II Business report

1 Economic conditions

The pace of economic growth slowed during the year under review. Average inflation-adjusted gross domestic product (GDP) in Germany rose by 1.4 percent year on year.

Domestic economic output in the first quarter of 2018 was up by 0.4 percent compared with the preceding quarter. This was followed by a similar GDP gain of 0.5 percent in the second quarter. However, the third quarter saw a contraction in German economic output of 0.2 percent, one of the reasons being the automotive industry's hesitant switch to the new European emissions testing requirements. In the fourth quarter of 2018, the country's GDP growth was 0.0 percent.

Once again, higher consumer spending provided a boost to the German economy in the reporting year, although not to the extent of the previous year. Growth in government spending continued to slip back. Consumer demand rose by 1.0 percent year on year, aided by robust trends in the labor market and no improvement in the extremely low returns available on consumer investments. One of the consequences of an intensification of trade disputes during the year was a lower trade balance compared with the previous year. In the year under review, businesses stepped up capital spending at a faster rate with production capacity utilization remaining at a high level.

The increase in tax receipts generated by the overall robust economic growth meant that public finances in Germany ended 2018 once again with a budget surplus of 1.7 percent of GDP.

In the year under review, economic output in the eurozone grew by 1.8 percent year on year, the economic recovery being sustained in the first and second quarters of 2018 with growth rates of 0.4 percent (in each case compared with the previous quarter). In both the third and final quarters of 2018, the economy grew at a rate of 0.2 percent in each case.

Consumer spending once again proved to be a key driver behind the economic recovery in the eurozone in the reporting year. However, geopolitical crises, various conflicts, and above all the uncertainty arising from the Brexit negotiations and the United Kingdom's EU exit planned for March 29, 2019 as well as from current US trade policy did have some impact on consumer confidence during the year. Furthermore, rising energy prices also had an adverse effect on consumer willingness to spend in 2018. Over the course of the year, it became clear that businesses were increasing their spending on capital equipment. In view of the geopolitical factors referred to above, which have weighed on the global economy, and because export growth in the eurozone is likely to have lost momentum, it is anticipated that the trade balance will not have made any notable contribution to economic growth.

In the United States, economic growth in the reporting year was 2.9 percent.

The economy has therefore gained further significant traction compared with 2017, when the year-on-year rate of expansion was 2.2 percent. Overall, the principal economic driver in the US remained the recovery in consumer spending, which was bolstered by further improvements in the labor market, notably a further fall in the unemployment rate and a sharp rise in recruitment. Investment by businesses in plant and machinery once again rose at a stronger rate, boosted not least by the impact of the corporate tax reforms that came into force at the beginning of the year. The recovery in house-building was also sustained.

Trends toward economic recovery in key emerging markets such as India and Russia were sustained in the year under review. On the other hand, some of the highly indebted newly industrializing countries, such as Argentina and Turkey, suffered new economic crises. The Chinese economy was unable to maintain the really high level of growth achieved in the previous year. By and large, the stimulus for German exports derived from the demand from emerging markets was weaker in the year under review.

2 The banking industry amid continued efforts to stabilize the economy of the eurozone

The return of a trend toward economic policy driven first and foremost by national interests gained significant momentum in individual countries in the year under review.

The policy of 'America first' introduced by the US government in the first few months of 2018 with the imposition of customs duties on products from China, the EU, Canada, and Mexico was then ratcheted up over the rest of the year.

The increasingly tough reciprocal customs tariff barriers between the US and China, together with the associated price increases on products affected by the customs duties, pose the risk of depressing global trade and weakening global economic growth as a consequence of the resulting downward pressure on the demand for goods.

These negative economic influences were reinforced throughout the EU by the dispute between Rome and Brussels regarding the compatibility with the EU's stability targets of the draft Italian budget for 2019 initially submitted by the Italian government; this dispute came to a head toward the end of the year under review. To add to this, a notable feature over the whole of the reporting year was the ongoing uncertainty surrounding the details of how the UK was going to leave the EU.

At the end of November 2018, the UK and the EU managed to reach an agreement in principle regarding the structure of the transition period to follow the Brexit implementation date of March 29, 2019. This agreement allowed for a transition period up to no later than 2022 during which time the UK and the EU intended to enter into a comprehensive trade agreement. However, this agreement in principle was rejected by a UK parliamentary vote on January 15, 2019.

Not least in view of past crises in the eurozone, the developments described above highlight the need for an overhaul and strengthening of European Monetary Union (EMU), initial proposals for which have been put forward by French President Emmanuel Macron and German Chancellor Angela Merkel.

