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Aareal Bank Group – Interim Report
1 January to 30 September 2018



**Aareal Bank
Group**

Key Indicators

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017
Results		
Operating profit (€ mn)	199	262
Consolidated net income (€ mn)	131	165
Consolidated net income allocated to ordinary shareholders (€ mn) ¹⁾	117	147
Cost/income ratio (%) ²⁾	41.8	41.1
Earnings per ordinary share (€) ¹⁾	1.97	2.46
RoE before taxes (%) ^{1) 3)}	9.7	12.6
RoE after taxes (%) ^{1) 3)}	6.3	7.8

	30 Sep 2018	31 Dec 2017
Statement of Financial Position		
Property finance (€ mn) ⁴⁾	25,126	25,088
Equity (€ mn)	2,853	2,924
Total assets (€ mn)	40,269	41,908
Regulatory indicators		
Risk-weighted assets (€ mn)	10,063	11,785
Common Equity Tier 1 ratio (CET1 ratio) (%)	20.8	19.6
Tier 1 ratio (T1 ratio) (%)	23.8	22.1
Total capital ratio (TC ratio) (%)	32.6	30.0
Common Equity Tier 1 ratio (CET1 ratio) – Basel IV (estimated) (%) ⁵⁾	13.4	13.4
Employees	2,775	2,800

	30 Sep 2018	31 Dec 2017
Moody's		
Issuer rating	A3	Baa1
Senior Preferred ⁶⁾	A3	–
Senior Non Preferred ⁷⁾	Baa1	Baa1
Bank deposit rating	A3	A3
Mortgage Pfandbrief Rating	Aaa	Aaa
Fitch Ratings		
Issuer default rating	BBB+	BBB+
Senior Preferred	A-	–
Senior Non Preferred	BBB+	BBB+
Deposit ratings	A-	A-
Sustainability ratings⁸⁾		
MSCI	AA	AA
ISS-oekom	prime (C)	prime (C)
Sustainalytics	70	70

¹⁾ The allocation of earnings is based on the assumption that net interest payable on the AT1 bond is recognised on an accrual basis.

²⁾ Structured Property Financing segment only

³⁾ On an annualised basis

⁴⁾ Excluding € 0.6 billion in private client business (31 December 2017: € 0.8 billion) and € 0.5 billion in local authority lending business by the former Westdeutsche ImmobilienBank AG (WestImmo) (31 December 2017: € 0.5 billion)

⁵⁾ Underlying RWA estimate, given a 72.5% output floor based on the final Basel Committee framework dated 7 December 2017. The calculation of the material impact upon Aareal Bank is subject to the outstanding EU implementation as well as the implementation of additional regulatory requirements (CRR II, EBA requirements, TRIM, etc.).

⁶⁾ Terminology Moody's: Senior Unsecured

⁷⁾ Terminology Moody's: Junior Senior Unsecured

⁸⁾ Please refer to our website (www.aareal-bank.com/en/responsibility/reporting-on-our-progress/) for more details.

This report contains rounded numbers, which may result in slight differences when aggregating figures and calculating percentages.

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Interim Group Management Report

Report on the Economic Position

Report on the Economic Position

Geopolitical uncertainties defined the environment over the first nine months of 2018. Besides the protectionist measures taken in the US, economic imbalances in some emerging markets fuelled uncertainty. The economy remained intact and economic expansion was robust, albeit at a slightly less dynamic pace than the year before.

Economy

The euro zone economy grew at a moderate pace in the first nine months of the year, with the third quarter showing a relatively weak growth rate. Industrial production was weaker in all three quarters, reflecting falling demand worldwide. Within the euro zone, growth was highest in the Netherlands and Spain. French and German growth rates were slightly below average, although French growth picked up pace significantly especially in the third quarter. By contrast, growth rates in Germany were low in the third quarter. Uncertainty arose as a result of the Italian parliamentary elections in February, which ultimately led to the creation of a Eurosceptic government. Growth in Italy was markedly below the euro zone average; the Italian economy stagnated in the third quarter.

Economic growth in the European Union (EU) was on a par with the euro zone thus far this year. As was the case in the previous year, growth in Poland and Sweden was considerably stronger than in the euro zone.

Following initial weakness, growth in the UK remained robust in the first nine months of the year, with the construction sector and private consumption in particular growing at an exceptional rate. Whilst negotiations surrounding the planned exit of the UK from the EU at the end of March 2019 have yielded initial agreements, such as a 21-month transition period, during which the UK will continue to have access to the EU internal market, numerous other issues – such as the border between

Ireland and Northern Ireland – remain unresolved at this stage.

Solid fundamental data and fiscal stimulus provided for strong growth in the US in the first nine months of the year. However, the import taxes levied against important trading partners and the backlashes from the countries in question have escalated political uncertainty and the risk of an open trade war.

The Chinese economy lost momentum during the course of the year, with slightly weaker exports and the negative effects of high private debt levels cited as some of the reasons for this. China responded to the import tariffs imposed by the US by also levying import taxes on a raft of US products. The situation worsened once more in the third quarter.

The labour markets benefited from the fundamentally good economy and the sustained economic cycle. In the euro zone, the trend of slightly falling unemployment rates continued in the first three quarters of 2018, whilst they remained stable, at a low level, in the UK and the US.

Financial and capital markets, monetary policy and inflation

The first nine months of the year on the financial markets was defined by volatility triggered by geopolitical events and the change in monetary policy. Particular noteworthy in this context was the political situation in Italy, which drove up Italian government bond yields. Emerging markets in particular were also affected.

The ECB set the course in the first half of 2018 for a turnaround in its monetary policy. In June, it announced it would end its net asset purchases at the end of 2018. The current purchase volume of € 30 billion monthly is expected to be reduced to € 15 billion monthly in the fourth quarter. Furthermore, the ECB plans to keep key interest rates low through summer 2019. No adjustments were made in the third quarter. The Bank of England on the other hand raised the base rate in August by

25 basis points to its present level of 0.75 %. The US Federal Reserve (Fed) increased its key rate corridor three times during the year – most recently in September – by 25 basis points each time, to 2.00-2.25 %.

The US dollar appreciated significantly against the euro, following an initial marked depreciation. The pound sterling on the other hand remained virtually constant vis-a-vis the euro initially, before easing slightly in the third quarter. The Canadian dollar weakened considerably against the euro in the first half of the year but managed to appreciate again slightly in the third quarter. The Swedish krona on the other hand weakened against the euro over the first three quarters.

Short-term interest rates exhibited significant differences between different currencies throughout the first three quarters, not least due to differences in monetary policy. In the euro zone and in Swedish krona, they remained slightly negative compared to the end of the previous year. In British pounds and Canadian dollars, rates rose slightly over the same period. However, they appreciated significantly in US dollars compared with the end of the previous year, before stabilising from mid-year onwards and remaining constant up to the end of the third quarter.

Long-term interest rates in the currency areas that are relevant to Aareal Bank rose steadily at the start of 2018 compared with the end of the previous year. Towards the end of the third quarter, euro zone and Swedish krona rates fell back again to (or slightly below) the levels seen at the end of 2017 – whereas US dollar, Canadian dollar and British pound rates were markedly higher at the end of the third quarter, compared to the 2017 year-end.

Ten-year government bond yields developed differently in the first three quarters owing to geopolitical uncertainties and adjustments in monetary policy. They fell in Germany, partially because of safe haven demand, but rose again slightly by the end of the third quarter. On the other hand, yields in Italy increased strongly during the third quarter. In the first half-year, the Italian government had

previously announced a far-reaching, expansive fiscal policy that is expected to replace the reform policy of the previous years. The continuous, albeit moderate upward trend continued in the US, with yields rising above the 3 % mark at times.

The rate of inflation in the euro zone rose slightly until the third quarter, to around 2.0 %. Inflation in the US also rose thus far this year to a level just over 2.5 %. In the UK, it fell again slightly from the highs of the previous year and remained at 2.5 % in the third quarter.

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, the implementation of the final draft of the Basel III framework into EU law (known as "Basel IV"), which was endorsed by the Basel Committee's Group of Governors and Heads of Supervision (GHOS). Furthermore, 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 documents (Guidelines on PD and LGD estimation, treatment of defaulted exposures, and determination of downturn LGD) will all bring about further regulatory changes. In addition, the amendments proposed by the ECB, EBA and the EU Commission on the treatment of non-performing loans must also be taken into account.

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

at 9.75 % thus far in 2018, comprising the total capital ratio of 8 % for Pillar I as well as a (Pillar 2) capital requirement of 1.75 % from the ECB's Supervisory Review and Evaluation Process (SREP). In addition, Aareal Bank is required to hold a (phased-in) capital conservation buffer of 1.875 %, plus a countercyclical capital buffer of 0.093 % forecast for the end of the year. Aareal Bank's pure SREP-driven CET1 requirement has been at 8.22 % thus far in 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 capital buffer forecast for the end of the year (0.093 %) (also mentioned above). No further liquidity requirements were imposed upon Aareal Bank.

Sector-specific and business developments

Structured Property Financing segment

Development of the volume of commercial property transactions was inconsistent across the different regions in the first nine months of 2018 compared with the same period of the previous year. It rose slightly in the Asia/Pacific region and in North America, but was noticeably lower in Europe than in the previous year.

Very low prime yields continue to be observed on numerous commercial property markets around the world. However, in some cases the markets for prime rents are in different phases of their business cycles. In the US, average rental growth in the office market is flattening out. In Europe, on the other hand, average rental growth in the office market continued to rise slightly, supported in particular by the high take-up volume. On the other hand, rental growth for retail property in the US stagnated, but was still slightly positive.

Fierce competition for the financing of existing commercial properties persisted in many markets. Margins in the European and US markets were under pressure this year so far, although they remained higher in the US than in Europe.

In a highly competitive and uncertain business environment, Aareal Bank was able to generate new business of € 6.1 billion in the first three quarters of 2018 (9m 2017: € 5.7 billion). Newly-originated loans amounted to € 4.8 billion during the period under review (9m 2017: € 3.8 billion). New business of € 1.9 billion (Q3 2017: € 1.9 billion) was generated in the third quarter of 2018, while newly-originated loans came to € 1.4 billion (Q3 2017: € 1.1 billion).

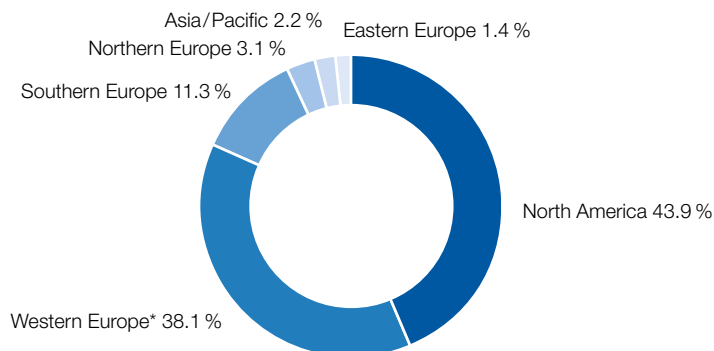
At 53.9 % (9m 2017: 57.4 %), the highest share of our new business was originated in Europe, followed by North America with 43.9 % (9m 2017: 41.3 %).

2.2 % of new business was originated in the Asia/Pacific region (9m 2017: 1.3 %).

New business¹⁾ 1 January -30 September 2018

by region (%)

Total volume: € 6.1 bn



* Including Germany

¹⁾ New business, excluding former WestImmo's private client business and local authority lending business

Europe

Commercial property transaction volumes generated in Europe in the first three quarters were noticeably lower, but stable overall compared with the previous year. The rate of decline varied in the different European markets. Whilst volumes accelerated in Belgium and Poland, they remained stable in France; declines were observed in Germany, Italy, Spain and the UK.

Cross-border and institutional investors were on the buy side for the most part, whereas private

investors tended to be sellers. REIT structures had balanced positions.

Rents for first-class commercial properties in the European economic centres showed a largely stable to slightly rising trend in the first nine months of 2018 compared with the end of the previous year. In the office property segment, slight increases were visible in some markets such as Berlin and Madrid. Average rents were stable in numerous markets, as were prime rents for logistics and retail property.

Prime yields for commercial property showed a mixed picture in the European economic centres.¹⁾ For office properties, yields – which were already at very low levels in some markets – once again declined slightly compared with the end of the previous year, for example, at the top German locations and in the Netherlands. Yields for retail properties continued to decline in Germany and the Netherlands, whilst they increased in France and in the UK. Yields for first-class logistics properties fell slightly in the first three quarters of 2018 compared with the end of the previous year. Political uncertainty in Italy had no direct impact on property market yields – in fact, they even declined slightly. For office properties outside the top-class range, yields tended to be stable to slightly lower. Yields for retail properties outside the prime locations were stable or rising slightly. The slight rises were observed particularly in France, Italy, the Netherlands, and the UK.

Hotel markets in the European economic centres painted a diverging picture during the first three quarters of 2018. Occupancy rates rose compared with the first three quarters of 2017 in some markets such as Brussels, London, Madrid and Paris. They fell slightly in Hamburg and Munich, and to a somewhat greater extent in Barcelona and Warsaw. The indicator of average revenue per available room (which is important for hotel markets) recorded a slight increase in most markets; strong increases were seen in Brussels and Paris. Average revenues per available hotel room in Hamburg and Munich were down slightly on the previous year. Barcelona and Warsaw, however, reported even greater declines.

Aareal Bank originated new business of € 1.3 billion (Q3 2017: € 1.2 billion) in Europe in the third quarter of 2018. New business in Europe in the first three quarters thus totalled € 3.3 billion (9m 2017: € 3.3 billion). The largest share by far was transacted in Western Europe, followed by Southern and Northern Europe; Eastern Europe's share was comparatively minor.

North America

Commercial property transaction volumes rose slightly during the first three quarters from the previous year. Investor interest thus remained high, despite rising interest rates.

REIT structures and private investors were clearly on the sell side, while institutional investors reported balanced investment positions. Cross-border investors were active market participants and clearly on the buy side.

Rents for office and retail properties were virtually stable on a national average in the US, compared to the final quarter of 2017. There were marginal differences in the regional centres. Rents for office properties rose slightly in Atlanta, Chicago and Los Angeles. By contrast, they stagnated in Boston, New York and Washington DC. Retail property rents rose somewhat in Atlanta and Denver, but showed a slightly declining trend in New York and San Francisco.

The first three quarters were characterised by a largely consistent yield development. On a national average, investment yields in the US hardly moved – compared to the year-end 2017 – for office and retail properties. A slight increase was observed for office properties in Washington, DC, both in and outside prime locations.

In the US, average occupancy rates for hotel properties remained stable year-on-year. Average revenue per available hotel room climbed slightly,

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

when measured against the comparable value from 2017. In Canada, occupancy rates rose slightly, whilst average revenue per available hotel room increased significantly.

Aareal Bank originated new business of € 0.5 billion in North America during the third quarter of 2018 (2017: € 0.7 billion), bringing aggregate new business in North America to € 2.7 billion for the first nine months of the year (2017: € 2.4 billion). This business was originated in the US and in Canada.

Asia/Pacific

Transaction volumes in the Asia/Pacific region were up somewhat year-on-year during the first three quarters of 2018.

Cross-border and institutional investors were on the buy side for the most part, while REIT structures and private investors were clearly on the sell side.

Rents for first-class office and retail properties in the metropolitan areas of Beijing and Shanghai were virtually unchanged from year-end 2017.

Investment yields for newly-acquired, high-quality office property remained stable in Beijing and Shanghai. Yields for retail property were stable in Beijing, whilst a slight decline was observed in Shanghai.

Developments on the hotel markets in Beijing and Shanghai have varied greatly this year so far compared with the corresponding prior-year period. Whilst the average revenue per available hotel room rose markedly and occupancy rates increased slightly in Beijing, occupancy figures in Shanghai fell slightly on stable average revenues per available hotel room.

Aareal Bank originated new business of € 0.1 billion (2017: negligible new business) in the Asia/Pacific region during the first three quarters of 2018.

Acquisition of Düsseldorf Hypothekbank AG (Düsselhyp)

On 10 September 2018, Aareal Bank Group reached an agreement with the Association of German Banks (Bundesverband Deutscher Banken e.V. – "BdB") on the acquisition of all shares in Düsseldorf Hypothekbank AG. Closing of the transaction is subject to regulatory approvals, and is currently expected to take place in 2018. The preliminary purchase price is approximately € 162 million. The final purchase price will depend upon market price fluctuations until the closing date.

Aareal Bank will not pursue any further strategic objectives with the acquisition. Düsseldorf Hypothekbank AG has undergone an orderly run-down process since 2015, under the auspices of its previous owner; the bank no longer actively originates new property finance business on the market. Aareal Bank is set to consistently pursue this orderly run-down.

For Aareal Bank, the transaction is expected to lead to a positive one-off effect from initial consolidation (negative goodwill) in the amount of approximately € 52 million. Operating profit for the 2019 financial year will presumably be burdened by the transaction, in a very low double-digit million amount. These costs have reduced the purchase price and increased negative goodwill accordingly.

Assuming the closing will take place in 2018, as planned, said one-off effect will materialise in the 2018 financial year. In such case, Aareal Bank will increase its original profit forecast for the 2018 financial year, expecting consolidated operating profit – including the one-off effect – to be in a range between € 312 million and € 352 million, and EpS to be in a range between € 3.47 and € 3.87.

Consulting/Services segment

Bank division Housing Industry

The housing industry and the commercial property sector in Germany have proven to be stable market segments. Rental income generated from a highly-diversified tenant group thus guarantees a secure

foundation. The German residential rental market continued to see a good development.

Digitalisation is becoming an increasingly determining factor in the institutional housing industry. A growing number of companies are initiating measures to enhance efficiencies in the core processes and boost service quality, focusing in particular on the areas of letting, accounting, controlling and customer service.

The first three quarters of 2018 saw the Bank's Housing Industry division strengthening its market position via the acquisition of new customers. Moreover, a large number of clients now use the new Corporate Banking Portal which, in addition to its accounts portal functionality, also serves as a platform for future digital offerings. We also continuously expanded our client base in the energy and waste disposal industries, especially through interface products (such as BK01 eConnect and BK01 immoconnect) facilitating cross-sector collaboration amongst client groups. Examples include accounting documentation and invoicing of energy supplies. This brought in more business partners from the housing industry – managing more than 120,000 residential units between them – for the payments and deposit-taking businesses.

At present, more than 3,700 clients throughout Germany are using our process-optimising products and banking services. In line with the "Aareal 2020" programme for the future, the volume of deposits from housing industry clients averaged around € 10.4 billion in the third quarter of 2018 (Q2 2018: € 10.5 billion). During the period under review, they averaged € 10.4 billion (9m 2017: € 9.9 billion). All in all, this reflects the strong trust that clients place in Aareal Bank.

Aareon

Aareon's contribution to consolidated operating profit amounted to € 21 million during the period under review (9m 2017: € 21 million). Results remained at the previous year's levels, due to non-recurring cost increases incurred with a major project as well as delays with another project.

Business volume of the ERP solutions was up on the previous year, supported by the previous year's acquisitions, among other things. Further customers opted for Wodis Sigma in Germany in the third quarter of 2018. Among these new customers, there are still 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 continues to implement a large number of migration projects. The GES system is approaching the end of its lifecycle. Most customers have opted in favour of one of the Wodis Sigma modern ERP systems or for SAP® solutions and Blue Eagle, or their systems were already migrated. The volume of business conducted with SAP® solutions and Blue Eagle is down slightly on the previous year, due to the aforementioned effects of a major project. Several commercial property companies opted for the RELion ERP solution.

In the Netherlands, two new key accounts were acquired for the Tobias AX ERP solution, within the scope of a tender. In the commercial property markets, several key customers renewed their contracts for the REMS solutions. Demand for the range of consulting services is growing in France due to new legal requirements. In addition, the Platinum solution that has been distributed successfully to date has led to a significant increase in maintenance revenues. Despite intense competition in the UK, Aareon UK succeeded in winning two important tenders for Aareon QL. Aareon Sverige has realised improvements in implementing projects in Northern Europe. The business in Norway is burdened by the effects of a major project.

In the course of the digital transformation process, the digital solutions of Aareon Smart World will be developed across the entire Group. This will be achieved on the one hand through the in-house research and development team, and the associated Group-wide transfer of knowledge. On the other hand, Aareon is entering into cooperation with proptech companies that have developed solutions providing added value to the Aareon Smart World stakeholders. In order to participate to a greater

extent in interesting and innovative enterprises, Aareon Group founded AV Management GmbH in the second quarter. It operates under the name Ampolon Ventures and is strongly linked to the start-up scene.

