic annual salary, a performance-related variable remuneration, as well as ancillary benefits. The Supervisory Board introduced a reduced entry-level remuneration for new members appointed to the Management Board. The majority of performance-related, variable remuneration is determined on the basis of a multiple-year assessment basis.

The amount of performance-related remuneration for Management Board members depends upon the individual Board member's performance, the performance of the division the respective member is responsible for, as well as the overall performance of Aareal Bank Group. The targets which are related to Aareal Bank Group's overall performance include annual targets and multiple-year targets. The measurement of the multiple-year target is undertaken retrospectively over a time period of three years. Annual and multiple-year targets are weighted using a ratio of 45 % (annual target) to 55 % (multiple-year target); within the annual target, individual, divisional, and Bank targets are weighted equally.

For each financial year, the Supervisory Board sets a target level for the Common Equity Tier 1 ratio (CET1 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 any of these two targets has not been achieved.

All targets for Management Board members 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. 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). Any negative deviations from targets will reduce performance-related remuneration. 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 Supervisory Board is entitled to increase or decrease the overall target achievement level by up to 20 %, applying reasonable discretion, in the event of any material, specified external or internal non-recurring effects, provided that the upper limit of 150 % for overall target achievement must not be exceeded. 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 in 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, the initial value for variable remuneration – as determined according to the principles set out above – 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 cash – pro rata temporis – over a defined retention 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 performance-related 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). Starting with performance-related remuneration for the 2018 financial year, the retention period will be extended to five years. 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 virtual shares, subject to a two-year

(starting with variable remuneration for the 2018 financial year: one-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 the division he/she is responsible for, as well as any weakness in the performance of Aareal Bank Group (ex-post risk adjustment). A negative individual performance contribution is deemed to be present, for example, in the event of breaches of the Code of Conduct and/or of Compliance guidelines, conduct that damages the Bank's reputation, or in the event of other misconduct which would justify a termination for good cause. Ex-post risk adjustment also involves a retrospective review as to whether the performance contributions assumed at the time of determining the initial value of performance-related remuneration are proven to be sustainable (backtesting). The Supervisory Board decides upon any adjustments to variable remuneration, according to its own best judgment, based on a recommendation by the Remuneration Control Committee. If any retained performance-related remuneration components are not awarded, or only in part, the remaining sum is forfeited, i.e. it is not carried forward into subsequent years. Moreover, 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.

Starting with variable remuneration for the 2018 financial year, agreements with Management Board members must ensure that any variable remuneration already disbursed may be reclaimed in certain cases of negative performance contribution (a "clawback"). Aareal Bank has already reached corresponding agreements with members of the Management Board, which will initially apply to variable remuneration for the 2018 financial year.

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 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 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 315a (1) 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 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 93 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 31 May 2017 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 30 May 2022. When exercising this authorisation, the Management Board will restrict the exclusion of shareholders' pre-emptive rights to a total of 20 % of the Company's share capital – including treasury shares and any shares issued during the term of this authorisation, under the authorisation under agenda item no. 6 of the Annual General Meeting held on 21 May 2014. 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 in relation to the 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. In addition, any acquisition of shares shall count towards the 10 % threshold for the authorisation for the acquisition of treasury shares. 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.