Joint EU-wide implementation of these initiatives was instigated at an EU summit at the end of June 2018, consisting of the first decisions in principle in relation to strengthening the European Stability Mechanism (ESM) and in particular concerning a backstop for the Single Resolution Fund (SRF).

At the beginning of December 2018, eurozone finance ministers (with the consent of the European Parliament) and, a few days later, the EU heads of state or government agreed to broaden the responsibility of the ESM so that it acts as the SRF backstop referred to above. This new structure is intended to take the form of a revolving credit line provided by the ESM for the SRF in an amount of approximately €60 billion to come into force no later than 2024. In addition, comprehensive resolutions were adopted related to a re-adjustment of EU banking regulation subject to the proviso of a further fall in the risk to which the EU banking sector is exposed.

At the same time, the agreed strengthening of the ESM specifies that, in the event of asymmetric shocks (such as possible negative effects on Ireland from Brexit), ESM precautionary credit lines can, for the most part, be utilized by EU countries whose economic conditions are generally still sound only if all debt criteria are satisfied, no excessive debt procedures (EDPs) have been instigated against these countries, and the countries concerned are not evidencing any excessive macroeconomic imbalances.

The content of the reform package described above and decided at EU level in December 2018 makes it clear that these measures at macroeconomic level alone are insufficient to increase the stability of the eurozone; it is also imperative that the individual EU countries themselves implement structural reforms with the aim of reducing their government debt.

On the whole, only limited progress was made in reducing new and total borrowing in the eurozone.

These efforts were supported by the ongoing phase of low interest rates and the continued path of economic recovery in the year under review, although the increase in the eurozone's economic output of 1.8 percent year on year during the reporting period was lower than the corresponding rise of 2.4 percent in 2017.

At the end of the third quarter of 2018, the total borrowing of the 19 eurozone countries equated to 86.1 percent of their GDP, a decrease of 2.1 percentage points compared with the figure of 88.2 percent as at September 30, 2017.

Even though France and Italy, countries that are important in generating overall economic growth in Europe, along with Portugal and Spain, which had been reliant on EU aid during the sovereign debt crisis, all made further gains in economic efficiency in the first nine months of 2018 compared with the first three quarters of 2017, they continued to suffer from a high level of indebtedness in the same way as some other eurozone countries, notably Greece.

Greece's public debt as a percentage of GDP stood at 182.2 percent in the third quarter of 2018 (third quarter of 2017: 174.9 percent) but the country continued on its path of economic recovery in 2018 compared with the previous year. Greece successfully exited its third economic adjustment program (loan of up to €86 billion) on August 20, 2018. However, if Greece is to make any noticeable impact in reducing its high level of indebtedness, it must sustain economic growth and continue with its reform policy and stringent budgetary discipline.

Italy is suffering from a high volume of non-performing loans in the banking sector and, above all, from having the highest relative government debt ratio in the eurozone after Greece; its public debt as a percentage of GDP stood at 133.0 percent in the third quarter of 2018 (third quarter of 2017: 133.6 percent).

This reflects a serious structural crisis, requiring sweeping reforms. Nevertheless, the coalition formed at the beginning of June 2018 between the far-right nationalist Lega and the populist Five Star Movement (M5S) based on the outcome of the parliamentary elections held on March 4, 2018 still put forward a proposed budget in mid-October 2018 for the coming year that involved new indebtedness of 2.4 percent of GDP. This included the withdrawal of social security cuts and suspension of the planned increase in value added tax. The new indebtedness of 2.4 percent, which ran counter to the EU's stability policy targets because of Italy's existing high level of indebtedness, led to a protracted dispute with the European Commission. Eventually, an agreement was reached with the Italian government on a slightly lower deficit ratio of 2.04 percent, which was enough to avert action by the EU authorities to instigate an excessive deficit procedure.

Portugal's public debt as a percentage of GDP stood at 125.0 percent in the third quarter of 2018 (third quarter of 2017: 129.5 percent) and the country made further progress on stabilizing its economy during the reporting year. The Portuguese economy was boosted in particular by steady consumer demand and a fall in unemployment. However, the banking sector continues to have significant legacy issues in the form of non-performing loans.

Spain's public debt as a percentage of GDP stood at 98.3 percent in the third quarter of 2018 (third quarter of 2017: 98.4 percent) and its economy continued to enjoy a pleasing rate of growth in the year under review. However, the new minority government with socialist Pedro Sanchez as Prime Minister, which took over after the previous conservative administration under Mariano Rajoy was ousted with a vote of no confidence at the beginning of June 2018, only has limited leeway because of the difficulty in securing a majority. The political instability is therefore hampering the necessary reform of the labor market and pension systems.