The digital solutions involved boosting the cross-border development of Aareon CRM in particular. The CRM app simplifies customer relationship management between housing companies and tenants or owners. The CRM app has been intensely marketed in Germany since the fourth quarter of 2017. It has already been rolled out in a major pilot project, and further customers were acquired.

Business volumes with digital solutions continued to increase year-on-year. We saw demand in Germany for the following digital solutions in particular: Aareon Archiv kompakt (document management), Mareon service portal (connectivity to craftsmen/maintenance), Aareon CRM (tenant/owner portal) and mobile solutions. Demand here benefits from the migration business with the ERP solutions, as a client's decision to opt for an ERP solution will, for the most part, lead directly to the acquisition of something (or somethings) digital.

Numerous customers, among them key accounts, opted for digital solutions in the Netherlands. Many products were rolled out too. In France, agreements were concluded for the digital Aareon solutions, such as Aareon CRM. In the UK, the newly-acquired ERP customers opted for further digital solutions at the same time.

The volume of business generated with add-on products is up slightly on the previous year. The positive development of the outsourcing business in Germany continued. BauSecura's insurance business also increased over the previous year.

Aareon is now targeting new markets, such as utilities. Aareon developed the cross-industry solution – Aareon Wechselmanagement – for the energy supply companies, together with other utilities, housing enterprises and metering service providers. It is designed to digitalise the processes involved in a change of tenant. Initial sales of the

solution have been concluded, and already rolled out for one customer.

Financial Position and Financial Performance

Financial performance

Group

Consolidated operating profit amounted to € 199 million during the first nine months of the financial year (9m 2017: € 262 million). The comparative figure for the previous year's period included € 50 million in net reversals of provisions in connection with the final agreement on contractual issues with a third party, which were still pending when Aareal Bank Group acquired former Corealcredit, and the release of tax assessment notes. This was offset by corresponding income tax expense of € 26 million. Moreover, effects from early loan repayments were lower.

Net interest income totalled € 400 million, an expected reduction from the previous year (9m 2017: € 449 million), which was largely due to the portfolio decline seen in the previous year, reflecting – amongst other factors – the scheduled reduction of the former WestImmo and Corealcredit portfolios.

Loss allowance amounted to € 33 million (9m 2017: € 53 million) and was thus in line with our expectations.

Net commission income increased to € 152 million (9m 2017: € 145 million), which was mainly due to higher sales revenue at Aareon.

The net € 16 million gain on derecognition of loan receivables (9m 2017: € 37 million) declined due to lower effects from early loan repayments.

The net loss from financial instruments (fvpl) and on hedge accounting in the aggregate amount of € -3 million (9m 2017: € 8 million) mainly resulted from exchange rate fluctuations and changes in the measurement of hedging derivatives (fvpl).

Consolidated net income of Aareal Bank Group

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾
€ mn		
Net interest income	400	449
Loss allowance	33	53
Net commission income	152	145
Net derecognition gain or loss	16	37
Gains/losses from financial instruments (fvpl)	-1	13
Net gain or loss from hedge accounting	-2	-5
Net gain or loss from investments accounted for using the equity method	-	-
Administrative expenses	344	388
Net other operating income/expenses	11	64
Operating profit	199	262
Income taxes	68	97
Consolidated net income	131	165
Consolidated net income attributable to non-controlling interests	2	6
Consolidated net income attributable to shareholders of Aareal Bank AG	129	159

¹⁾ Comparative amounts reclassified according to the new classification format

At € 344 million (9m 2017: € 388 million), administrative expenses were reduced as expected, thanks to lower running costs and transformation costs.

Overall, this resulted in consolidated operating profit of € 199 million for the first nine months of the year (9m 2017: € 262 million). Taking into consideration tax expenses of € 68 million and non-controlling interest income of € 2 million, consolidated net income attributable to shareholders of Aareal Bank AG amounted to € 129 million (9m 2017: € 159 million). Assuming the pro rata temporis accrual of net interest payments on the ATI bond, consolidated net income allocated to ordinary shareholders stood at € 117 million (9m 2017: € 147 million). Earnings per ordinary share amounted to € 1.97 (9m 2017: € 2.46) and annualised return on equity (RoE) before taxes to 9.7 % (9m 2017: 12.6 %).

Structured Property Financing segment

Operating profit in the Structured Property Financing segment amounted to € 222 million during the first nine months of the financial year (9m 2017: € 281 million). The comparative figure for the pre-

vious year's period included € 50 million in net reversals of provisions in connection with the final agreement on contractual issues with a third party, which were still pending when Aareal Bank Group acquired former Corealcredit, and the release of tax assessment notes. This was offset by corresponding income tax expense of € 26 million. Moreover, effects from early loan repayments were lower.

Segment net interest income of € 409 million showed an expected decline from the previous year (9m 2017: € 457 million), which was largely due to the portfolio decline seen in the previous year, reflecting – amongst other factors – the scheduled reduction of the former Westlmmo and Corealcredit portfolios.

Loss allowance amounted to € 33 million (9m 2017: € 53 million) and was thus in line with our expectations.

The net € 16 million gain on derecognition of loan receivables (9m 2017: € 37 million) declined due to lower effects from early loan repayments.

The net loss from financial instruments (fvpl) and on hedge accounting in the aggregate amount of € -3 million (9m 2017: € 8 million) mainly resulted from exchange rate fluctuations and changes in the measurement of hedging derivatives (fvpl).

At € 182 million (9m 2017: € 234 million), administrative expenses were reduced as expected,

thanks to lower running costs and transformation costs.

Overall, operating profit for the Structured Property Financing segment was € 222 million (9m 2017: € 281 million). Taking income tax expenses of € 77 million into consideration (9m 2017: € 104 million), the segment result was € 145 million (9m 2017: € 177 million).

Structured Property Financing segment result

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾
€ mn		
Net interest income	409	457
Loss allowance	33	53
Net commission income	6	4
Net derecognition gain or loss	16	37
Gains/losses from financial instruments (fvpl)	-1	13
Net gain or loss from hedge accounting	-2	-5
Net gain or loss from investments accounted for using the equity method	-	-
Administrative expenses	182	234
Net other operating income/expenses	9	62
Operating profit	222	281
Income taxes	77	104
Segment result	145	177

¹⁾ Comparative amounts reclassified according to the new classification format

Consulting/Services segment result

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017
€ mn		
Sales revenue	171	162
Own work capitalised	5	3
Changes in inventory	-	0
Other operating income	3	3
Cost of materials purchased	30	26
Staff expenses	116	109
Depreciation, amortisation and impairment losses	11	9
Net gain or loss from investments accounted for using the equity method	-	-
Other operating expenses	45	43
Interest and similar income/expenses	0	0
Operating profit	-23	-19
Income taxes	-9	-7
Segment result	-14	-12

Consulting/Services segment

Sales revenue generated in the Consulting/Services segment developed positively during the first nine months 2018, totalling € 171 million (9m 2017: € 162 million), driven particularly by Aareon's higher sales revenues. The persistent low interest rate environment continued to burden margins from the deposit-taking business that are reported in sales revenues.

The cost of materials purchased rose to € 30 million (9m 2017: € 26 million), whilst staff expenses increased to € 116 million (9m 2017: € 109 million) and depreciation/amortisation/write-downs to € 11 million (9m 2017: € 9 million).

Other items were roughly unchanged from the previous year's levels.

Overall, segment operating profit for 2018 was € -23 million (9m 2017: € -19 million). Aareon's contribution was € 21 million (9m 2017: € 21 million).

Taking income taxes into consideration, the segment result amounted to € -14 million (9m 2017: € -12 million).

Financial position

Consolidated total assets as at 30 September 2018 amounted to € 40.3 billion, after € 41.9 billion as at 31 December 2017.

Property financing portfolio

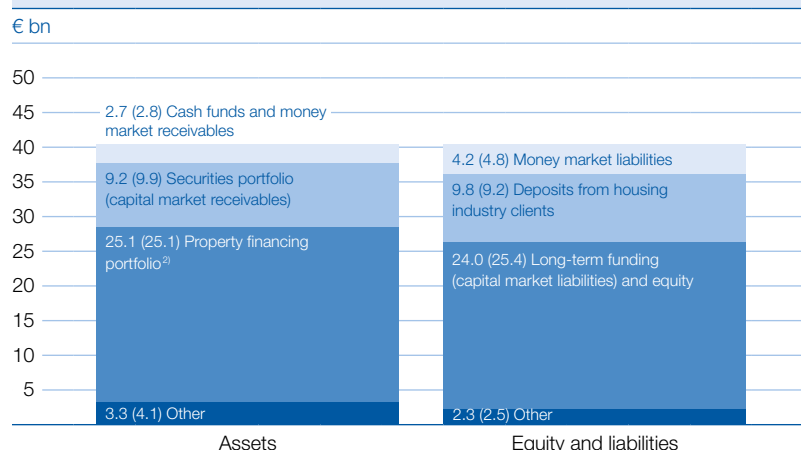
The volume of Aareal Bank Group's property financing portfolio stood at € 25.1 billion as at 30 September 2018 (31 December 2017: € 25.1 billion). The international share of the portfolio increased to 87.4 % (31 December 2017: 84.8 %) – due, in particular, to the planned reduction of the former Westlmmo and Corealcredit portfolios.

At the reporting date (30 September 2018), Aareal Bank Group's property financing portfolio was composed as shown in the graphs beside and on the following page, compared with year-end 2017.

Whilst the portfolio shares of Germany and Eastern Europe declined by 2.6 and 2.3 percentage points, respectively, the North American portfolio share rose by about 2.2 percentage points; Western Europe was up by 1.7 percentage points. Portfolio shares for all other regions remained relatively stable.

The share of hotel property and logistics property increased by 1.2 or 1.7 percentage points, respectively, compared to year-end 2017, whilst the share of office property was reduced by 2.8 percentage

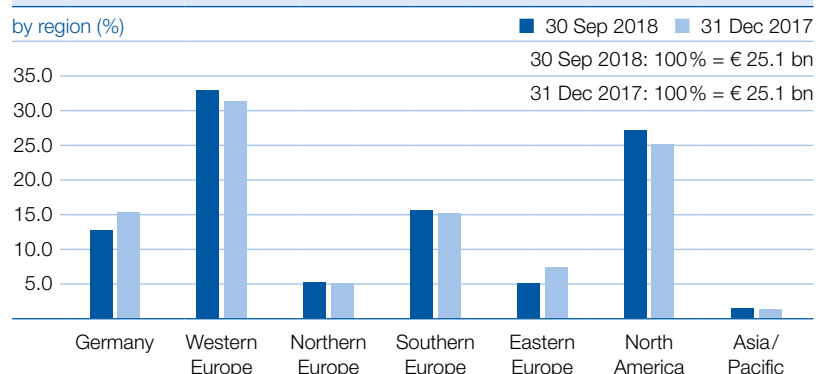
Asset/liability structure as at 30 Sep 2018 (31 Dec 2017¹⁾)



¹⁾ Comparative amounts reclassified according to the new classification format

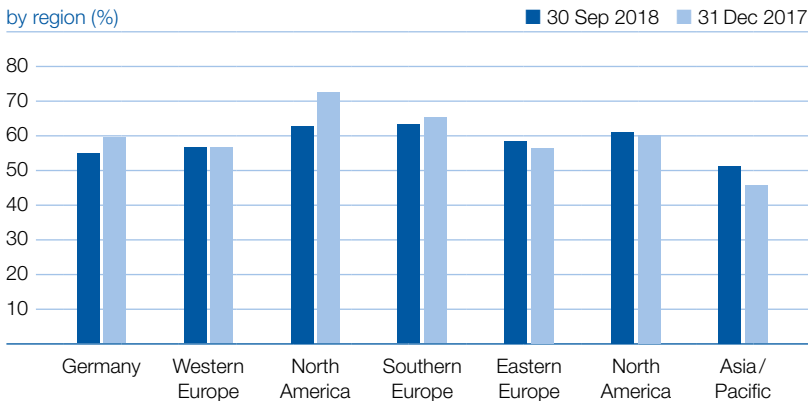
²⁾ Excluding € 0.6 billion in private client business (31 December 2017: € 0.8 billion) and € 0.5 billion in local authority lending business by the former Westdeutsche ImmobilienBank AG (Westlmmo) (31 December 2017: € 0.5 billion)

Property financing volume¹⁾ (amounts drawn)



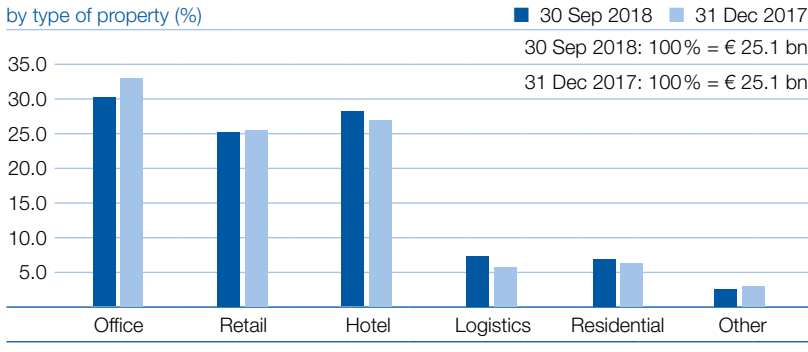
¹⁾ Excluding former Westlmmo's private client business and local authority lending business

Average LTV of property financing¹⁾

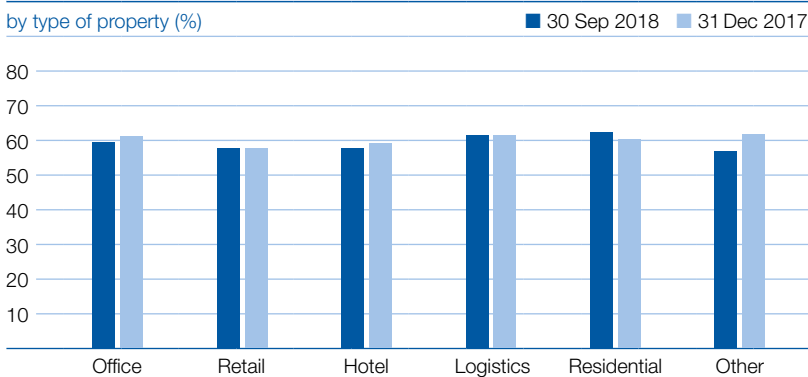


Note that the loan-to-value ratios are calculated on the basis of drawdowns and market values, including supplementary collateral with sustainable value, excluding defaulted property financings.

Property financing volume¹⁾ (amounts drawn)



Average LTV of property financing¹⁾



Note that the loan-to-value ratios are calculated on the basis of drawdowns and market values, including supplementary collateral with sustainable value, excluding defaulted property financings.

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

points. The share of other property types in the overall portfolio remained almost unchanged compared to the year-end 2017.

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

As at 30 September 2018, the nominal volume of the securities portfolio²⁾ was € 7.7 billion (31 December 2017: € 8.3 billion). 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.³⁾ More than 75 % of the portfolio fulfils the requirements for "High Quality Liquid Assets" (as defined in the Liquidity Coverage Ratio (LCR)).

Financial position

Funding and equity

Funding

Aareal Bank Group has remained very solidly funded throughout the first nine months of the 2018 financial year. Total long-term refinancing as at 30 September 2018 amounted to € 21.4 billion (31 December 2017: € 22.8 billion), comprising Pfandbrief issues as well as senior unsecured and subordinated issues. As at the reporting date, Aareal Bank also had € 9.8 billion at its disposal in deposits generated from the business with the housing industry (31 December 2017: € 9.2 billion). Money-market liabilities amounted to € 4.2 billion (31 December 2017: € 4.8 billion).

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

²⁾ As at 30 September 2018, the securities portfolio was carried at € 9.2 billion (31 December 2017: € 9.9 billion).

³⁾ The rating details are based on the composite ratings.

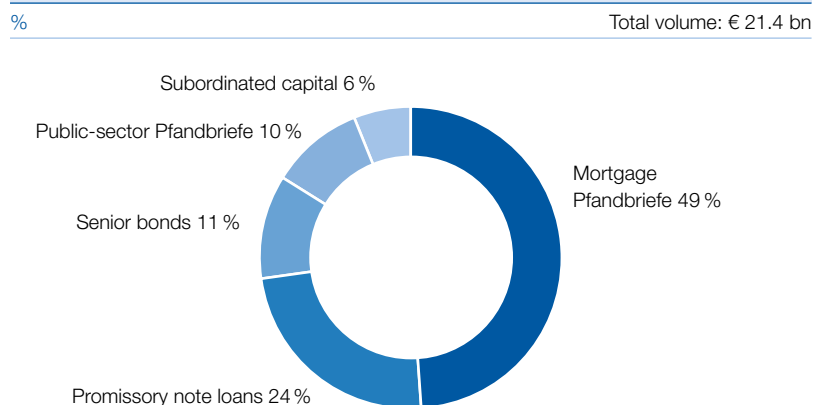
Aareal Bank Group very successfully raised € 2.5 billion on the capital markets during the first nine months of 2018. Total volume comprises € 2 billion in Pfandbriefe and € 0.5 billion in senior unsecured issues, comprising three benchmark Mortgage Pfandbrief issues of € 500 million each, plus a benchmark Mortgage Pfandbrief issue of GBP 250 million. The remaining € 0.5 billion in senior unsecured placements in turn comprised € 0.2 billion in senior non-preferred and € 0.3 billion in senior preferred securities.

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 € 2,853 million as at 30 September 2018 (31 December 2017: € 2,924 million), comprising € 300 million for the Additional Tier I (AT I) bond. Equity declined due to the distribution of dividends, and a distribution on the AT I bond. Please

Capital market funding mix as at 30 September 2018



also refer to the statement of changes in shareholders' equity, and to our explanations in Note 20.

For further information on the transitional effects resulting from the introduction of IFRS 9, please refer to the sub-section "First-time application of IFRS 9 Financial Instruments" in the "Basis of Accounting" section of the Notes.

Regulatory capital

	30 Sep 2018	31 Dec 2017
€ mn		
Common Equity Tier 1 (CET 1)	2,095	2,305
Tier 1 (T1)	2,395	2,600
Total capital (TC)	3,285	3,536
%		
Common Equity Tier 1 ratio (CET 1 ratio)	20.8	19.6
Tier 1 ratio (T1 ratio)	23.8	22.1
Total capital ratio (TC ratio)	32.6	30.0
CET1 ratio – Basel IV (estimated) – ¹⁾	13.4	13.4

¹⁾ Underlying RWA estimate, given a 72.5 % output floor based on the final Basel Committee framework dated 7 December 2017.

The calculation of the material impact upon Aareal Bank is subject to the outstanding EU implementation as well as the implementation of additional regulatory requirements (CRR II, EBA requirements, TRIM, etc.).

The regulatory measurement of risk-weighted assets (RWAs) in the area of credit risks is based on both the Advanced Internal Ratings-Based Approach (AIRBA), and on the standardised approach (CRSA). This is subject to various realignments,

(“Basel IV”, EBA requirements), or a review of underlying approved internal models (TRIM). We cannot rule out that considerable increases might occur in this context.

Analysis of risk-weighted assets (RWA)

30 September 2018

	EAD	Risk-weighted assets (RWA)			Regulatory capital requirements
		AIRBA	CRSA	Total	
€ mn					
Credit risks	42,362	7,713	650	8,363	669
Companies	26,949	5,675	79	5,754	460
Institutions	2,879	348	14	362	29
Public-sector entities	10,904	0	20	20	2
Other	1,630	1,690	537	2,227	178
Market price risks				100	8
Credit Valuation Adjustment				189	15
Operational risks				1,411	113
Total	42,362	7,713	650	10,063	805

31 December 2017

	EAD	Risk-weighted assets (RWA)			Regulatory capital requirements
		AIRBA	CRSA	Total	
€ mn					
Credit risks	44,141	8,577	1,432	10,009	801
Companies	27,539	6,400	778	7,178	574
Institutions	3,065	376	14	390	31
Public-sector entities	11,664	0	21	21	2
Other	1,873	1,801	619	2,420	194
Market price risks				134	11
Credit Valuation Adjustment				209	17
Operational risks				1,433	114
Total	44,141	8,577	1,432	11,785	943

Risk Report

Aareal Bank Group Risk Management

The Annual Report 2017 contains a comprehensive description of Aareal Bank Group's risk management approach, including the corresponding organisational structure and workflows in the lending and trading businesses, as well as the methods and procedures used for measuring and monitoring risk exposure. Within the scope of this interim report, we will once again briefly outline the key components of our risk management structure, together with the key developments during the period under review. The business policy set by the Management Board, and duly acknowledged by the Supervisory Board, provides the conceptual framework for Aareal Bank Group's risk management. Taking this as a basis, and strictly considering the Bank's risk-bearing capacity, we have formulated detailed strategies for managing the various types of risk. These risk strategies, as well as the Bank's business strategy, are adapted to the changed environment at least once a year, adopted by the Management Board, and duly acknowledged by the Supervisory Board. Suitable risk management and risk control processes are deployed to implement the risk strategies, and to ascertain the Bank's ability to bear risk. A monthly internal risk report is prepared for all material types of risk, and submitted to the Bank's Management Board and Supervisory Board.

Risk-bearing capacity and risk limits

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

sufficient potential risk cover in order to service all liabilities (the 'gone concern' approach). The statements below relate to the going-concern approach which the Bank has implemented as a primary management process.

In accordance with this approach, potential risk cover is determined using data derived from the income statement and from the statement of financial position; this derivation also forms the basis for determining regulatory capital. The risk-bearing capacity concept is based on the conservative planning of Tier I capital until the next year-end date, and the subsequent year-end, respectively. This involves setting aside the maximum amount of own funds required as potential risk cover to offset risks without causing a breach of minimum requirements pursuant to the Capital Requirements Regulation (CRR). Aareal Bank has set 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.

The reduction of regulatory capital, in the course of the changeover to IFRS 9, had an identical impact on aggregate risk cover. Given the use of planned Tier I capital, this effect was already accounted for as at 31 December 2017. The regular rolling forward of aggregate risk cover to the planning date of 31 December 2019 took place during the second quarter.

We are also currently working intensively on the implementation of the ECB's guideline on the Internal Capital Adequacy Assessment Process (ICAAP), published for consultation. In this context, and within the scope of regular adjustments to the cover assets pools, we adjusted the risk taxonomy in line with regulatory expectations. Specifically, the previous category of market price risk has been broken up with the introduction of risk categories IRRBB (interest rate risk in the banking book) and CSRBB (credit spread risk in the banking book), in line with regulatory requirements; individual limits have been set for these new categories. Foreign exchange risk remains assigned to other market

risk. The risk-reducing inclusion of inter-risk correlations is no longer permitted for the purposes of determining risk-bearing capacity utilisation – a key cause for the increase of this indicator. Property risk has been excluded from credit risk, now forming a separate risk type with specific limits. Likewise, "Other risks" has been split, with specific counterparty credit risk (CVA exposure) having been reclassified to CSRBB; business and strategic risks remain within "Other risks".

Risk-bearing capacity of Aareal Bank Group

– Going-concern approach –

	30 Sep 2018
€ mn	
Own funds for risk cover potential	2,531
less 7.75 % of RWA (Tier 1 capital (T1))	1,019
Freely available funds	1,512
Utilisation of freely available funds	
Loan loss risks	203
Interest rate risk in the banking book (IRRBB)	55
Credit spread and migration risks in the banking book (CSRBB)	279
Other market risks	93
Operational risks	85
Investment risks	21
Property risks	50
Business and strategic risks	21
Total utilisation	806
Utilisation as a percentage of freely available funds	53 %

	31 Dec 2017
€ mn	
Own funds for risk cover potential	2,623
less 7.75 % of RWAs (Tier 1 capital (T1))	870
Freely available funds	1,753
Utilisation of freely available funds	
Credit risks	265
Market risks	145
Operational risks	86
Investment risks	21
Other risks	173
Total utilisation	690
Utilisation as a percentage of freely available funds	39 %

As a result, we now distinguish eight risk categories (instead of five to date), each with separate limits.

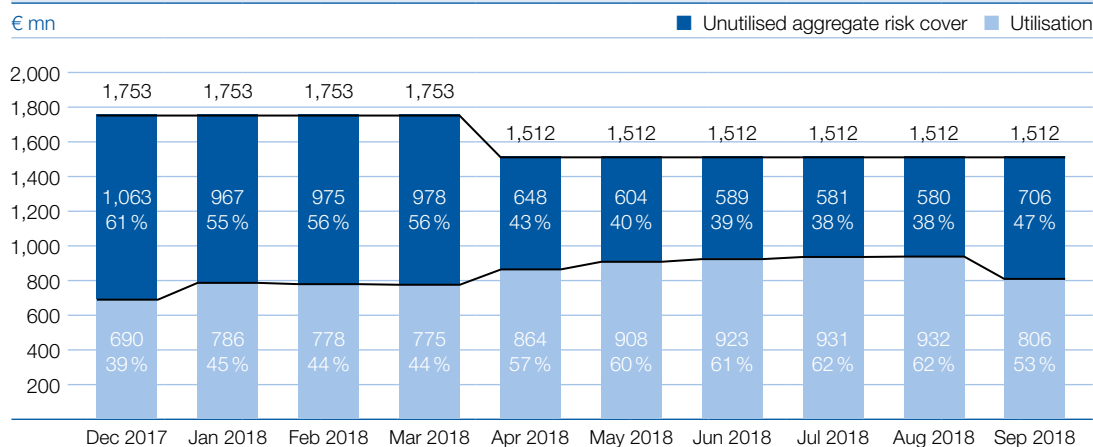
We adopt a conservative stance with respect to setting risk limits. The aggregation of individual limits is based on the assumption that no risk-mitigating correlation effects exist amongst different types of risk. Taking into account the prior deduction of a minimum Tier 1 ratio of 7.75% of RWA, the value-at-risk (VaR) models used to quantify risks are based on a confidence interval of 95% and a one-year holding period (250 trading days). Limits are defined at Group level, as well as for the individual Group entities. A detailed monthly report provides information regarding the utilisation of individual limits for the material types of risk, as well as on the overall limit utilisation. These are being monitored as part of daily reporting. No limit breaches were detected during the period under review.

Given the change in the risk taxonomy, comparison with end-of-year values is not possible. The increase in utilisation in April 2018 was largely due to the regular adjustment of aggregate risk cover, an increase in RWAs used to calculate prior deductions, and to the aggregation of utilisation levels for new types of risk (which are now added up). In September 2018, utilisation declined, largely on the back of refined calculations regarding business and strategic risks.

The following chart (p. 19) shows the development of risk limit utilisation during the course of the year, including the effects of the changes made.

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".

Development of risk limit utilisation during the course of 2018



Loan loss 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.

Risk measurement and monitoring

Aareal Bank's structural organisation and business processes are consistently geared towards effective and efficient risk management. Regulatory requirements are fully taken into account for the organisation of operations and workflows in the credit and trading businesses.

Processes in the credit and trading businesses are designed to consistently respect the clear functional division of Sales units ("Markt") and Credit Management ("Marktfolge"), up to and including senior management level. The independent Risk Con-

trolling division is responsible for identifying, quantifying and monitoring all material risks at portfolio level, and for maintaining a targeted risk reporting system.

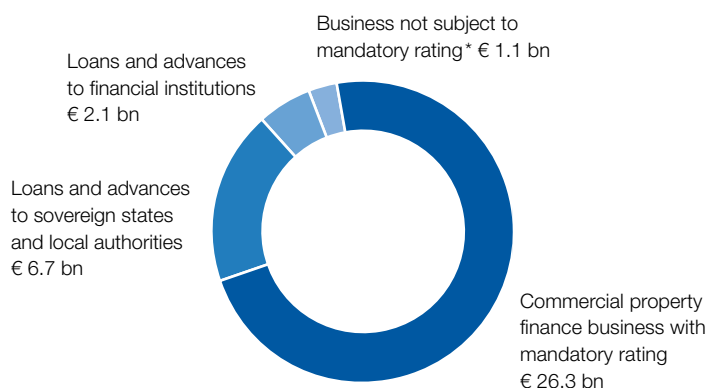
Aareal Bank employs different risk classification procedures tailored to the requirements of the respective type of business for the initial, regular, or event-driven assessment of counterparty credit risk. Forward-looking as well as macro-economic information is taken into consideration for risk classification procedures, and in the valuation of collateral. The respective procedures and parameters are subject to permanent review and adjustment. Responsibility for development, quality assurance, and monitoring implementation of procedures, is outside the Sales units.

Methods used to measure, control and monitor concentration and diversification effects on a portfolio level include two different credit risk models. Based on these models, the Bank's decision-makers are regularly informed of the performance and risk content of property financing exposures, and of business with financial institutions. The models in question allow the Bank to include in particular, rating changes and correlation effects in the assessment of the risk concentrations.

Breakdown of on-balance sheet and off-balance sheet business (gross carrying amounts¹⁾)

by rating procedure (€ bn)

30 September 2018

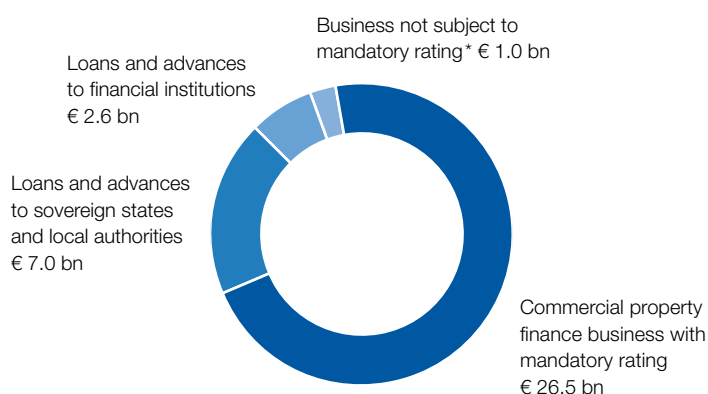
¹⁾ Excluding hedge adjustment

* Including the private client business of former Westimmo and housing industry clients

Breakdown of on-balance sheet and off-balance sheet business (gross carrying amounts¹⁾)

by rating procedure (€ bn)

1 January 2018

¹⁾ Excluding hedge adjustment; * Including the private client business of former Westimmo

Within the process-oriented monitoring of individual exposures, the Bank uses various tools to monitor exposures on an ongoing basis: besides the tools already described, this includes rating reviews, the monitoring of payment arrears, and the regular, individual analysis of the largest exposures. The intensity of loan coverage is oriented

upon the credit risk exposure. Intensified handling triggers recognition of loss allowance, in the amount of lifetime expected credit loss for the financial instrument concerned (Stage 2).

The following tables provide a breakdown of gross carrying amounts (excluding hedge adjustment) of on-balance sheet as well as off-balance sheet credit business, money-market business, and capital markets business, by rating class and loss allowance stages. Figures are based on Aareal Bank Group's internal default risk rating classes. The default definition follows Article 178 of the CRR. To facilitate comparison, figures as at 1 January 2018 including adjustments pursuant to IFRS 9 were shown as previous year's values.

Monthly reporting covers the material aspects of credit risk; it is supplemented by detailed information – which also fully covers specific credit portfolio developments (broken down by country, property and product type, risk classes, and collateral categories, for example), in line with regulatory requirements – at least on a quarterly basis. Risk concentrations are being taken into account in particular.

Trading activities are restricted to counterparties for whom the requisite limits are in place. 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. Persons holding position responsibility are informed about relevant limits and their current usage, regularly and without delay.

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.

In summary, during the period under review, the existing set of tools and methods continued to enable the Bank to adopt suitable risk management or risk mitigation measures, where required, at an early stage.

On-balance sheet commercial property finance business with mandatory rating**30 September 2018**

	Stage 1	Stage 2	Stage 3	fvpl	Total	1 Jan 2018
€ mn						
Class 1						
Class 2	117				117	88
Class 3	208				208	399
Class 4	1,707				1,707	1,345
Class 5	3,027			149	3,176	3,025
Class 6	3,588	17		122	3,727	3,717
Class 7	3,148				3,148	3,242
Class 8	5,327	70		159	5,556	5,620
Class 9	3,012	110		62	3,184	3,335
Class 10	1,491				1,491	1,368
Class 11	310	96		55	461	480
Class 12	545	51			596	518
Class 13	68	14			82	261
Class 14		192		58	250	3
Class 15				4	4	
Defaulted			1,405	23	1,428	1,614
Total	22,548	550	1,405	632	25,135	25,015

On-balance sheet loans and advances to financial institutions**30 September 2018**

	Stage 1	Stage 2	Stage 3	fvpl	Total	1 Jan 2018
€ mn						
Class 1	1,231				1,231	
Class 2	32				32	1,398
Class 3	15				15	25
Class 4	64				64	55
Class 5						5
Class 6	35				35	43
Class 7	209				209	466
Class 8	417	93			510	516
Class 9	3				3	30
Class 10	24				24	51
Classes 11-18						
Defaulted						
Total	2,030	93			2,123	2,589

On-balance sheet loans and advances to sovereign states and local authorities

30 September 2018

	Stage 1	Stage 2	Stage 3	fvpl	Total	1 Jan 2018
€ mn						
Class 1	2,199				2,199	1,601
Class 2	1,843			77	1,920	1,579
Class 3	792			32	824	1,784
Class 4	126			33	159	348
Class 5	176	31			207	57
Class 6	23				23	207
Class 7	117				117	118
Class 8	24	52			76	103
Class 9	158	901		88	1,147	1,186
Classes 10-20						
Defaulted						
Total	5,458	984		230	6,672	6,985

Off-balance sheet commercial property finance business with mandatory rating

30 September 2018

	Stage 1	Stage 2	Stage 3	fvpl	Total	1 Jan 2018
€ mn						
Classes 1-2						
Class 3						57
Class 4	34				34	25
Class 5	80				80	33
Class 6	223			51	274	365
Class 7	154				154	242
Class 8	281	5			286	254
Class 9	145				145	223
Class 10	79				79	106
Class 11	8				8	17
Class 12	36				36	12
Class 13						
Class 14	3	6			9	
Class 15						
Defaulted			88		88	108
Total	1,043	11	88	51	1,193	1,442

Country risks

Our comprehensive approach to risk management also includes measuring and monitoring country risk exposure. 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). Country risk exposure is managed using a cross-divisional process. The respective country limits are determined on the basis of a country risk assessment by the Bank's senior management. The Risk Controlling division is responsible for the continuous monitoring of country limits and limit utilisation, and for periodical reporting.

Interest rate risk in the banking book

Definition

Interest rate risk in the banking book (IRRBB) is defined as the risk exposure of instruments held in the banking book which are sensitive to changes in interest rates, caused by yield curve shifts.

Specifically, for Aareal Bank this includes:

- risks arising from maturity transformation in the event of yield curve shifts (so-called gap risk), which, in turn, are broken down into:
 - risks from cash flows which are sensitive to interest rates, relative to the general yield curve (interest rate risk or repricing risk);
 - risks arising from the valuation of future cash flows, relative to the general yield curve (yield curve risk);
- risks from cash flows which are sensitive to interest rates, in terms of spreads to the general yield curve (basis risk);
- risks from explicit and implied options (option risk);
- risks arising from changing valuation of pension liabilities (pension risk);
- risks from fluctuations in the value of fund assets (fund risk); and
- risks from changes in Aareal Bank's specific funding spreads (funding risk).

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 exposure to interest rate risk in the banking book on a daily basis.

The VaR concept has been broadly accepted as the predominant method for measuring economic interest rate risk in the banking book. VaR quantifies risk as the maximum loss that will occur within a certain period of time, and given a defined probability.

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. 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). 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.

Credit spread and migration risks in the banking book

Definition

We define credit spread and migration risks in the banking book (CSRBB) as any type of spread risk exposure of instruments held in the banking book which are sensitive to changes in interest rates, where the risk cannot be assigned to IRRBB nor to counterparty credit risk.

Specifically, for Aareal Bank this includes:

- valuation risks that are dependent upon spreads (credit spread risk);
- specific price risks from the bond portfolio, wherein the bonds are mainly sovereign bonds (sovereign risk);
- exposure of loans to rating migration (migration risk); and
- replacement risk (CVA buffer).

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 exposure to credit spread risk in the banking book on a daily basis.

Risk measurement differentiates between underlying exposures and sub-risks. Accordingly, credit spread risks from securities and sovereign risk are calculated using VaR concepts, in line with the methods described in connection with interest rate risk in the banking book. In this context, VaR

quantifies risk as the loss that will not be exceeded within a certain period of time, and given a defined probability.

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 for this risk category. 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.

Loan migration risks are determined by reference to stressed migration matrices: risk is defined as the change in expected loss over the lifetime of the loan, based on a 95 % confidence interval. The CVA buffer amount is taken from the amount determined in accordance with CRR requirements.

Other market risks

Definition

Other market risks are broadly defined as the threat of losses due to changes in market parameters.

Residual market risks which are not assigned to IRRBB or CSRBB are summarised under "market risk". Specifically, for Aareal Bank this includes:

- risks resulting from fluctuations of spot foreign exchange (FX) rates;
- risks resulting from fluctuations of forward foreign exchange rates (FX risk) and;
- risks from the regulatory review of the trading book (Financial Risk in the Trading Book – FRTB).

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 port-

folio as defined by the CRR. Given that no such trades have been concluded during the current year, trading book risks were not relevant during the period under review.

Commodities are irrelevant for the Bank’s business. Hence, the market risk exposures are currently related to the relevant risk parameters of spot and forward foreign exchange rates only. These exchange rate risks are largely eliminated through hedges.

Risk measurement and monitoring

Risk Controlling informs the members of the Management Board responsible for Treasury and risk monitoring about the risk position and exposure to other market risks on a daily basis.

The VaR concept has been broadly accepted as the predominant method for measuring economic market risk. VaR quantifies risk as the maximum loss that will occur within a certain period of time, and given a defined probability.

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. 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.

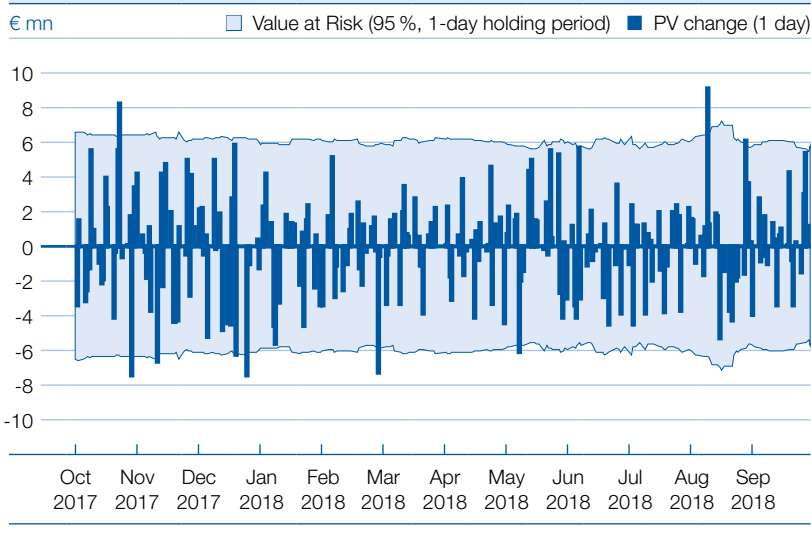
Furthermore, in addition to the risk category limit, a separate trading limit has been determined for Aareal Bank AG, as an institution authorised to maintain a trading book.

Backtesting

The quality of forecasts made using statistical models is checked through a monthly 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).

Present values and 1-day VaR during the course of 2017 / 2018



The backtesting exercise shown below comprises all risk positions subject to daily changes from the “other market risks” category.

Six negative outliers at Group level occurred during the last 250 trading days, affirming the high forecasting quality of the VaR model we use.

Operational risks

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.

Aareal Bank's legal department compiles all information concerning any legal disputes involving Aareal Bank Group, whether in or out of court. 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 as well as event-driven reports on legal risks identified to Aareal Bank's legal department, which reports to the Management Board, also (at least) on a quarterly basis. Moreover, information about legal risks is included in operational risk reporting. Aareal Bank's policy for managing and monitoring operational risks is geared to achieving a risk-minimising or loss-limiting effect at an early stage, by employing a pro-active approach. The Risk Report in the 2017 Annual Report contains a detailed description of controlling tools employed by the Bank to manage operational risk, plus the relevant responsibilities.

A current analysis using these controlling tools has not indicated any disproportionate operational risk exposure for the Bank, nor were any material risk concentrations evident.

Operational risk management also includes the reporting to the Bank's Management Board about outsourced activities and processes.

Investment risks

We define 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.

All relevant Group entities are subject to regular audits, including a review and assessment of their risk situation. There were no significant changes in investment risk during the period under review.

Property risks

We define property risk as the threat of unexpected losses arising from changes in the value of property held by the Bank, or by fully-consolidated subsidiaries.

Due to the special character of property risk (involving marketing risks, for example), special methods and procedures are employed to deal with investment risk. All relevant property holdings are subject to regular audits, including a review and assessment of their risk situation. There were no significant changes in property risk during the period under review.

Business risks and strategic risks

Strategic risk is defined as the risk of unexpected losses, usually brought about by a decline in profits due to income falling short of expectations, whereby the shortfall cannot be compensated for by cost reductions. Strategic risk may emerge from changes in the competitive or regulatory environment, or due to unsuitable positioning in the macro-economic environment.

In this context, we distinguish between investment risk and allocation risk, whereby large parts of these risks are already covered by various planning scenarios, and are thus incorporated in aggregate risk cover. These risks are closely monitored during the course of the regular planning review process. The methodology was refined during the third quarter of 2018.

Liquidity risks

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.

Treasury is responsible for managing liquidity risks. Risk Controlling prepares a daily liquidity report submitted to responsible members of the Management Board.

The appropriateness of the Bank's liquidity is assessed in a liquidity report prepared using an internal liquidity risk model: the aggregate of all potential cash inflows and outflows over a three-month period is compared to the liquidity stock. There were no liquidity shortages throughout the period under review. Further details are provided in the comments on the Bank's liquidity in the section on "Refinancing and Equity".

Report on Expected Developments and 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 at the end of September 2018 was characterised by a number of major uncertainties. The key factors in this regard relate to geopolitical risks, protectionist economic policy, changing monetary policy and the impact of a weakening economy.

The low interest rate environment remains a risk factor for 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 expect a further rise in interest rates in the US and an end to quantitative easing measures in the euro zone, markets remain vulnerable. 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.

Protectionist measures adopted by the US pose a threat to both macro-economic performance and the financial markets. An open trade war cannot currently be ruled out, which, in addition to the reduction in trade in goods and services, could also cause turbulence on the financial markets.

A major risk factor in Europe is the impact of the UK's exit from the EU (Brexit) – in spite of the transitory period agreed upon. Right now, any agreement on a "controlled" Brexit appears to be very difficult to achieve, and possibly will only occur at a very late stage. We continue to see significant economic risks from this – both for the UK and for the EU, and especially in the event of an uncontrolled Brexit. Differences about the EU's future orientation might cause further uncertainty; The tension within European countries as a result of increased migration should be mentioned here also. Political uncertainty in Spain is also in the spotlight. 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 sovereign debt crisis might still raise its head again in Europe: the problem of high levels of indebtedness continues to exist. Specifically, the risks associated with the Italian government programme, which provides for a planned increase in public-sector spending, is worth mentioning in this context: an expansive fiscal policy might increase Italian debt further, negatively affecting the refinancing situation for businesses and the State. This would in turn have a negative impact on the financial markets. Further disparity in monetary

policy between the US and the euro zone, political realignments and significant changes in fiscal policy may all heighten the risks.

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 many uncertainties and adverse factors mentioned above, the economic momentum associated with strong consumption and robust investments is likely to continue in 2018. Real global economic output for the full year 2018 is expected to grow at a slightly higher rate than in the previous year. Moreover, inflation is expected to rise markedly, particularly in the euro zone and the US. However, trends vary from region to region. 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 expect slightly lower overall growth in the euro zone for 2018 than in 2017, albeit remaining high in historical comparison. 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. We must therefore assume that the Netherlands and Spain will achieve high growth rates, albeit short of the previous year's levels. We anticipate stable but robust growth in Germany and France, although growth is expected to be significantly lower than in the previous year. The Italian economy is expected to grow at a slightly lower level than in the previous year. Stimulus from the new government programme is not initially expected this year.

In 2018, the economic development of the EU as a whole is anticipated to be similar to that of the euro zone countries. In the UK, we anticipate growth to be slightly lower than in the previous year. Brexit will continue to be a burden. The Polish

economy is expected to maintain the strong growth seen in the previous year. Economic growth in Denmark is forecast to be markedly weaker than in 2017, but still at a good level. In Sweden, we expect last year's strong growth to continue, with this year's growth rate even higher. As far as Russia's economy is concerned, we expect a slightly higher growth rate in 2018 than in the previous year.

In the US, the economy should grow at a more dynamic pace in the current year on the basis of strong exports and high levels of investments as well as robust consumption. Whilst uncertainty regarding economic policy remains, especially concerning protectionist measures, the tax reform adopted in December 2017 is nonetheless likely to provide clearly positive impulses. In Canada, we anticipate a significantly lower rate of real global economic output, compared to the previous year. The main factor here is the slowdown in consumer spending.

In China, following a year influenced by government intervention, amongst others things, we expect the trend of slowing real GDP growth rates to continue. Factors influencing economic development in China are the targeted reduction of overcapacity 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. Moreover, protectionist measures could also have a negative impact on trade.

Against a backdrop of positive economic growth, we expect most labour markets across the euro zone as well as in other European countries to register slowly decreasing to virtually stagnating unemployment rates for 2018. The US unemployment rate is also likely to continue to fall moderately.

Financial and capital markets, monetary policy and inflation

These risks and uncertainties are also impacting on the financial markets in the current year. Were they to materialise to a significant extent, they might cause turbulence on capital markets as well. Under current conditions, volatility should

remain moderate overall. We continue to believe that the financial markets will remain receptive towards refinancing and new securities issues.

Monetary policy in the euro zone will continue to be extremely expansionary this year, as confirmed by the decisions taken by the ECB in June 2018. The ECB intends to initially scale back its asset purchase programme in the autumn and to end its net purchases by the end of the year. The ECB has no plans to raise interest rates this year. In contrast, further interest rate hikes are expected in the US, whilst the Fed will likely continue the reduction of its balance sheet. In the UK, the Bank of England has not indicated any further interest rate changes for 2018.

In addition to the changes in monetary policy, the positive development of the US economy is underpinning the gradual rise in interest rates this year. A further moderate rise in short-term and long-term interest rates is expected in the US as a result of the hike in base rates; in the euro zone, there could also be a degree of upward pressure, particularly on longer-term interest rates, in light of the phasing-out of the asset purchase programme. Nevertheless, levels in the euro zone should remain low.

Inflation is expected to rise on the basis of higher energy prices and higher import prices in the majority of currency areas. Inflation in the euro zone is expected to be slightly higher than in the previous year, although the ECB's target of just below 2% should be almost reached. A further increase to well over 2% is expected in the US. In China, too, a significant increase to slightly over 2% is expected.

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").

Furthermore, the EBA has finalised its Guidelines related to the Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP). In addition, the Single European Supervisory Mechanism (SSM) has drawn up expectations regarding the structure of ICAAP and ILAAP based on a multi-year plan. These are expected to be specified further in 2018.

Moreover, 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. In addition, EBA has published guidelines on PD and LGD estimates, the treatment of defaulted exposures, and the determination of downturn LGDs – which will need to be implemented.

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.

Following an amendment to the German Regulation Determining Critical Infrastructure (Verordnung zur Bestimmung Kritischer Infrastrukturen – "BSI-KritisV"), Aareal Bank AG is now additionally subject

to reporting requirements vis-à-vis the German Federal IT Security Authority (BSI). The BSI requires that areas and systems classified as "critical infrastructure" must be certified by mid-2019. The Bank has launched a corresponding project and commissioned this certification.

Sector-specific and business developments

Structured Property Financing segment

Commercial property will continue to be a sought-after asset class in many markets during the remainder of the year. Accordingly, global transaction volumes are set 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 influence the market value of commercial property over the course 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 for 2018 as a whole, including the Netherlands, Poland and Sweden.

For France, Germany and Spain on the other hand, we consider slightly positive growth to be possible. The situation in the UK is subject to uncertainty because of the Brexit vote. In Italy, political uncertainties could have a negative impact on values, even if the economic situation suggests stability. Market values could fall in some sub-markets, although we anticipate a stable development overall. We anticipate that 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. Rising interest rates pose certain risks for this development. In Canada, we see a probability for a stable performance.

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.

For 2018 as a whole, we continue to expect a slight upward trend in 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 Madrid and Paris, for example. We expect occupancy ratios in London to show a slight decline, to levels that are, however, still elevated – whilst the possibility exists for average revenues per available hotel room to slightly rise year-on-year.

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, and in this context we are confident that lenders will be willing to lower their 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 have raised the target range for new business to between € 8 billion and € 9 billion for the 2018 financial year. The focus this year is on the high-margin US market. The increase compared to the original target reflects higher renewals as well as several large portfolio financings. Aareal Bank Group's property financing portfolio – including the private client business and local authority lending business of former WestImmo – should amount to between € 25 billion and € 28 billion at the end of 2018, subject to currency fluctuations. To manage our portfolio and risk exposure, we also use syndications which facilitate larger-sized financing solutions.

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

Consulting/Services segment

Bank division Housing Industry

We expect the development for the German housing and commercial property industries to be characterised by a high degree of stability during the remainder of the current year, thanks mainly to

largely constant rental returns and long-term financing structures.

The demand for new housing and the completion of respective properties remains higher in urban areas than in rural areas, which can be seen from the corresponding price increases. However, rents and purchase prices are also continuing to rise in rural areas. Moreover, the prevailing urbanisation trend is likely to further boost demand for housing in the major cities and their surrounding areas. Hence, it is fair to expect further rent increases. Market tightness is also due to the large volume of flats which have been approved but not yet built. The minimum level of 380,000 to 400,000 new flats targeted by the German Federal government and housing associations is thus likely to be missed for 2018 as well. According to the German Federal Statistical Office, construction of around 168,500 flats was approved during the first half of 2018. In general, this low figure should keep the pressure up in the housing market.

The housing industry's increased focus on digital solutions – whether for the optimisation of business processes or further development of their own business models – provides an ideal environment in which Aareal Bank can support the industry with services related to electronic payments.

We see good opportunities during the fourth quarter of 2018 to acquire new clients and to intensify 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 revenues 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 both the UK and Sweden is set to be optimised, and the potential in the existing customer base in these countries is to be exploited more intensively.

Aareon expects an increase in revenues in the ERP business – in Germany in particular through its acquisition of the mse companies – and in the consulting business, due to the ongoing migration of GES customers to Wodis Sigma, whilst ERP revenues are expected to remain unchanged year-on-year in France, the Netherlands and the UK. Growth drivers in the global ERP business are the Scandinavian solution Incit Xpand and the British product Aareon QL. The aforementioned optimisation measures in the UK and Sweden are already proving successful.

Digital solutions are expected to show strong growth. This growth will be driven in particular by the CRM solutions (portal and app) in France, Germany, the Netherlands and the UK. We also anticipate increased demand for mobile services in Germany and the UK. In the Netherlands, growth is expected in the area of digital solutions with Trace & Treasury (for managing 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.

In addition, we anticipate being able to maintain and improve the positive trend seen in our German outsourcing business during the previous year and in our Dutch cloud services business.

Aareon anticipates a marked overall increase in sales revenue and profits for 2018. Aareon's contribution to consolidated operating profit is anticipated between € 37 million and € 38 million (originally: around € 40 million), due to non-recurring cost increases incurred with a major project as well as delays with another project. These costs are unlikely to be recovered during the course of this year, on account of the high workload.

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 remainder of the 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.

Provided that the acquisition of Düsseldorf Hypothekenbank AG (agreed upon in September) will be closed in 2018, as planned, we expect consolidated operating profit for the current year

between € 312 million and € 352 million – as already communicated: we raised the target during the quarter under review, in connection with said acquisition, by the expected associated non-recurring income (negative goodwill) of approximately € 52 million.

In this scenario, earnings per share (EpS) are projected in a range between € 3.47 and € 3.87. We expect return on equity (RoE) before taxes between 11.5 % and 13 %, also including said non-recurring income – adjusted for this, RoE before taxes is expected to be between 9.5 % and 11 %. We affirm our medium-term target RoE of around 12 % before taxes.

Whilst net interest income is developing in line with projections, net derecognition gain has been markedly lower than our original estimates, as well as lower year-on-year, driven by the market. Accordingly, from today's perspective, achieving net interest income (including net derecognition gain) in the projected range between € 570 million and € 610 million will be difficult. However, from today's perspective, administrative expenses are highly likely to be slightly below the projected range of € 470 million to € 500 million.

Net commission income is projected to increase to a range between € 215 million and € 235 million. We anticipate full-year loss allowance between € 50 million and € 80 million.

We expect the property financing portfolio – including the private client business and local authority lending business of former WestImmo – to amount to between € 25 billion and € 28 billion at the end of 2018, subject to currency fluctuations. We are targeting new business of between € 8 billion and € 9 billion in the current year, a range that is slightly higher than our previous projection. In the Consulting/Services segment, we continue to expect our IT subsidiary Aareon to contribute between € 37 million and € 38 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 %.

Consolidated Interim Financial Statements

Statement of Comprehensive Income

Income Statement

€ mn	Notes	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾
Interest income from financial instruments (ac and fvoci)		627	628
Interest income from financial instruments (fvpl)		26	5
Market-driven modification gains		3	n/a
Interest expenses for financial instruments (ac)		87	81
Interest expenses for financial instruments (fvpl)		166	103
Market-driven modification losses		3	n/a
Net interest income	1	400	449
Loss allowance excluding credit-driven net modification gain or loss		33	53
Credit-driven net modification gain or loss		0	n/a
Loss allowance	2	33	53
Commission income		183	172
Commission expenses		31	27
Net commission income	3	152	145
Net gain or loss on the derecognition of financial assets (ac)		16	37
Net gain or loss on the derecognition of financial liabilities (ac)		0	–
Net gain or loss on the derecognition of financial assets (fvoci)		–	0
Net derecognition gain or loss	4	16	37
Net gain or loss from financial instruments (fvpl)	5	-1	13
Net gain or loss from hedge accounting	6	-2	-5
Net gain or loss from investments accounted for using the equity method		–	–
Administrative expenses	7	344	388
Net other operating income/expenses	8	11	64
Operating profit		199	262
Income taxes		68	97
Consolidated net income		131	165
Consolidated net income attributable to non-controlling interests		2	6
Consolidated net income attributable to shareholders of Aareal Bank AG		129	159
Earnings per share (EpS)			
Consolidated net income attributable to shareholders of Aareal Bank AG ²⁾		129	159
of which: allocated to ordinary shareholders		117	147
of which: allocated to AT1 investors		12	12
Earnings per ordinary share (in €) ³⁾		1.97	2.46
Earnings per AT1 unit (in €) ⁴⁾		0.12	0.12

¹⁾ Comparative amounts reclassified according to the new classification format

²⁾ The allocation of earnings is based on the assumption that net interest payable on the AT1 bond is recognised on an accrual basis.

³⁾ Earnings per ordinary share are determined by dividing the earnings allocated to ordinary shareholders of Aareal Bank AG by the weighted average of ordinary shares outstanding during the financial year (59,857,221 shares). Basic earnings per ordinary share correspond to diluted earnings per ordinary share.

⁴⁾ Earnings per AT1 unit (based on 100,000,000 AT1 units with a notional amount of € 3 each) are determined by dividing the earnings attributable to AT1 investors by the weighted average of AT1 units outstanding during the financial year. Earnings per AT1 unit (basic) correspond to (diluted) earnings per AT1 unit.

Statement of Comprehensive Income

Reconciliation from Consolidated Net Income to Total Comprehensive Income

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾
€ mn		
Consolidated net income	131	165
Items that will not be reclassified subsequently to profit or loss		
Changes in the reserve from remeasurements of defined benefit plans	3	10
Remeasurements	4	14
Taxes	-1	-4
Items that are reclassified subsequently to profit or loss		
Changes in the reserve from the measurement of debt instruments (fvoci)	-7	-2
Gains or losses from debt instruments (fvoci)	-10	-3
Reclassifications to the income statement	-	-
Taxes	3	1
Changes in hedging reserves	-	-15
Gains or losses from derivatives used to hedge future cash flows	-	-22
Reclassifications to the income statement	-	0
Taxes	-	7
Changes in the reserve from foreign currency basis spreads	-8	n/a
Gains or losses from foreign currency basis spreads	-11	n/a
Reclassifications to the income statement	-	n/a
Taxes	3	n/a
Changes in currency translation reserves	3	-13
Gains or losses from translating foreign operations' financial statements	1	-13
Reclassifications to the income statement	-	-
Taxes	2	-
Other comprehensive income	-9	-20
Total comprehensive income	122	145
Total comprehensive income attributable to non-controlling interests	2	6
Total comprehensive income attributable to shareholders of Aareal Bank AG	120	139

¹⁾ Comparative amounts reclassified according to the new classification format

Statement of Comprehensive Income

Income Statement (Quarterly Development)

€ mn	Quarter 3 2018	Quarter 3 2017 ¹⁾
Interest income from financial instruments (ac and fvoci)	215	202
Interest income from financial instruments (fvpl)	9	2
Market-driven modification gains	1	n/a
Interest expenses for financial instruments (ac)	29	26
Interest expenses for financial instruments (fvpl)	64	34
Market-driven modification losses	1	n/a
Net interest income	131	144
Loss allowance excluding credit-driven net modification gain or loss	14	26
Credit-driven net modification gain or loss	0	n/a
Loss allowance	14	26
Commission income	61	57
Commission expenses	10	9
Net commission income	51	48
Net gain or loss on the derecognition of financial assets (ac)	5	20
Net gain or loss on the derecognition of financial liabilities (ac)	0	–
Net gain or loss on the derecognition of financial assets (fvoci)	–	–
Net derecognition gain or loss	5	20
Net gain or loss from financial instruments (fvpl)	0	10
Net gain or loss from hedge accounting	1	1
Net gain or loss from investments accounted for using the equity method	–	–
Administrative expenses	107	120
Net other operating income/expenses	3	5
Operating profit	70	82
Income taxes	24	31
Consolidated net income	46	51
Consolidated net income attributable to non-controlling interests	1	0
Consolidated net income attributable to shareholders of Aareal Bank AG	45	51

¹⁾ Comparative amounts reclassified according to the new classification format

Statement of Comprehensive Income

Reconciliation from Consolidated Net Income to Total Comprehensive Income (Quarterly Development)

€ mn	Quarter 3 2018	Quarter 3 2017 ¹⁾
Consolidated net income	46	51
Items that will not be reclassified subsequently to profit or loss		
Changes in the reserve from remeasurements of defined benefit plans	5	-1
Remeasurements	7	-2
Taxes	-2	1
Items that are reclassified subsequently to profit or loss		
Changes in the reserve from the measurement of debt instruments (fvoci)	-3	2
Gains or losses from debt instruments (fvoci)	-4	3
Reclassifications to the income statement	–	–
Taxes	1	-1
Changes in hedging reserves	–	4
Gains or losses from derivatives used to hedge future cash flows	–	6
Reclassifications to the income statement	–	–
Taxes	–	-2
Changes in the reserve from foreign currency basis spreads	6	n/a
Gains or losses from foreign currency basis spreads	10	n/a
Reclassifications to the income statement	–	n/a
Taxes	-4	n/a
Changes in currency translation reserves	0	-5
Gains or losses from translating foreign operations' financial statements	0	-5
Reclassifications to the income statement	–	–
Taxes	0	–
Other comprehensive income	8	0
Total comprehensive income	54	51
Total comprehensive income attributable to non-controlling interests	1	0
Total comprehensive income attributable to shareholders of Aareal Bank AG	53	51

¹⁾ Comparative amounts reclassified according to the new classification format

Statement of Financial Position

	Notes	30 Sep 2018	31 Dec 2017 ¹⁾	31 Dec 2016 ¹⁾
€ mn				
Assets				
Financial assets (ac)	9	33,154	33,715	38,438
Cash funds (ac)		1,927	2,081	1,786
Loan receivables (ac)		25,616	26,316	29,767
Money market and capital market receivables (ac)		5,559	5,225	6,800
Receivables from other transactions (ac)		52	93	85
Loss allowance (ac)	10	-554	-540	-554
Financial assets (fvoci)	11	4,113	5,424	5,949
Money market and capital market receivables (fvoci)		4,110	5,422	5,947
Equity instruments (fvoci)		3	2	2
Financial assets (fvpl)	12	2,728	2,449	2,983
Loan receivables (fvpl)		632	196	–
Money market and capital market receivables (fvpl)		230	–	–
Positive market value of designated hedging derivatives (fvpl)		1,196	1,926	2,481
Positive market value of other derivatives (fvpl)		670	327	502
Investments accounted for using the equity method		7	7	0
Intangible assets	13	155	153	126
Property and equipment	14	257	253	252
Income tax assets		15	52	68
Deferred tax assets		74	99	134
Other assets	15	320	296	312
Total		40,269	41,908	47,708
Equity and liabilities				
Financial liabilities (ac)	16	35,236	36,630	40,587
Money market and capital market liabilities (ac)		24,264	26,109	29,935
Deposits from the housing industry (ac)		9,776	9,164	9,191
Liabilities from other transactions (ac)		160	92	95
Subordinated capital (ac)		1,036	1,265	1,366
Financial liabilities (fvpl)	17	1,579	1,703	3,181
Negative market value of designated hedging derivatives (fvpl)		1,202	1,479	2,529
Negative market value of other derivatives (fvpl)		377	224	652
Provisions	18	534	570	680
Income tax liabilities		23	29	71
Deferred tax liabilities		14	19	28
Other liabilities	19	30	33	32
Equity	20	2,853	2,924	3,129
Subscribed capital		180	180	180
Capital reserves		721	721	721
Retained earnings		1,703	1,798	1,734
AT1 bond		300	300	300
Other reserves		-53	-77	-48
Non-controlling interests		2	2	242
Total		40,269	41,908	47,708

¹⁾ Comparative amounts reclassified according to the new classification format; recognised amounts of the previous period as at 1 January 2017 correspond to the recognised amounts as at 31 December 2016

Statement of Changes in Equity

	Equity as at 1 Jan 2018 ¹⁾	Adjustment due to first-time application of IFRS 9	Adjusted equity as at 1 Jan 2018	Total comprehensive income for the period	Payments to non-controlling interests	Dividends	AT1 coupon	Other changes	Equity as at 30 Sep 2018
€ mn									
Subscribed capital	180		180						180
Capital reserves	721		721						721
Retained earnings	1,798	-60	1,738	129		-150	-16	2	1,703
AT1 bond	300		300						300
Other reserves	-77	33	-44	-9					-53
Reserve from remeasurements of defined benefit plans	-91		-91	3					-88
Reserve from the measurement of equity instruments (fvoci)	0		0						0
Reserve from the measurement of debt instruments (fvoci)	24	29	53	-7					46
Hedging reserves	-1	1							
Reserve from changes in the value of foreign currency basis spreads		3	3	-8					-5
Currency translation reserves	-9		-9	3					-6
Total	2,922	-27	2,895	120		-150	-16	2	2,851
Non-controlling interests	2		2	2	-2				2
Equity	2,924	-27	2,897	122	-2	-150	-16	2	2,853

	Equity as at 1 Jan 2017 ¹⁾	Total comprehensive income for the period	Payments to non-controlling interests	Dividends	AT1 coupon	Other changes	Equity as at 30 Sep 2017 ¹⁾
€ mn							
Subscribed capital	180						180
Capital reserves	721						721
Retained earnings	1,734	159		-120	-16	-7	1,750
AT1 bond	300						300
Other reserves	-48	-20					-68
Reserve from remeasurements of defined benefit plans	-100	10					-90
Reserve from the measurement of equity instruments (fvoci)	0						0
Reserve from the measurement of debt instruments (fvoci)	29	-2					27
Hedging reserve	17	-15					2
Reserve from changes in the value of foreign currency basis spreads							
Currency translation reserves	6	-13					-7
Total	2,887	139		-120	-16	-7	2,883
Non-controlling interests	242	6	-6			-241	1
Equity	3,129	145	-6	-120	-16	-248	2,884

¹⁾ Comparative amounts reclassified according to the new classification format

Statement of Cash Flows (condensed)

	2018	2017 ¹⁾
€ mn		
Cash and cash equivalents as at 1 January	2,081	1,786
Cash flow from operating activities	240	683
Cash flow from investing activities	2	-14
Cash flow from financing activities	-396	-246
Total cash flow	-154	423
Effect of changes in exchange rates	0	0
Cash and cash equivalents as at 30 September	1,927	2,209

¹⁾ Within the scope of the changeover to IFRS 9 and the business model allocation, cash flows from securities were re-allocated from investment activities to operating activities.

Notes (condensed)

Basis of Accounting

Legal framework

Aareal Bank AG is a listed public limited company incorporated under German law, with its registered office in Wiesbaden, Germany. It is the parent company of an international property finance and services group.

This quarterly financial report for the period ended 30 September 2018 was prepared pursuant to the provisions of section 115 of the German Securities Trading Act (Wertpapierhandelsgesetz – "WpHG") in conjunction with section 117 no. 2 of the WpHG and was approved for publication by the Management Board on 7 November 2018. It comprises the present interim condensed consolidated financial statements, as well as an interim group management report.

Aareal Bank AG prepares its condensed interim consolidated financial statements in accordance with International Financial Reporting Standards (IFRSs) applicable within the European Union (EU) as at the reporting date, in connection with the provisions pursuant to section 315e (1) of the German Commercial Code (Handelsgesetzbuch – "HGB"). In particular, the interim consolidated financial statements comply with the requirements for interim financial reporting set out in IAS 34. The reporting currency is the euro (€).

Reporting entity structure

Subsidiaries of Aareal Bank AG are included in the consolidated financial statements by way of full consolidation. Companies over which Aareal Bank AG may exercise a significant influence ("associates") are included in the consolidated financial statements, using the equity method. The present interim report is based on the same consolidation methods as were applied in the consolidated financial statements as at 31 December 2017.

There were no material changes to the basis of consolidation during the period under review.

Accounting Policies

Accounting standards

Recognition and measurement within Aareal Bank Group are based on accounting policies applied consistently throughout the Group. The consolidated financial statements are prepared on a going concern basis.

We generally apply accounting policies – and the presentation of financial statements – consistently, in order to ensure the comparability of financial statements over time. The classification format was adjusted within the framework of the first-time application of IFRS 9.

Information is presented in accordance with the principle of materiality. Minor differences may occur regarding the figures stated, due to rounding.

The Bank observes the general prohibition of setting off assets against liabilities. To the extent that the criteria of IAS 12.74 are met, deferred tax assets and deferred tax liabilities are offset. If the requirements set out in IAS 32.42 are met, financial assets and liabilities are reported on a net basis.

Income and expenses are recognised on an accrual basis and recorded in the income statement in the period to which they relate.

Interest income and expenses are recognised using the effective interest method. In the case of impaired receivables, interest income and expenses are recognised only up to the amount of the net carrying amount. Interest from derivatives designated for hedge accounting and economic hedging relationships is included in net interest income. Interest from derivative hedging instruments is shown under interest from financial instruments (ac and fvoci). Based on the IFRIC decision "Presentation of interest revenue for particular financial instruments", we have stated interest from economic hedging relationships under interest from financial instruments (fvpl). The previous year's figures were adjusted accordingly. We provide specific information on negative interest from financial assets or positive interest from financial liabilities in the Notes, under net interest income. These assets and liabilities are deposits as well as money market and securities repurchase transactions.

Dividend income is recognised when there is a corresponding legal title.

Commission income and expenses include revenue from the provision of goods or services in the ordinary course of business. This mainly refers to IT consulting projects, trainings, licence and maintenance agreement and hosting or outsourcing services. Revenue recognition is assessed on the basis of the five-step model in accordance with IFRS 15. If the performance obligation is not satisfied over time, it is satisfied at a certain point in time.

The presentation of the financial position and the financial performance in the consolidated financial statements depends on the recognition and measurement methods underlying the preparation of the financial statements, as well as on estimates and assumptions made by the management in relation to uncertain future events. Any assessments required for recognition and measurement are prepared in line with the relevant accounting standards. Estimates and assumptions are based on historical experience and other factors, such as planning and current expectations and forecasts with respect to the occurrence of future events. The estimates and assessments themselves as well as the underlying assessment factors and estimation techniques are reviewed regularly and compared with actual outcome. In our view, the parameters used are relevant and reasonable.

The most significant estimates and assumptions of the management primarily refer to the calculation of provisions, loss allowances and provisions in the lending business, the measurement of goodwill, property and tax assets and liabilities. We refer to the item-specific disclosures in this section for information related to the estimates and assumptions actually made within the context of recognition and measurement.

An asset is recognised in the statement of financial position when it is probable that an associated future economic benefit will flow to the Company and the asset can be measured reliably.

A liability is recognised if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and when the settlement amount of the liability can be measured with sufficient reliability.

Changes in accounting policies

Unless specifically indicated otherwise, the accounting policies applied in the preparation of the consolidated financial statements 2017 were also applied in the preparation of these condensed interim consolidated financial statements, including the calculation of comparative figures. Given the extensive changes due to the new classification scheme and IFRS 9, we have provided a full overview of accounting policies for ease of reference.

The following financial reporting standards (IASs/IFRSs) were required to be applied for the first time in the reporting period:

IFRS 9 Financial Instruments

IFRS 9 Financial Instruments introduces new rules for the accounting of financial instruments, and generally replaced IAS 39 Financial Instruments: Recognition and Measurement as at 1 January 2018. We present the changes in the chapter "First-time application of IFRS 9 Financial Instruments" in this section.

IFRIC 22 Foreign Currency Transactions and Advance Consideration

The objective of this interpretation is to clarify the accounting treatment of transactions that include the receipt or payment of consideration in a foreign currency.

IFRS 15 Revenue from Contracts with Customers

IFRS 15 governs the recognition of revenue from contracts with customers based on a uniform model. The standard supersedes the current revenue recognition provisions set out in IAS 11 and IAS 18 as well as the related interpretations. IFRS 15 has to be applied by all companies that enter into contracts with customers for the delivery of goods or the provision of services unless these contracts are within the scope of other standards. Accordingly, amongst other things, financial instruments and other contractual rights or obligations within the scope of IFRS 9 are excluded from the scope of IFRS 15. The core principle of IFRS 15 for revenue recognition is that an entity has to recognise revenue when the performance obligations assumed are satisfied, i.e. when control over the goods and services has been transferred. Revenue has to be recognised in an amount that reflects the consideration that the entity expects to receive in exchange for those goods or services. IFRS 15 introduces a 5-step model based on which the amount and the timing of revenue recognition are determined. In addition, the standard requires additional disclosures, including, amongst other things, a disaggregation of total revenue, performance obligations, a reconciliation of opening and closing balances of contractual net assets and liabilities as well as significant judgements and estimates. Aareal Bank Group has reviewed the effects of the new standard on the consolidated financial statements by analysing the relevant standard contracts on the basis of the 5-step model. Within the Group, these changes mainly affect Aareon. Aareon has adjusted its processes. Within the scope of this adjustment, we have changed the breakdown of net commission income to reflect the product view which is relevant for management purposes. Commission income from advisory and other services is broken down into ERP products, digital solutions, and add-on products. Commission expenses from advisory and other services have been renamed as purchased services. Net commission income from trustee and administered loans, securities business, and other lending and money market transactions has been summarised as net commission income from lending and other banking business. Other net commission income has been renamed net commission income from other activities. Moreover, commission income is also shown in segment reporting. The modified retrospective approach did not have any material consequences for Aareal Bank Group.

Annual Improvements Cycle 2014 – 2016

Within the scope of the Annual Improvements Cycle, the IASB publishes clarifications and minor changes to the existing standards IFRS 1, IFRS 12 and IAS 28.

Amendments to IAS 40: Transfers of Investment Property

The amendments clarify the provisions regarding transfers to or from investment property. The amendments mainly refer to the question whether property under construction or in development that was previously classified as inventory can be reclassified to the investment property category when there is evidence of a change in use.

Clarifications to IFRS 15: Revenue from Contracts with Customers

In April 2016, the IASB issued the final version of the amendment standard IFRS 15. The amendment includes clarifications regarding various rules set out in IFRS 15, and also simplifications concerning the transition to the new standard. The clarifications refer to the identification of the service obligations from a contract, the assessment as to whether a company acts as principal or agent of a transaction, and the assessment as to whether revenue from a licence granted has to be recognised either as at a particular reporting date or during a specific period. The simplifications refer to options regarding the presentation of contracts that are either completed at the beginning of the earliest period presented, or which were modified prior to the beginning of the earliest period presented. This is to reduce the complexity and costs of the transition to the new standard.

Amendments to IFRS 2: Classification and Measurement of Share-based Payment Transactions

In June 2016, the IASB issued amendments to IFRS 2 that clarify classification and measurement of share-based payment transactions. The amendments relate to the following areas: (i) accounting for cash-settled share-based payment transactions that include a performance condition, (ii) the classification of share-based payment transactions with a settlement feature for withholding tax obligations and (iii) accounting for modifications of share-based payment transactions that change the classification from "cash-settled" to "equity-settled".

Amendments to IFRS 4: Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts

In September 2016, the IASB issued amendments to IFRS 4. The amendments refer to the first-time application of IFRS 9 by insurers. Due to different effective dates for IFRS 9 and the new standard for insurance contracts, without these amendments, results will be more volatile for a transitional period; in addition, conversion efforts will be doubled.

Except for IFRS 9, the revised standards did not have any material consequences for the consolidated interim financial statements of Aareal Bank Group.

First-time application of IFRS 9 Financial Instruments

IFRS 9 Financial Instruments introduces new rules for the accounting of financial instruments, and generally replaced IAS 39 Financial Instruments: Recognition and Measurement from 1 January 2018. The first-time application had an effect of € -27 million (after taxes) on equity carried on the statement of financial position, and of € -17 million on regulatory equity (full Basel III implementation pursuant to Directive 2013/36/EU and Regulation (EU) No 575/2013 of the European Parliament and the Council). The effect of first-time application comprises various individual effects.

Under the new model for classification and measurement of financial assets, the subsequent measurement of financial assets is based on three categories with different measurement methods and different recognition methods related to changes in value:

- "Financial assets measured at amortised cost (ac) using the effective interest method";
- "Financial assets at fair value through other comprehensive income (fvoci)"; and
- "Financial assets at fair value through profit or loss (fvpl)".

The classification to the measurement categories is based on the criteria of business model and contractual characteristics of the financial assets (the so-called "SPPI criterion" = solely payments of principal and interest). The allocation of financial instruments to the business models was made as at 1 January 2018. The major portion of the financial instruments was allocated to the "amortised cost" measurement category. We recorded a positive overall effect of € 28 million (after taxes) from the transition on the revaluation surplus, due to the reversal of the revaluation surplus from securities reclassified in accordance with IAS 39, and from changes in the measurement category of individual securities (to fvpl, because the SPPI criterion is not met, or due to an assignment to the residual business model). In addition, adjustments during the contract term that lead to a change in the contractual cash flows, but that are not of an extent that the previous financial asset is derecognised and a new financial asset is recognised, will result in non-substantial modifications. In this case, the carrying amount of a financial asset is adjusted and a modification gain or loss is determined. The transition effect from market-driven modifications amounted to € -6 million (after taxes). Credit-driven modification effects are included in the effects resulting from the allocation of items into the Stage 3 category of loss allowances.

There are special rules for equity instruments as there is an option to measure these either through other comprehensive income or through profit or loss. This did not have any transition effect.

The accounting rules for financial liabilities do not result in any material changes. An exception to this is the inclusion of changes from own credit risk in case of financial liabilities measured at fair value through profit or loss. These changes may not be recognised through profit or loss, but through other comprehensive income. The Group currently does not have any financial liabilities measured at fair value.

The new rules for impairment (expected credit loss model) replaced the previous incurred credit loss model. The objective of this is an earlier measurement and recognition of loss allowances. IFRS 9 prescribes three stages which are used to determine the amount of the loss allowances to be recognised and the recognition of interest. Financial assets are allocated to Stage 1. Twelve-month expected credit losses are recognised for these assets. If the credit risk increases significantly, the loss allowance is increased to the total amount of lifetime expected credit losses (Stage 2). If there is objective evidence of impairment in relation to a financial asset, a loss allowance at an amount equal to the expected credit losses over the entire remaining term also has to be recognised and, in addition, interest revenue has to be recognised based on the net carrying amount (Stage 3). The impairment model set out in IFRS 9 has to be applied to financial assets of the categories "Measured at amortised cost" and "Measured at fair value through other comprehensive income" as well as to loan commitments and financial guarantees. In addition, lease receivables and trade receivables are covered by the new impairment rules. To the extent that financial instruments are measured at fair value through profit or loss, no loss allowance is recognised for such financial instruments; instead, they are reported at their net carrying amount.

Portfolio-based allowances for credit losses were already recognised within the Group under IAS 39. Calculation under Stage 1 in accordance with IFRS 9 continues to be on the basis of a twelve-month loss. In Stage 2, additions to loss allowances were recognised due to the recognition of a loss allowance at an amount equal to the expected credit losses over the entire remaining term. The transition effect for Stage 1 and Stage 2 amounted to approximately € -27 million (after taxes).

Specific allowances for credit losses pursuant to IAS 39 were recognised where estimated future cash flows fall below the carrying amount of a loan receivable. This methodology was developed further into a probability-weighted multi-scenario analysis. The transition effect amounted to € -22 million (after taxes) for Stage 3.

Hedge accounting rules were changed by establishing a closer relationship between the entity's risk management strategy, the reasons for entering into hedging instruments and the recognition of hedging relationships in the entity's financial statements. Non-derivative items may also be included in hedge accounting; net positions are now also eligible for designation as hedges. A voluntary discontinuation of hedge accounting – so-called de-designation – is no longer permitted under the new regulations. Hedging relationships may only be discontinued when the objective of risk management has been changed. In contrast, the new IFRS 9 allows for an adjustment of hedging relationships if this is necessary (rebalancing). The requirements regarding effectiveness have also been simplified: only qualitative assessments of effectiveness and prospective effectiveness tests have to be performed. In addition, foreign currency basis spreads may be recognised as part of the costs of the hedge. Changes in the fair value due to this component are recognised directly in equity in the reserve from foreign currency basis spreads. Due to the separation of the macro-hedge accounting project from IFRS 9 and its postponement, the application of the new hedge accounting rules in IFRS 9, for the time being, allows for the continued application of special rules for fair value hedge accounting for portfolio hedges of interest rate risks in IAS 39. The Group does not currently use this option. The Group uses the simplifications under micro-hedge accounting and for foreign currency basis spreads. This did not have any transition effect on equity.

IFRS 9 comprises comprehensive disclosure requirements, above all in the area of impairments, leading to numerous new requirements. The disclosures on financial instruments continue to be based on IFRS 7, which was amended and significantly extended in the context of the publication of IFRS 9.

Due to the introduction of IFRS 9 and in order to increase the transparency of the financial statements, the classification format was adjusted. The following table shows a reconciliation of the financial instruments by measurement categories under IAS 39 to IFRS 9 (before taxes).

	IAS 39 31 Dec 2017	IAS 39 reclassified 31 Dec 2017	Reclassi- fication	Revaluation OCI	Retained earnings	IFRS 9 1 Jan 2018
€ mn						
Financial assets (ac)						
Cash funds (ac)		2,081				2,081
from cash funds (lar)	2,081					
Loan receivables (ac)		26,316				25,885
from loans and advances to banks (lar)	5					
from loans and advances to customers (lar)	26,311				27	
less loan receivables (fvpl)			-458			
Money market and capital market receivables (ac)		5,225				6,087
from loans and advances to banks (lar)	774					
from loans and advances to customers (lar)	1,338					
from non-trading assets (lar, htm)	3,113			63		
plus money market and capital market receivables (fvoci)			1,594	-41		
less money market and capital market receivables (fvoci)			-505			
less money market and capital market receivables (fvpl)			-249			
Receivables from other transactions (ac)		93	2			95
from other (financial) assets (lar)	93					
Financial assets (fvoci)						
Money market and capital market receivables (fvoci)		5,422				4,343
from non-trading assets (afs)	5,422					
plus money market and capital market receivables (ac)			505	10		
less money market and capital market receivables (ac)			-1,594			
Equity instruments (fvoci)		2				2
from non-trading assets (afs)	2					
Financial assets (fvpl)						
Loan receivables (fvpl)		196				604
from loans and advances to customers (hft)	196					
plus (net) loan receivables (ac)			408			
Money market and capital market receivables (fvpl)		-			2	251
plus money market and capital market receivables (ac)			249			
Positive market value of designated hedging derivatives (fvpl)		1,926				1,387
from positive market value of derivative hedging instruments (hft)	1,926					
less positive market value of other derivatives (fvpl)			-539			
Positive market value of other derivatives (fvpl)		327				866
from trading assets (hft)	327					
plus positive market value of designated hedging derivatives (fvpl)			539	-1	1	
Total		41,588	-48	31	30	41,601

	IAS 39 31 Dec 2017	IAS 39 reclassified 31 Dec 2017	Reclassi- fication	Revaluation OCI	Retained earnings	IFRS 9 1 Jan 2018
€ mn						
Financial liabilities (ac)						
Money market and capital market liabilities (ac)		26,109				26,109
from liabilities to banks (lac)	1,914					
from liabilities to customers (lac)	16,601					
from certificated liabilities (lac)	7,594					
Deposits from the housing industry (ac)		9,164				9,164
from liabilities to customers (lac)	9,164					
Liabilities from other transactions (ac)		92				92
from other (financial) liabilities (lac)	92					
Subordinated capital (ac)		1,265				1,265
Subordinated capital (lac)	1,265					
Financial liabilities (fvpl)						
Negative market value of designated hedging derivatives (fvpl)		1,479				1,318
from negative market value of derivative hedging instruments (hft)	1,479					
less negative market value of other derivatives (fvpl)			-161	1	-1	
Negative market value of other derivatives (fvpl)		224				385
from trading liabilities (hft)	224			6	-6	
plus negative market value of other derivatives (fvpl)			161			
Total		38,333	-	7	-7	38,333

	IAS 39 31 Dec 2017	IAS 39 reclassified 31 Dec 2017	Reclassi- fication	Revaluation OCI	Retained earnings	IFRS 9 1 Jan 2018
€ mn						
Loss allowance on financial assets (ac)						
Loan receivables (ac)		-540				-571
from loans and advances to customers (lar)	-540				-81	
less loan receivables (fvpl)			50			
Money market and capital market receivables (ac)		-				-20
from non-trading assets (lar, htm)	-				-15	
plus money market and capital market receivables (fvoci)					-5	
Receivables from other transactions (ac)		-				-2
from other (financial) assets (lar)	-		-2			
Provisions for unrecognised lending business		-4				-6
from provisions in the lending business for unrecognised items	-4				-2	
Loss allowance in reserves from debt instruments (fvoci)						
Money market and capital market receivables (fvoci)		-				0
from non-trading assets (afs)	-				0	
Total	-544	-544	48	-	-103	-599

The total transition effect of € -27 million (after taxes) recognised under equity comprises the revaluation effects disclosed in other comprehensive income and retained earnings of € -42 million, less tax effects of € 15 million.

Within the scope of the first-time application, non-trading assets (afs) were allocated to the "hold" business model and since then have been measured at amortised cost. Debt securities held on the reporting date were carried at € 1,508 million, reflecting their fair value. Therefore, there was no material difference required to be reported in the revaluation surplus in accordance with IAS 39.

Currency translation

Individual line items in the financial statements of each Group entity are measured on the basis of the currency of the primary economic environment the respective entity operates in ("functional currency").

The consolidated financial statements are prepared in euro, being both the functional and the reporting currency.

Monetary assets and liabilities denominated in a foreign currency, unsettled cash market/spot transactions and non-monetary items measured at fair value are all translated to the functional currency on the basis of the ECB reference rate prevailing on the balance sheet date. Non-monetary items measured at amortised cost are translated using historical rates. Foreign exchange forward transactions are measured at the forward exchange rate prevailing on the balance sheet date.

Currency translation adjustments on monetary assets and liabilities must be recognised in income. Depending on the relevant measurement category, currency translation adjustments on non-monetary items are either recognised directly in equity (in the currency translation reserves), or recognised in the income statement (in net trading income).

Financial statements of consolidated subsidiaries, which are presented in a currency other than the euro, are translated at the ECB reference rate prevailing at the reporting date. Translation differences are recognised in equity, in the currency translation reserves.

Determination of fair value

The determination of fair value is governed by IFRS 13 and applies to financial instruments and non-financial assets or liabilities. In accordance with IFRS 13.9, the fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The determination of the fair value is based on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. Another factor to be taken into account is whether Aareal Bank can enter into a transaction for the relevant asset or liability at the price in that market at the measurement date. The principal market is the market with the greatest volume and the highest level of activity for the asset or liability to which Aareal Bank has access. In the absence of a principal market for the financial instrument, the most advantageous market is used to determine the fair value. The most advantageous market is the market that maximises the amount that would be received to sell the asset, or minimises the amount that would be paid to transfer the liability.

Fair value hierarchy

In accordance with IFRS 13.72 et seqq., the fair value determination is based on the fair value hierarchy pursuant to which the inputs used are classified into various hierarchy levels on the basis of their respective market proximity and objectivity. The fair value of assets and liabilities is allocated to Level 1 of the fair value hierarchy if it is determined on the basis of unadjusted qualifying prices in active markets for identical assets or liabilities. Fair values determined using inputs other than qualifying prices included within Level 1 that are observable for the financial instrument, either directly or indirectly, are included in Level 2 of the fair value hierarchy. Fair values determined using valuation techniques where one or more material inputs are not based on observable market data are assigned to Level 3 of the fair value hierarchy. The estimation uncertainties as regards fair value measurement increase the higher the level is.

Measurement methods

The property and public-sector loans included in loan receivables are measured using the discounted cash flow method for the purpose of the determination of fair value. Discounting of future cash flows of a transaction is based on transaction-specific risk-adjusted interest rates. These are derived on the basis of a virtually risk-free market interest rate for each currency depending on the relevant term, taking into account add-ons for risks specific to the counterparty as well as credit costs. In the case of loans subject to fixed interest rates, the contractually agreed payments are used as future cash flows. The future cash flows for floating-rate loans are derived using the future forward interest rates, taking into account the relevant spread for customer-specific terms and conditions.

Debt securities and promissory note loans for which no current market price is available are measured through an analysis of future payments using the fully-capitalised earnings value approach, where the inputs are based on observable market data. These approaches include the discounted cash flow (DCF) method which is used to determine the present value of contractual cash flows until the expected end of the term. The present value is determined based on the benchmark curve applicable for the relevant market, taking into account mark-ups based on credit quality and liquidity. The valuation model used for options included in the transaction is the commonly used Black-Scholes model or appropriate numerical procedures.

The fair value of OTC derivatives as well as of OTC hedging derivatives is determined on the basis of sector-specific standardised measurement models, such as the present value method or option pricing models. These techniques are based on inputs of active markets, such as interest rates, yield curves and credit spreads. The fair value of foreign exchange forwards is generally based on current forward exchange rates quoted on active markets. Adjustments for specific counterparty risks (CVA and DVA) are not taken into account for the determination of the present value of derivatives at Aareal Bank, as they are deemed immaterial. Since the derivatives are part of highly effective collateral agreements (Credit Support Annex to the ISDA Master Agreement and Collateral Annex to the German Master Agreement on Financial Derivatives Transactions) which are each subject to a master collateralisation agreement, measurement adjustments to reflect any potential counterparty credit risk or own credit risk are not required. The Bank uses the overnight interest rate swap curve (OIS curve) for the measurement of derivatives secured by cash collateral.

Amortised cost is an adequate estimate of fair value for cash funds, other loan receivables as well as short-term money market receivables and liabilities.

Day-one gains or losses

As a rule, the transaction price equals the fair value at initial recognition. In contrast, there can be differences between the initial fair value determined using a valuation technique and the transaction price. These so-called day-one gains or losses may only be recognised immediately when all the inputs on which the valuation parameters are based are observable in the market. Otherwise, the difference has to be amortised through profit or loss over the term of the transaction.

Recognition and measurement of financial instruments

Pursuant to IAS 32, a financial instrument is any contract that gives rise to a financial asset at one contracting party and a financial liability or equity instrument at another contracting party.

Recognition

Financial instruments (including derivative financial instruments) must be recognised if the reporting entity has become a party to the contractual provisions of such financial instruments. Trade date and settlement date are not the same for regular way purchases and sales of financial assets. Such regular way purchases and sales may be accounted for either at trade date or at settlement date. At Aareal Bank Group, financial instruments (fvpl) are recognised at the trade date, while all other financial instruments are recognised at the settlement date.

Financial instruments have to be derecognised when the contractual rights to the cash flows from the financial asset expire or an entity transfers the financial asset, including substantially all its risks and rewards. The modification of the contractual terms may also result in the derecognition of a financial instrument and the recognition of a new financial instrument.

If only a portion of risks and rewards is transferred and a portion of control is retained, the financial asset is recognised only to the extent of its continuing involvement. The extent of the continuing involvement corresponds to the extent to which the Company is exposed to changes in the value of the financial asset. A financial liability is derecognised when it is extinguished, i.e. when the obligation specified in the contract is discharged.

Modification

As a matter of principle, a modification is defined as any change made to existing terms of a loan agreement or a contractual adjustment during the loan or contract term. This applies regardless of the reasons for the modification (credit-driven or market-driven). Contractual adjustments may either lead to the derecognition of the "old" and the recognition of a "new" asset when such adjustments are substantial to the extent that they, in essence, constitute a new asset (hereinafter referred to as "substantial modification") or to the recalculation of the carrying amount and the recognition of a net modification gain or loss, when such adjustments constitute an adjustment of an existing asset (hereinafter referred to as "non-substantial modification").

The contractual adjustments subject to modifications may generally be caused by the borrower's credit quality and solvency (credit-driven modifications) or the granting of more favourable terms and conditions in an existing contract or the adjustment of the framework for financings as a result of changes in the customer's financing needs (market-driven modifications).

Both substantial and non-substantial modifications have an impact on profit or loss.

The amount of net modification gains or losses arising from non-substantial modifications is determined by the difference of the gross carrying amounts before and after the modification. Net modification gains or losses arising from market-driven modifications are recognised in net interest income, while credit-driven modifications are reported in the loss allowance. Subsequently, the changes in the carrying amount of the receivable is amortised over the remaining term of the receivable and recorded in net interest income.

In the case of a substantial modification, the old asset has to be derecognised, and a new asset has to be recognised. The difference of the gross carrying amounts before and after the modification is reported as net derecognition gain or loss in the case of market-driven modifications. In the case of credit-driven modifications, a loss allowance is recorded prior to derecognition in an amount that covers the entire difference between the old carrying amount and the fair value determined at the time of initial recognition.

Measurement

Upon initial recognition, financial instruments are measured at fair value plus any transaction costs.

Subsequent measurement of financial assets is based on the classification of the financial instrument. Depending on the classification, financial assets are measured at amortised cost, at fair value through other comprehensive income or at fair value through profit or loss. Investments in equity instruments are measured at fair value through profit or loss, unless an irrevocable election is made at initial recognition to present subsequent changes in fair value in other comprehensive income. Within Aareal Bank Group, this election is exercised as a rule due to the investment characteristics of the equity instruments.

Financial liabilities are measured at amortised cost.

In addition, financial assets and liabilities may be designated as at fair value through profit or loss if certain prerequisites are met. Aareal Bank Group does not make use of this option.

Classification

The classification, i.e. the determination of the measurement category of a financial asset is to be assessed on the basis of two criteria. The objective criterion refers to the contractual design as to whether the payments solely represent payments of interest and principal on the principal amount outstanding (SPPI = solely payments of principal and interest). Relevant criteria were defined that are reviewed at initial recognition. For example, this may be financings with a primary investment risk or contractually agreed payments that depend on the borrower's economic performance. The subjective classification criterion refers to the business model, i.e. the aim that a company pursues for a group of assets.

Subsequent **measurement has to be based on amortised cost (ac)** when the financial instrument is held in order to collect contractual cash flows (business model "Hold") and additionally the contractual cash flows represent solely payments of principal and interest, i.e. are SPPI compliant. This classification category is used for a large portion of the lending and securities business.

Subsequent **measurement at fair value, with changes in fair value being recognised initially directly in equity and subsequently reclassified to profit or loss (so-called recycling) (fair value through other comprehensive income (fvoci))** has to be made when financial instruments are SPPI compliant and are held either to collect contractual cash flows or to be sold (business model "Hold & Sell").

Subsequent **measurement at fair value, with changes in fair value being recognised through profit or loss (fvpl)**, has to be made if the financial instrument is not SPPI compliant or cannot be allocated to one of the two business models. The latter is the case for example when there is the purpose of selling such financial instruments in the near term due to syndication covenants.

Loss allowance

Loss allowances are based on the internal staging and expected credit loss (ECL/EL) model of Aareal Bank. For this purpose, financial instruments measured at amortised cost and at fair value through other comprehensive income as well as loan commitments and financial guarantees are allocated to various stages at both initial recognition and subsequent measurement. The related loss allowances are recognised in the amount of the twelve-month or the lifetime expected credit loss.

- **Stage 1:** All financial instruments without impairment trigger are allocated to this stage at initial recognition. If the credit risk is not significantly increased or if the absolute credit risk can be classified as low, the financial instrument has to remain in Stage 1 for subsequent measurement. Loss allowances are recognised in the amount of the losses expected for the following twelve months and interest income is calculated on the basis of the gross carrying amount, applying the effective interest method. Loss allowances have to be recognised on a present value basis.
- **Stage 2:** All financial instruments where credit risk has increased significantly since initial recognition are allocated to this stage. Loss allowances are recognised in the amount of the losses expected for the entire remaining term of the instrument and interest income is calculated on the basis of the gross carrying amount, applying the effective interest method. Loss allowances have to be recognised on a present value basis. The significant increase in credit risk for the allocation to Stage 2 is determined using the so-called expected downgrade bank-internal staging model and taking into consideration quantitative and qualitative criteria such as the credit rating of the customer, the intensity of customer handling and payment defaults. If the significant increase in credit risk no longer applies, the financial instrument is re-transferred to Stage 1. A description of the credit risk methods and systems in place at Aareal Bank AG is presented in the Risk Report as part of the Management Report.
- **Stage 3:** This stage includes all financial instruments where there is objective evidence of impairment (impairment trigger or credit impaired). Loss allowances are recognised in the amount of the losses of the lifetime expected credit loss, and interest income is calculated on the basis of the net carrying amount (i.e. gross carrying amount less loss allowance) using the effective interest method. The lifetime expected credit loss in Stage 3 is determined as the difference between the gross carrying amount and the present value of expected future cash flows (discounted using the original effective interest). If the impairment triggers no longer apply, the financial instrument is re-transferred to Stage 1 or 2.
- **POCI (purchased or originated credit impaired):** This category includes all financial instruments that were subject to an impairment trigger at initial recognition. The loss allowance is recorded in the amount of the lifetime expected credit loss.

The expected credit loss is generally determined by Aareal Bank using a model-based procedure where, depending on the stage, one- or multi-year parameters are used. The calculation of the expected loss in Stage 1 and of lifetime expected credit loss in Stage 2 is based on the one-year or lifetime probability of default (PD), respectively, the loss given default (LGD), the expected exposure at default (EAD), a discount factor (DF), the expected contractual term and the current and expected economic environment such as the GDP, long-term interest and unemployment rate. A period of not more than twelve months

is assessed for Stage 1, while the expected contractual term of the financial instrument has to be taken into account for Stages 2 and 3 (and, in addition, the expected term for loan repayment in Stage 3). The expected loss in Stage 3 is usually determined on the basis of individually estimated cash flows (ECF procedure) in several probability-weighted scenarios. The amount of the loss allowance is determined as being the difference between the carrying amount of the asset and the present value of the expected future cash flows, discounted using the original effective interest rate applicable at initial recognition (taking into account the marketability of collateral provided). Collateral is largely provided in the form of land charges or mortgages; these are measured at fair value which is generally based on either the income capitalisation approach or the discounted cash flow method. Impairment triggers are strong indications for a decline of the borrower's credit quality, arrears as well as further indications that not all interest and principal payments can be made as contractually agreed.

The loss allowance for debt instruments measured at amortised cost are reported in the item "Loss allowance (ac)", for debt instruments measured at fair value through other comprehensive income in the item "Reserve from the measurement of debt instruments (fvoci)" and for loan commitments and financial guarantees under provisions. Debt instruments reported under POCI are accounted for on a net basis, i.e. without any loss allowance. Changes in loss allowance are reflected by increasing or decreasing the carrying amount through other loss allowance.

If the receivables are not recoverable, the corresponding loss allowance is utilised and the receivable is derecognised. Direct write-offs are not made.

The loss allowance for receivables from other transactions is determined using a simplified procedure in the amount of the lifetime expected credit losses.

Hedging relationships

The risk management strategy set out in the Risk Report is the basis for the recognition of hedging relationships. At Aareal Bank Group, risks from value fluctuations or from changed cash flows are hedged in the case of transactions not measured at fair value through profit or loss. In this context, the risks from hedged items are intended to be offset by entering into hedging derivatives where the fair value changes or the changes in the cash flows have the opposite direction compared to those of the hedged item. Average prices of the hedges are not relevant for risk management. Hedging relationships are not recorded for transactions that are measured at fair value through profit or loss. The results from economic hedging relationships are offset in net gain or loss from transactions measured at fair value.

Hedge accounting in accordance with IFRS 9 distinguishes various forms of hedging relationships.

Fair value hedges are used to hedge hedged items against fair value changes resulting from changes in interest rates or from changes in interest and exchange rates that are determined accordingly as hedged risk. At Aareal Bank Group, property loans, securities and promissory note loans are typically hedged using interest rate swaps and cross-currency swaps. The derivatives used for hedging are accounted for at fair value through profit or loss. The offsetting fair value changes of the hedged item resulting from the hedged risk are also recognised through profit or loss. The proportion of the fair value changes of the hedged item not attributable to the hedged risk is accounted for in line with the classification of the hedged item. A fully effective hedging relationship results in offsetting measurement results. The hedging relationship may result in adjustments in the carrying amount of the underlying transaction. Such adjustments will only be recognised in profit or loss at the end of the transaction term.

Derivatives used as hedging instruments for the purposes of a cash flow hedge serve to hedge future cash flows against changes in interest rates or interest and exchange rates resulting from variable-rate financial assets and liabilities. The effective portion of measurement gains or losses from the derivative is recorded in equity, in the hedging reserve. The ineffective portion of these measurement gains or losses is recorded directly in profit or loss. When the hedging relationship ceases to exist, the amounts recorded in the other reserves are transferred to the income statement at the same time as gains or losses on the former underlying transaction are recognised in profit or loss. The underlying transaction is recognised in line with the rules for the measurement category to which the underlying transaction has been allocated.

Hedges of a net investment in a foreign operation are used to hedge currency risks arising on the translation of the net assets of foreign Group companies. The effective portion of measurement gains or losses from derivative hedging instruments is recognised directly in equity in the currency translation reserve. The ineffective portion of the hedging derivative's fair value changes have to be recognised in the income statement. The gain or loss on the hedging derivative relating to the effective portion of the hedge that has been recognised directly in equity shall be recognised in profit or loss on disposal of the foreign operation. Any translation differences resulting from the translation of an entity with a different functional currency into the Group currency also have to be recognised directly in equity in the currency translation reserve; they will be reclassified to the income statement upon disposal of the foreign operation.

The effectiveness of hedging relationships is reviewed by way of a forward-looking sensitivity analysis regarding the hedged risks. Factors which may lead to ineffectiveness include the term of transactions or payment dates, or diverging market conventions for underlying transactions and related hedges which affect the relevant measurement parameters (e.g. discounting using an OIS rate). Currency basis spreads are accounted for as hedging costs, with fair value changes of this element recognised in other comprehensive income. In the event of any changes to hedging relationships occurring in the course of risk management, the hedge ratio of existing hedges and/or hedged items is adjusted accordingly.

Cash funds

Cash funds include cash on hand and balances with central banks. Cash funds are exclusively allocated to the measurement category "ac".

Loan receivables

The item "Loan receivables" comprises property loans, loans to local authorities and other loan receivables, including deferred interest. Loan receivables can be allocated to all measurement categories. The portion of loan commitments not disbursed is reported as contingent liabilities.

Money market and capital market receivables

Money market and capital market receivables consist of money market receivables, promissory note loans and debt securities, including deferred interest. This item also includes unconsolidated equity instruments. Money market and capital market receivables may generally be allocated to all measurement categories. Equity instruments are allocated to the measurement category "fvoci".

Receivables from other transactions

The item "Receivables from other transactions" comprises trade receivables and other financial receivables. Receivables from other transactions are exclusively allocated to the measurement category "ac".

Positive market value of designated hedging derivatives/ Negative market value of designated hedging derivatives

The items "Positive market value of designated hedging derivatives" and "Negative market value of designated hedging derivatives" include derivatives with positive or negative market values from fair value hedges, cash flow hedges and hedges of a net investment in a foreign operation, including deferred interest. Derivatives are exclusively allocated to the measurement category "fvpl". The basis for the recognition of hedging relationships is described in the chapter "Recognition and measurement of financial instruments" in this section. Effects from the measurement of these derivatives are reported in the item "Net gain or loss from hedge accounting", together with the effects from the measurement of the transactions.

Positive market values of other derivatives / Negative market value of other derivatives

Derivative financial instruments that are not part of recognised hedging relationships are reported in Aareal Bank Group under positive or negative market values of other derivatives. They are mainly used to hedge economic market price risks. Derivatives are exclusively allocated to the measurement category "fvpl". Results from the measurement and the termination of the derivatives are reported in the item "Net gain or loss from financial instruments (fvpl)". Interest received or paid in connection with these derivatives is also recorded generally in the item "Net gain or loss from financial instruments (fvpl)". Interest received or paid for derivatives entered into for hedging purposes which, however, do not meet the hedge accounting criteria, is reported in net interest income. Effects from the measurement of these derivatives are reported in the item "Net gain or loss from financial instruments (fvpl)", together with the effects from the measurement of the transactions.

Investments accounted for using the equity method

Investments accounted for using the equity method include shares in companies where Aareal Bank Group can exercise significant influence (associates) as well as shares in joint ventures.

Investments in associates included in this item are recognised at cost when the significant influence arises, and subsequently carried at amortised cost whereby, in particular, the share of results of operations of any financial year is recognised in income.

The equity method applied to the major associates was based on the most recent available financial statements prepared under local GAAP.

Intangible assets

The item "Intangible assets" consists of proprietary software, goodwill and other intangible assets such as purchased software and licenses.

Intangible assets (except goodwill) are carried at cost, less accumulated amortisation and any impairment losses.

Research costs incurred in connection with software development are expensed as they are incurred. Development costs are capitalised from the time when the software development can be regarded as completed from a technical perspective, and several other conditions are fulfilled. Borrowing costs directly attributable to software development are part of the cost. They are amortised on a straight-line basis, using an estimated economic life of ten years. Purchased software is also deemed to have a limited useful life. The procedure followed for the determination of amortisation of purchased software is the same as the procedure used for proprietary software. Amortisation is recognised in administrative expenses.

Goodwill is defined as the excess of the cost of acquisition over the fair value of the Group's interest in the net assets of an acquired entity, at the time of acquisition (positive difference). Goodwill is carried at historical cost less accumulated impairments. Any negative goodwill (badwill) arising upon acquisition is immediately charged against income.

In case the annual impairment test shows that there are indications of impairment of intangible assets (as set out in IAS 36) and that the recoverable amount is lower than the carrying amount of the asset concerned, the asset is written down through profit or loss, to the estimated recoverable amount.

If it is impossible to estimate the recoverable amount for a specific asset, the recoverable amount of the cash-generating unit that the asset belongs to must be determined. A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Aareal Bank Group defines cash-generating units either on the basis of a single subsidiary or on product level. The recoverable amount of an asset or a cash-generating unit is the higher of fair value less costs to sell and value in use. (Value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset or cash-generating unit.) Future cash flows are determined based on medium-term projections. The present value of the future cash flows is determined using discount factors which are in line with the risks involved. Accordingly, the recognition of intangible assets and the impairment test is also subject to estimation uncertainties.

Property and equipment

Property and equipment includes owner-occupied land and buildings, office furniture and equipment as well as a hotel which is operated by Aareal Bank. Property and equipment is measured at cost, less accumulated depreciation and impairment losses. Depreciation and impairment losses are reported under administrative expenses, while those of the owner-operated hotel are shown in net other operating income/expenses.

Owner-occupied buildings reported under property and equipment are depreciated on a straight-line basis, over a period of 25 to 50 years. Owner-occupied land is not depreciated. Please refer to the explanations in the Notes on other assets for the accounting method to be applied for land and buildings which are not owner-occupied. Office furniture and equipment items are depreciated using the straight-line method, applying the following periods:

	Depreciation period
Other property and equipment	
IT equipment	3-7 years
Other office furniture and equipment	5-13 years

Tenant improvements are depreciated based on the principles applicable for the relevant building.

For details on recognising impairments as defined in IAS 36, please refer to the explanations in the Note on intangible assets in this section.

Gains and losses upon disposal of property and equipment are recognised in income (in net other operating income/expenses).

The costs to purchase property and equipment in the amount of up to € 250.00 (low-value assets) are expensed as they are incurred.

Deferred tax assets/deferred tax liabilities

Deferred taxes are reported in the items "Deferred tax assets" and "Deferred tax liabilities".

Deferred tax assets are recognised when they are deemed recoverable. The recoverability is assessed using tax planning (internal assessment) on the basis of medium-term Group planning. Accordingly, deferred tax assets are only recognised to the extent that we deem it probable that future taxable profits will be available against which the temporary differences and tax loss carryforwards can be utilised. Deferred taxes are calculated on the basis of country- and company-specific tax rates expected to apply at the time of the realisation of temporary differences and set-off against loss carryforwards.

Deferred tax assets and deferred tax liabilities are offset in accordance with IAS 12.74 when there is a legally enforceable right to set off current tax assets against current tax liabilities and when the deferred tax assets and the deferred tax liabilities relate to income taxes levied by the same taxation authority on either the same taxable entity or tax group.

Other assets

The item "Other assets" includes properties, contract assets and miscellaneous assets. Properties reported under other assets are intended for short-term disposal, though the IFRS 5 criteria are not met. They are measured at the lower of cost or net realisable value, in accordance with IAS 2, and therefore are subject to estimation uncertainties.

Money market and capital market liabilities

The item "Money market and capital market liabilities" comprises money market liabilities, mortgage Pfandbriefe, registered public-sector Pfandbriefe, promissory note loans and other debt securities, including deferred interest. Money market and capital market activities are allocated to the measurement category "ac".

Deposits from the housing industry

The item "Deposits from the housing industry" includes deposits payable on demand and term deposits, including deferred interest. Deposits from the housing industry are allocated to the measurement category "ac".

Liabilities from other transactions

The item "Liabilities from other transactions" comprises trade payables and other financial liabilities. Liabilities from other transactions are exclusively allocated to the measurement category "ac".

Subordinated capital

The item "Subordinated capital" consists of subordinated liabilities, profit-participation certificates and silent participations. Subordinated funds raised do not provide for any early repayment obligation. In the event of liquidation or insolvency, claims on interest and principal from these liabilities are subordinated to the claims of all other creditors, which are not subordinated themselves. Pursuant to the terms and conditions of issue, holders of profit-participation certificates have a claim on interest payments which takes precedence over the profit entitlements of shareholders. To the extent that a distribution would cause a net loss, said interest claim would be reduced, possibly down to zero, creating a claim for back-payment during the term of the certificates at the same time. Repayment takes place at the nominal amount (subject to any loss sharing), on the day after the Annual General Meeting passing resolutions regarding the relevant financial year. The profit-participation certificates evidence creditors' rights; they do not grant any share in the liquidation proceeds.

Subordinated capital is allocated to the measurement category "ac".

Other liabilities

The item "Other liabilities" includes deferred income, liabilities from other taxes, contract liabilities and miscellaneous liabilities.

Provisions

The item "Provisions" comprises provisions for pensions and similar obligations, provisions for staff expenses and non-staff operating costs, provisions for risks related to unrecognised items in the lending business, provisions for legal or tax risks, as well as other provisions. Provisions are recognised when there is a present legal or constructive obligation towards third parties arising from a past event, the outflow of resources to meet this obligation is probable and the amount of the obligation can be reliably estimated. Provisions, including uncertain tax positions, are measured on the basis of the best estimate of expenditure required to settle the obligation (most likely value) required as at the reporting date. In the context of acquisitions in accordance with IFRS 3, contingent liabilities, including uncertain tax obligations, were also recognised at their expected value. These are released when the reasons for their recognition cease to exist.

Measurement is subject to several uncertainties and often requires significant estimates made by the management in relation to various factors that may not apply subsequently. The final amount of the liabilities may deviate significantly from the measurement previously made in accounting. For example, the outcome of individual legal proceedings may not be predicted with certainty.

If utilisation in the short term, i.e. within twelve months, from the obligation is not expected, the provision will be recognised at present value.

Provisions for pensions and similar obligations

Aareal Bank Group maintains various pension plans as defined in IAS 19. For the purpose of reporting pension obligations, IAS 19 makes a distinction between defined contribution plans and defined benefit plans.

Under defined contribution plans, an enterprise pays fixed contributions into a separate entity or a fund and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. Contributions paid to the statutory pension insurance scheme are also classified as defined contribution plans. The contributions paid to a defined contribution plan are recorded as staff expenses.

Defined benefit obligations are all pension obligations that do not meet the criteria of a defined contribution obligation. The amount of obligations usually depends on one or several factors, including age, length of service, and salary.

The Group's obligations under defined benefit plans are recognised as a provision in the consolidated statement of financial position. These are based on general works agreements on an employee pension scheme, individual agreements with executive staff as well as individual agreements concluded with the members of the Company's senior management. Projected economic and demographic developments as well as salary trends must be applied to the calculation of the provisions. Calculating the amount of provisions in the Group is based on actuarial opinions which are prepared by external actuaries on the basis of Aareal Bank-specific and Group-wide standardised parameters.

Provisions for pensions and similar obligations under defined benefit plans are determined in accordance with IAS 19 on the basis of the projected unit credit method; the various defined benefit plans are measured separately. The fair value of the plan assets is deducted from the present value of the pension obligation, taking into account, if applicable, the rules for the asset ceiling in relation to a surplus of plan assets over the benefit obligation. The resulting amount represents the net defined benefit liability (provision) or the net defined benefit asset. The net interest expense in the financial year is determined by applying the discount factor calculated at the beginning of the financial year to the net liability calculated as at that date. The discount rate used to determine the present value of the obligation is based on the capital market rate of high quality corporate bonds with comparable maturities at the reporting date. Determination is based on the GlobalRate:Link method by Willis Towers Watson. The data basis consists of corporate bonds recorded by Bloomberg which have a rating of at least "AA" and are denominated in the same currency as the underlying pension obligation. Actuarial gains and losses (remeasurements), which – in connection with the amount of obligations – arise on changes in expectations regarding life expectancy, pension increases, salary development, discount rate compared to the estimation made at the beginning of the period or compared to the actual trend during the period, are recorded in other comprehensive income in the item "Changes in the reserve from remeasurements of defined benefit plans". Actuarial gains and losses (remeasurements) recorded in other comprehensive income may not be reclassified subsequently to profit or loss (recycling). Differences between the expected return on plan assets, determined at the beginning of the period using the then applicable discount rate, and the actual return on plan assets (remeasurement) at the end of the period are also recognised in other comprehensive income. Actuarial gains and losses as well as the difference between expected and actual return on plan assets are included in other reserves. They are reported separately in the statement of changes in equity. Accordingly, the recognition of pension obligations is also subject to estimation uncertainties.

Share-based payment

Aareal Bank Group maintains share-based payment plans subject to cash settlement in accordance with IFRS 2. We refer to the Remuneration Report as part of the Notes to the consolidated financial statements as at 31 December 2017, which includes a detailed description of the plans and their scope as well as information on the valuation model applied and the effects of share-based payments on the Group's financial position and performance.

Provisions for obligations arising from share-based remuneration plans have been recognised under administrative expenses, in the amount of the fair value of the relevant obligation at the reporting date.

Equity

Equity comprises subscribed capital, capital reserves, retained earnings and other reserves. Other reserves include the reserve from remeasurements of defined benefit plans, the reserve from the measurement of equity and debt instrument at fair value through other comprehensive income, the hedging reserves, the reserve from changes in the value of foreign currency basis spreads and currency translation reserve. In addition, the item "Equity" includes non-controlling interests as well as the so-called Additional Tier 1 bond (AT1 bond). The AT1 bond is classified as equity since there is neither an obligation to repay the bond nor is there an obligation for ongoing debt service (payment of a dividend). The transaction costs directly attributable to the issue of the AT1 bond as well as dividends paid are deducted directly from equity, net of taxes.

Financial guarantee contracts

A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss that it incurs because a specified debtor fails to make payment when due. A guarantor recognises a financial guarantee contract as a liability at the date of addition, using the fair value of the guarantee obligation. The obligation is subsequently measured at the greater of a provision recorded in accordance with IAS 37 and the original amount, less any accumulated amortisation. Within Aareal Bank Group, financial guarantee contracts are presented based on the present value of the claim resulting from the future premium payments of the holder, and offset with the obligation for the guarantee (net basis).

Notes to the Statement of Comprehensive Income

(1) Net interest income

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾
€ mn		
Interest income from financial assets (ac)	621	623
Loan receivables (ac)	608	610
Money market and capital market receivables (ac)	13	13
Interest income from financial liabilities (ac)	6	5
Money market and capital market liabilities (ac)	4	3
Deposits from the housing industry (ac)	2	2
Interest income from financial assets (fvoci)	0	0
Money market and capital market receivables (fvoci)	0	0
Current dividend income	0	0
Interest income from financial instruments (fvpl)	26	5
Loan receivables (fvpl)	15	–
Money market and capital market receivables (fvpl)	5	–
Other derivatives (fvpl)	6	5
Market-driven modification gains	3	n/a
Total interest and similar income	656	633
Interest expenses from financial liabilities (ac)	79	73
Money market and capital market liabilities (ac)	58	52
Deposits from the housing industry (ac)	2	0
Liabilities from other transactions (ac)	0	0
Subordinated capital (ac)	19	21
Interest expenses from financial assets (ac)	8	8
Cash funds (ac)	7	7
Money market and capital market receivables (ac)	1	1
Interest expenses for financial instruments (fvpl)	166	103
Other derivatives (fvpl)	166	103
Market-driven modification losses	3	n/a
Total interest and similar expenses	256	184
Total	400	449

¹⁾ Comparative amounts reclassified according to the new classification format

Net interest income totalled € 400 million, an expected reduction from the previous year (9m 2017: € 449 million), which was largely due to the portfolio decline seen in the previous year, reflecting – amongst other factors – the scheduled reduction of the former Westlmmo and Corealcredit portfolios.

(2) Loss allowance

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾
€ mn		
Additions	80	65
Reversals	44	13
Direct write-offs	-	17
Recoveries on loans and advances previously written off	3	16
Loss allowance - other items	0	n/a
Credit-driven net modification gain or loss	0	n/a
Total	33	53

¹⁾ Comparative amounts reclassified according to the new classification format

Loss allowance amounted to € 33 million (9m 2017: € 53 million) and was thus in line with our expectations. Please also refer to our explanations in the Notes (10, 18, and 20).

(3) Net commission income

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾
€ mn		
Commission income from		
ERP products	118	114
Digital solutions	29	25
Additional products	9	9
Banking business and other activities	27	24
Total commission income	183	172
Commission expenses for		
Purchased services	28	24
Banking business and other activities	3	3
Total commission expenses	31	27
Total	152	145

¹⁾ Comparative amounts reclassified according to the new classification format

Net commission income increased to € 152 million (9m 2017: € 145 million), which was mainly due to higher sales revenue at Aareon.

(4) Net derecognition gain or loss

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾
€ mn		
Net gain or loss on the derecognition of financial assets (ac)		
Loan receivables (ac)	16	37
Money market and capital market receivables (ac)	–	–
Net gain or loss on the derecognition of financial liabilities (ac)		
Money market and capital market liabilities (ac)	0	–
Net gain or loss on the derecognition of financial assets (fvoci)		
Money market and capital market receivables (fvoci)	–	0
Total	16	37

¹⁾ Comparative amounts reclassified according to the new classification format

The € 16 million net gain on derecognition of loan receivables (9m 2017: € 37 million) declined due to lower effects from early repayments.

(5) Net gain or loss from financial instruments (fvpl)

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾
€ mn		
Net gain or loss from loan receivables (fvpl)	-6	–
Net gain or loss from money market and capital market receivables (fvpl)	1	0
Net gain or loss from other derivatives (fvpl)	7	6
Currency translation	-3	7
Total	-1	13

¹⁾ Comparative amounts reclassified according to the new classification format

(6) Net gain or loss from hedge accounting

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017
€ mn		
Ineffective portion of fair value hedges	-2	-1
Ineffective portion of cash flow hedges	–	-4
Ineffective portion of net investment hedges	0	0
Total	-2	-5

(7) Administrative expenses

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017
€ mn		
Staff expenses	192	240
Wages and salaries	151	198
Social security contributions	25	25
Pensions	16	17
Other administrative expenses	134	133
Depreciation, amortisation and impairment of property and equipment and intangible assets	18	15
Total	344	388

At € 344 million (9m 2017: € 388 million), administrative expenses were reduced as expected, thanks to lower running costs and transformation costs.

(8) Net other operating income/expenses

	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017
€ mn		
Income from properties	47	49
Income from the reversal of provisions	2	72
Income from goods and services	0	0
Miscellaneous other operating income	19	12
Total other operating income	68	133
Expenses for properties	47	41
Expenses for other taxes	3	5
Other operating expenses	7	23
Total other operating expenses	57	69
Total	11	64

The comparative figure for the previous year's period included € 50 million in net reversals of provisions in connection with the final agreement on contractual issues with a third party, which were still pending when Aareal Bank Group acquired former Corealcredit, and the release of tax assessment notes. This was offset by corresponding income tax expense of € 26 million.

Notes to the Statement of Financial Position

(9) Financial assets (ac)

	30 Sep 2018	31 Dec 2017 ¹⁾
€ mn		
Cash funds (ac)	1,927	2,081
Cash on hand	0	0
Balances with the central bank	1,927	2,081
Loan receivables (ac)	25,616	26,316
Property loans	25,088	25,701
Public-sector loans	471	537
Other loan receivables	57	78
Money market and capital market receivables (ac)	5,559	5,225
Money market receivables	727	713
Promissory note loans	1,202	1,399
Bonds	3,630	3,113
Receivables from other transactions (ac)	52	93
Trade receivables	27	56
Other financial receivables	25	37
Total	33,154	33,715

¹⁾ Comparative amounts reclassified according to the new classification format

(10) Loss allowance (ac)

30 September 2018

	Stage 1	Stage 2	Stage 3	Receivables from other transactions (ac)	Total loss allowance (ac)
€ mn					
Balance as at 1 January	32	42	517	2	593
Additions	18	10	47	0	75
Utilisation	–	–	80	0	80
Reversals	14	6	20	0	40
Transfer to Stage 1	1	-1	0	–	0
Transfer to Stage 2	-1	1	0	–	0
Transfer to Stage 3	0	0	0	–	0
Interest rate effect	–	–	4	–	4
Currency adjustments	0	0	1	0	1
Transfers	–	–	–	1	1
Balance as at 30 September	36	46	469	3	554

The loss allowances for financial assets measured at amortised cost refers to loan receivables, money and capital market receivables as well as receivables from other transactions (largely trade receivables) that are measured at amortised cost.

30 September 2017¹⁾

	Specific valuation allowance	Portfolio impairment allowance	Total loss allowance for recognised items	Provisions in the lending business for unrecognised items	Total loss allowance and provisions in the lending business
€ mn					
Loss allowance as at 1 January	435	119	554	5	559
Additions	61	4	65	–	65
Utilisation	30	–	30	0	30
Reversals	10	–	10	3	13
Unwinding	22	–	22	–	22
Changes in the basis of consolidation	–	–	–	–	–
Currency adjustments	-4	-1	-5	0	-5
Loss allowance as at 30 September	430	122	552	2	554

¹⁾ Comparative values determined in accordance with IAS 39

(11) Financial assets (fvoci)

	30 Sep 2018	31 Dec 2017 ¹⁾
€ mn		
Money market and capital market receivables (fvoci)	4,110	5,422
Promissory note loans	–	–
Bonds	4,110	5,422
Equity instruments (fvoci)	3	2
Equities and other non-fixed income securities	0	–
Other investments	3	2
Total	4,113	5,424

¹⁾ Comparative values determined in accordance with IAS 39

(12) Financial assets (fvpl)

	30 Sep 2018	31 Dec 2017 ¹⁾
€ mn		
Loan receivables (fvpl)	632	196
Property loans	632	196
Public-sector loans	–	–
Money market and capital market receivables (fvpl)	230	–
Promissory note loans	91	–
Bonds	139	–
Positive market value of designated hedging derivatives (fvpl)	1,196	1,926
Positive market value of fair value hedges	1,196	1,915
Positive market value of cash flow hedges	–	8
Positive market value of net investment hedges	–	3
Positive market value of other derivatives (fvpl)	670	327
Positive market value of economic hedging derivatives	486	80
Positive market value of other derivatives	184	247
Total	2,728	2,449

¹⁾ Comparative amounts reclassified according to the new classification format

(13) Intangible assets

	30 Sep 2018	31 Dec 2017
€ mn		
Goodwill	85	85
Proprietary software	29	24
Other intangible assets	41	44
Total	155	153

(14) Property and equipment

	30 Sep 2018	31 Dec 2017
€ mn		
Land and buildings and construction in progress	227	221
Office furniture and equipment	30	32
Total	257	253

(15) Other assets

	30 Sep 2018	31 Dec 2017 ¹⁾
€ mn		
Properties	197	203
Contractual assets	27	19
Miscellaneous	96	74
Total	320	296

¹⁾ Comparative amounts reclassified according to the new classification format

(16) Financial liabilities (ac)

	30 Sep 2018	31 Dec 2017 ¹⁾
€ mn		
Money market and capital market liabilities (ac)	24,264	26,109
Money market liabilities	4,186	4,821
Promissory note loans	5,129	5,421
Mortgage Pfandbriefe	10,473	11,036
Public-sector Pfandbriefe	2,130	2,578
Other debt securities	2,346	2,230
Other financial liabilities	0	23
Deposits from the housing industry (ac)	9,776	9,164
Payable on demand	7,935	7,314
Term deposits	1,841	1,850
Liabilities from other transactions (ac)	160	92
Trade accounts payable	12	18
Other liabilities	148	74
Subordinated capital (ac)	1,036	1,265
Subordinated liabilities	1,036	1,060
Profit-participation certificates	–	12
Silent participations	–	193
Total	35,236	36,630

¹⁾ Comparative amounts reclassified according to the new classification format

(17) Financial liabilities (fvpl)

	30 Sep 2018	31 Dec 2017 ¹⁾
€ mn		
Negative market value of designated hedging derivatives (fvpl)	1,202	1,479
Negative market value of fair value hedges	1,191	1,464
Negative market value of cash flow hedges	–	15
Negative market value of net investment hedges	11	–
Negative market value of other derivatives (fvpl)	377	224
Negative market value of economic hedging derivatives	239	34
Negative market value of miscellaneous other derivatives	138	190
Total	1,579	1,703

¹⁾ Comparative amounts reclassified according to the new classification format

(18) Provisions

	30 Sep 2018	31 Dec 2017 ¹⁾
€ mn		
Provisions for pensions and similar obligations	368	351
Provisions for unrecognised lending business	8	4
Other provisions and contingent liabilities	158	215
Total	534	570

¹⁾ Comparative amounts reclassified according to the new classification format

Changes in the discount rate require a revaluation of the amount of obligations. This is recognised directly in other comprehensive income, under changes in the reserve from defined benefit plans.

(19) Other liabilities

	30 Sep 2018	31 Dec 2017 ¹⁾
€ mn		
Deferred income	2	0
Liabilities from other taxes	14	17
Contract liabilities	13	16
Miscellaneous	1	0
Total	30	33

¹⁾ Comparative amounts reclassified according to the new classification format

(20) Equity

	30 Sep 2018	31 Dec 2017 ¹⁾
€ mn		
Subscribed capital	180	180
Capital reserves	721	721
Retained earnings	1,703	1,798
AT1 bond	300	300
Other reserves		
Reserve from remeasurements of defined benefit plans	-88	-91
Reserve from the measurement of equity instruments (fvoci)	0	0
Reserve from the measurement of debt instruments (fvoci)	46	24
Hedging reserves	-	-1
Reserve from foreign currency basis spreads	-5	n/a
Currency translation reserve	-6	-9
Non-controlling interests	2	2
Total	2,853	2,924

¹⁾ Comparative amounts reclassified according to the new classification format

The item "Reserve from the measurement of debt instruments (fvoci)" includes loss allowance of € 0 million (2017: n/a).

Treasury shares

No treasury shares were held during the period under review.

Distributions

The Annual General Meeting of Aareal Bank AG held on 23 May 2018 resolved that Aareal Bank AG's net retained profit of € 149,643,052.50 for the financial year 2017, as reported under the German Commercial Code (HGB), be used to distribute a dividend of € 2.50 per notional no-par value share.

In addition, on 30 April 2018, the Management Board resolved on a distribution in relation to the AT1 instruments, pursuant to the terms and conditions of the notes.

Within Aareal Bank Group's consolidated statement of financial position, a dividend payment and a distribution on the AT1 bond reduce the retained earnings item within consolidated equity.

Notes to Financial Instruments

A detailed description of the system in place at Aareal Bank Group to measure, limit, and manage risks throughout Aareal Bank Group is presented in the Risk Report as part of the Group Management Report. The disclosures on the description and the extent of the risks arising from financial instruments in accordance with IFRS 7 are included (in part) in the Risk Report.

(21) Fair value hierarchy in accordance with IFRS 13

The carrying amounts of financial instruments held by Aareal Bank Group which are reported at fair value in the statement of financial position are presented in the following table according to the three-tier fair value hierarchy pursuant to IFRS 13.72 et seqq. The presentation is made for each class of financial instrument:

30 September 2018

	Fair value total	Fair value level 1	Fair value level 2	Fair value level 3
€ mn				
Financial assets (fvoci)	4,113	4,110	–	3
Money market and capital market receivables (fvoci)	4,110	4,110	–	–
Equity instruments (fvoci)	3	–	–	3
Financial assets (fvpl)	2,728	–	2,096	632
Loan receivables (fvpl)	632	–	–	632
Money market and capital market receivables (fvpl)	230	–	230	–
Positive market value of designated hedging derivatives (fvpl)	1,196	–	1,196	–
Positive market value of other derivatives (fvpl)	670	–	670	–
Financial liabilities (fvpl)	1,579	–	1,579	–
Negative market value of designated hedging derivatives (fvpl)	1,202	–	1,202	–
Negative market value of other derivatives (fvpl)	377	–	377	–

31 December 2017¹⁾

	Fair value total	Fair value level 1	Fair value level 2	Fair value level 3
€ mn				
Financial assets (fvoci)	5,424	5,422	–	2
Money market and capital market receivables (fvoci)	5,422	5,422	–	–
Equity instruments (fvoci)	2	–	–	2
Financial assets (fvpl)	2,449	–	2,253	196
Loan receivables (fvpl)	196	–	–	196
Money market and capital market receivables (fvpl)	–	–	–	–
Positive market value of designated hedging derivatives (fvpl)	1,926	–	1,926	–
Positive market value of other derivatives (fvpl)	327	–	327	–
Financial liabilities (fvpl)	1,703	–	1,703	–
Negative market value of designated hedging derivatives (fvpl)	1,479	–	1,479	–
Negative market value of other derivatives (fvpl)	224	–	224	–

¹⁾ Comparative amounts reclassified according to the new classification format

In the first nine months of 2018, there were no material transfers between the hierarchy levels for the various financial instruments.

The fair values of financial instruments recognised at fair value in the statement of financial position that are assigned to Level 3 of the fair value hierarchy developed as follows during the period under review:

	Loan receivables (fvpl)
€ mn	
Fair value as at 1 January 2018¹⁾	604
Change in measurement	-4
Position changes	
Additions	499
Derecognitions	468
Deferred interest	1
Fair value as at 30 September 2018	632

¹⁾ Fair value in accordance with IAS 39 as at 31 December 2017: € 196 million

Financial instruments held in the Bank's portfolio contributed € -4 million to the net gain or loss from financial instruments (fvpl).

Regarding loan receivables (ac), the add-ons for risks specific to the counterparty represent the material input parameter not observable in the market. Regarding the non-defaulted loans, an increase/decrease by 1 % would lead to a decrease/increase of the fair value by approximately € 10 million.

(22) Comparison of carrying amounts and fair values of the financial instruments

The fair values of financial instruments are compared with their carrying amounts in the following table. The presentation is made for each class of financial instrument:

	Carrying amount 30 Sep 2018	Fair value 30 Sep 2018	Carrying amount 31 Dec 2017 ¹⁾	Fair value 31 Dec 2017 ¹⁾
€ mn				
Financial assets (ac)	32,600	33,050	33,175	33,698
Cash funds (ac)	1,927	1,927	2,081	2,081
Loan receivables (ac)	25,085	25,660	25,776	26,308
Money market and capital market receivables (ac)	5,539	5,414	5,225	5,218
Receivables from other transactions (ac)	49	49	93	91
Financial assets (fvoci)	4,113	4,113	5,424	5,424
Money market and capital market receivables (fvoci)	4,110	4,110	5,422	5,422
Equity instruments (fvoci)	3	3	2	2

¹⁾ Comparative amounts reclassified according to the new classification format

>

	Carrying amount 30 Sep 2018	Fair value 30 Sep 2018	Carrying amount 31 Dec 2017 ¹⁾	Fair value 31 Dec 2017 ¹⁾
€ mn				
Financial assets (fvpl)	2,728	2,728	2,449	2,449
Loan receivables (fvpl)	632	632	196	196
Money market and capital market receivables (fvpl)	230	230	–	–
Positive market value of designated hedging derivatives (fvpl)	1,196	1,196	1,926	1,926
Positive market value of other derivatives (fvpl)	670	670	327	327
Financial liabilities (ac)	35,236	35,417	36,630	36,961
Money market and capital market liabilities (ac)	24,264	24,386	26,109	26,349
Deposits from the housing industry (ac)	9,776	9,776	9,164	9,164
Liabilities from other transactions (ac)	160	160	92	90
Subordinated capital (ac)	1,036	1,095	1,265	1,358
Financial liabilities (fvpl)	1,579	1,579	1,703	1,703
Negative market value of designated hedging derivatives (fvpl)	1,202	1,202	1,479	1,479
Negative market value of other derivatives (fvpl)	377	377	224	224

¹⁾ Comparative amounts reclassified according to the new classification format

(23) Day-one profit or loss

Aareal Bank Group has entered into transactions that were not effected on the principal market or the most advantageous market for the asset or liability concerned. In these cases the transaction price does not correspond to the fair value of the asset or liability, because the determination of the fair value using a valuation technique which assumes a transaction on a principal market results in a fair value that deviates from the transaction price. The financial instruments are carried at the transaction price upon initial recognition. The difference between the transaction price and the fair value measured based on the valuation model (the so-called day-one profit or loss) is amortised over the term of the transaction in the income statement, since the fair value of these derivatives is determined using valuation models whose inputs are not fully based on observable market factors.

The table below shows the development of the day-one profit or loss during the year under review. The day-one profit or loss is recognised as an item to be deducted from the carrying amount of the respective underlying derivative position:

	2018	2017
€ mn		
Balance as at 1 January	6	12
Additions from new transactions	-2	1
Reversals through profit or loss in the period	2	7
Balance as at 30 September	2	6

Segment Reporting

(24) Segment results

	Structured Property Financing		Consulting/ Services		Consolidation/ Reconciliation		Aareal Bank Group	
	1 Jan- 30 Sep 2018	01.01.- 30.09.2017 ¹⁾	01.01.- 30.09.2018	01.01.- 30.09.2017	01.01.- 30.09.2018	01.01.- 30.09.2017	01.01.- 30.09.2018	01.01.- 30.09.2017 ¹⁾
€ mn								
Net interest income	409	457	0	0	-9	-8	400	449
Loss allowance	33	53	0				33	53
Net commission income	6	4	141	136	5	5	152	145
Net derecognition gain or loss	16	37					16	37
Net gain or loss from financial instruments (fvpl)	-1	13					-1	13
Net gain or loss from hedge accounting	-2	-5					-2	-5
Net gain or loss from investments accounted for using the equity method								
Administrative expenses	182	234	166	157	-4	-3	344	388
Net other operating income/ expenses	9	62	2	2	0	0	11	64
Operating profit	222	281	-23	-19	0	0	199	262
Income taxes	77	104	-9	-7			68	97
Consolidated net income	145	177	-14	-12	0	0	131	165
Consolidated net income attributable to non-controlling interests	0	4	2	2			2	6
Consolidated net income attributable to shareholders of Aareal Bank AG	145	173	-16	-14	0	0	129	159
Allocated equity	1,735	1,772	177	155	573	592	2,485	2,519
Cost/income ratio (%)	41.8	41.1	115.3	114.2			59.7	55.2
RoE before taxes (%) ^{2), 3)}	15.7	19.6	-18.2	-18.3			9.7	12.6
Employees (average)	806	895	1,960	1,849			2,766	2,744
Segment assets	29,581	33,184	10,688	10,083			40,269	43,267

¹⁾ Comparative amounts reclassified according to the new classification format

²⁾ On an annualised basis

³⁾ The allocation of earnings is based on the assumption that net interest payable on the AT1 bond is recognised on an accrual basis.

Commission income from contracts with customers is allocated to the segments as follows:

	Structured Property Financing		Consulting/ Services		Consolidation/ Reconciliation		Aareal Bank Group	
	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾	1 Jan - 30 Sep 2018	1 Jan - 30 Sep 2017 ¹⁾
€ mn								
ERP Products			119	114	-1		118	114
Digital solutions			29	25			29	25
Add-on products			17	16	-8	-7	9	9
Banking business and other activities	7	7	20	17			27	24
Total	7	7	185	172	-9	-7	183	172

¹⁾ Comparative amounts reclassified according to the new classification format

(25) Segment Reporting (Quarterly Development)

	Structured Property Financing		Consulting/ Services		Consolidation/ Reconciliation		Aareal Bank Group	
	Quarter 3 2018	Quarter 3 2017 ¹⁾	Quarter 3 2018	Quarter 3 2017	Quarter 3 2018	Quarter 3 2017	Quarter 3 2018	Quarter 3 2017 ¹⁾
€ mn								
Net interest income	134	147	0	0	-3	-3	131	144
Loss allowance	14	26	0				14	26
Net commission income	2	1	48	45	1	2	51	48
Net derecognition gain or loss	5	20					5	20
Net gain or loss from financial instruments (fvpl)	0	10					0	10
Net gain or loss from hedge accounting	1	1					1	1
Net gain or loss from investments accounted for using the equity method								
Administrative expenses	53	68	56	53	-2	-1	107	120
Net other operating income/expenses	2	4	1	1	0	0	3	5
Operating profit	77	89	-7	-7	0	0	70	82
Income taxes	27	34	-3	-3			24	31
Consolidated net income	50	55	-4	-4	0	0	46	51
Consolidated net income attributable to non-controlling interests	0	0	1	0			1	0
Consolidated net income attributable to shareholders of Aareal Bank AG	50	55	-5	-4	0	0	45	51
Allocated equity	1,735	1,772	177	155	573	592	2,485	2,519
Cost/income ratio (%)	36.9	37.2	113.2	117.0			55.9	52.8
RoE before taxes (%) ^{2) 3)}	16.3	18.8	-15.8	-20.2			10.3	12.0

Commission income from contracts with customers is allocated to the segments as follows:

	Structured Property Financing		Consulting/ Services		Consolidation/ Reconciliation		Aareal Bank Group	
	Quarter 3 2018	Quarter 3 2017 ¹⁾	Quarter 3 2018	Quarter 3 2017	Quarter 3 2018	Quarter 3 2017	Quarter 3 2018	Quarter 3 2017 ¹⁾
€ mn								
ERP Products			40	38	0		40	38
Digital solutions			10	8			10	8
Add-on products			3	2	-1		2	2
Banking business and other activities	3	3	6	6		0	9	9
Total	3	3	59	54	-1	0	61	57

¹⁾ Comparative amounts reclassified according to the new classification format

²⁾ On an annualised basis

³⁾ The allocation of earnings is based on the assumption that net interest payable on the AT1 bond is recognised on an accrual basis.

Other Notes

(28) Contingent liabilities and loan commitments

	30 Sep 2018	31 Dec 2017
€ mn		
Contingent liabilities	170	124
Loan commitments	1,548	1,749
of which: irrevocable	1,128	1,355

(29) Employees

The number of Aareal Bank Group employees is shown below:

	30 Sep 2018 ¹⁾	Average 1 Jan - 30 Sep 2018 ²⁾	31 Dec 2017 ¹⁾	Average 1 Jan - 30 Dec 2017 ²⁾
Salaried employees	2,617	2,615	2,644	2,600
Executives	158	151	156	158
Total	2,775	2,766	2,800	2,758
of which: Part-time employees	571	545	544	531

¹⁾ This number does not include 207 employees of the hotel business (31 December 2017: 57 employees).

²⁾ This number does not include 217 employees of the hotel business (1 January to 31 December 2017: 198 employees).

(30) Related party disclosures in accordance with IAS 24

In the first nine months of the 2018 financial year, there were no material transactions with related parties that would have to be reported here.

(31) Events after the interim reporting period

There have been no events subsequent to the end of the interim reporting period under review that need to be disclosed at this point.

Executive Bodies of Aareal Bank AG

Supervisory Board

Marija Korsch ^{1) 2) 3) 4) 5) 6)}

Chairman of the Supervisory Board
Former partner of Bankhaus Metzler seel.
Sohn & Co. Holding AG

Prof. Dr Stephan Schüller ^{1) 2) 3)}

Deputy Chairman of the Supervisory Board
Former spokesman of the General Partners of
Bankhaus Lampe KG

Dieter Kirsch ^{1) 2) 7)}

Deputy Chairman of the Supervisory Board
Aareal Bank AG

York-Detlef Bülow ⁷⁾
(until 31 March 2018)

Aareal Bank AG

Thomas Hawel ^{6) 7)}

Aareon Deutschland GmbH

Petra Heinemann-Specht ^{4) 5) 7)}

(since 1 April 2018)

Aareal Bank AG

Richard Peters ^{1) 3) 6)}

President and Chairman of the Management Board
of Versorgungsanstalt des Bundes und der Länder

Dr Hans-Werner Rhein ^{1) 4) 5)}

German Lawyer (Rechtsanwalt)

Sylvia Seignette ^{4) 5)}

Former CEO for Germany and Austria,
Crédit Agricole CIB (formerly Calyon)

Elisabeth Stheeman ^{4) 5) 6)}

External Member of the Bank of England's
Financial Policy Committee (FPC)

Hans-Dietrich Voigtländer ^{2) 3) 6)}

Senior Partner at BDG Innovation +
Transformation GmbH & Co. KG

Prof. Dr Hermann Wagner ^{3) 4) 5)}

Chairman of the Audit Committee
German Chartered Accountant, Tax Consultant

Beate Wollmann ^{3) 7)}

Aareon Deutschland GmbH

Management Board

Hermann Josef Merkens

Chairman of the Management Board

Marc Hess

(since 1 October 2018)

Member of the Management Board

Dagmar Knopek

Member of the Management Board

Christiane Kunisch-Wolff

Member of the Management Board

Thomas Ortmanns

Member of the Management Board

Christof Winkelmann

Member of the Management Board

¹⁾ Member of the Executive and Nomination Committee; ²⁾ Member of the Remuneration Control Committee; ³⁾ Member of the Audit Committee;

⁴⁾ Member of the Risk Committee; ⁵⁾ Member of the Committee for Urgent Decisions; ⁶⁾ Member of the Technology and Innovation Committee;

⁷⁾ Employee representative

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Financial Calendar

27 February 2019	Presentation of preliminary results for the 2018 financial year
28 March 2019	Publication of annual report as at 31 December 2018
9 May 2019	Publication of results as at 31 March 2019
22 May 2019	Annual General Meeting – Kurhaus, Wiesbaden
13 August 2019	Publication of results as at 30 June 2019
12 November 2019	Publication of results as at 30 September 2019

Locations



Aareal Bank, Real Estate Structured Finance: Brussels, Dublin, Istanbul, London, Madrid, Moscow, New York, Paris, Rome, Shanghai, Singapore, Stockholm, Warsaw, Wiesbaden | **Aareal Estate AG:** Wiesbaden | **Westdeutsche Immobilien Servicing AG:** Mainz, Münster

Aareal Bank, Group Business Consulting & Services: Berlin, Essen, Leipzig, Wiesbaden | **Aareon AG:** Berlin, Bochum, Coventry, Dortmund, Emmen, Enschede, Gorinchem, Grathem, Hamburg, Helsinki, Hilversum, Hückelhoven, Karlskrona, Leipzig, Lund, Mainz, Meudon-la-Forêt, Mölndal, Munich, Nantes, Norrtälje, Orléans, Oslo, Paris, Piteå, Southampton, Stockholm, Stuttgart, Swansea, Toulouse, Wiener Neudorf | **Aareal First Financial Solutions AG:** Mainz | **Deutsche Bau- und Grundstücks-AG:** Berlin, Bonn, Dresden, Düsseldorf, Essen, Frankfurt/Main, Freiburg, Hanover, Leipzig, Moscow, Munich, Wuppertal

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**Aareal Bank
Group**