France's public debt as a percentage of GDP stood at 99.5 percent in the third quarter of 2018, only a slight reduction compared with the figure a year earlier (third quarter of 2017: 99.9 percent). The enthusiasm of the general public for the structural reforms introduced by President Emmanuel Macron in the first year of his term of office waned increasingly over the course of the year. Following a rail strike that dragged on for several months and that had a notable adverse impact on economic growth in the second quarter of 2018, the 'yellow vest' protest movement sparked off by higher carbon taxes on fuel rapidly gathered pace during the last few weeks of 2018 and became such a strong opposition force that it is likely more extensive reforms, such as the standardization of the system of competing pension regimes to cut costs, will have to undergo a retrospective review.

The trends in the eurozone described above show that the European Central Bank (ECB) with its policy of quantitative easing has 'bought' the necessary time for the EU countries burdened with significant debt to reduce their fundamental budget deficits. Nonetheless, the countries specified above have for the most part made only limited efforts to reduce their high levels of indebtedness and bring in the necessary structural reforms. This is especially worrying because it is questionable whether the EMU countries concerned will be in any position at all (because of the size of their debt burden) to cope with substantially higher interest rates arising from further normalization of the ECB's monetary policy.

It is clear that the current low level of interest rates has also had the effect of decreasing various EMU countries' efforts to implement austerity measures because the availability of low interest rates is noticeably reducing the debt burden anyway.

One of the main reasons why politicians are generally reluctant to introduce the necessary structural improvement measures to reduce public debt is that various EU countries are still seeing strong political movements that oppose the jointly agreed stabilization efforts of the single currency area. Aside from the UK's decision to leave the EU, the parliamentary elections in Austria, Italy, and Hungary have also shown, in particular, that increasingly anti-EU forces are gaining momentum and, as in the case of Italy recently, have even made it into government.

A key reason for the European Commission's reluctance to strictly implement the stability criteria under the Fiscal Compact agreed by the EU member states at the beginning of 2012 is most probably also the widespread return to a more nationalistic focus apparent within the eurozone. In the Fiscal Compact, the signatory countries committed to reducing their debt (as a proportion of GDP) each year by one twentieth of the difference between the debt level and the Maastricht limit of 60 percent of GDP.

At the same time, the ECB's current policy of zero and negative interest rates is making it harder for savers to build up sufficient capital and, in particular, to ensure they have adequate provision for old age. Although the weakness of the euro resulting from low interest rates is boosting companies' exports, it is also diminishing their efforts to lower costs and improve productivity. Furthermore, the ECB's policy of maintaining extremely low interest rates boosts the risk of misallocations and even the formation of bubbles in real estate and equities markets, which could jeopardize the stability of financial markets.

There is also a danger that future interest-rate rises in individual eurozone countries could lead to a wave of insolvencies among companies with chronic profitability problems. This may subdue economic growth and even trigger a recession if the situation worsens sufficiently. The countries giving rise to concerns about a sharp rise in insolvencies in the event of an interest-rate hike are Greece, Portugal, and Italy, because they each have a high proportion of non-performing loans to companies. This indicates a prevalence of firms with a sustained lack of profitability.

Another problem facing the ECB is that it will find itself with insufficient leeway in the event of an economic downturn and accompanying fall in inflation, because key interest rates will still be close to zero.

At its meeting on December 13, 2018, the ECB decided that its asset purchase program (quantitative easing, QE) launched in March 2015 would be discontinued at the end of 2018 following the reduction in the volume of monthly bond purchases from €30 billion to €15 billion in October 2018. At the same time, however, the ECB would continue to reinvest funds from maturing QE bonds. Explaining this move, ECB President Mario Draghi said that there was increased confidence that inflation in the eurozone was moving in the medium term in the direction of the central bank's target of below, but close to, 2.0 percent. At the meeting on December 13, 2018, the ECB also decided to leave the main refinancing rate unchanged at 0.00 percent and the deposit facility for banks at minus 0.40 percent.

By contrast, the Federal Reserve (Fed) raised its target range for the federal funds rate by 25 basis points on March 21, June 13, September 26, and again on December 19, 2018, taking the target range to the current level of 2.25 percent to 2.50 percent.

Against a backdrop of challenging market conditions, all the major German banks had to accept a fall in operating profits in 2018. The loss allowances for loans and advances recognized by the major banks were mostly lower than in 2017. Administrative expenses increased slightly year on year in the majority of cases.

3 Financial performance

3.1 Financial performance at a glance

The DZ BANK Group successfully consolidated its position in the year under review in challenging market conditions influenced primarily by the extremely low level of interest rates and demanding regulatory requirements.

The year-on-year changes in the key figures that made up the net profit generated by the DZ BANK Group in 2018 were as described below.

FIG. 2 – INCOME STATEMENT

€ million	2018	2017	Change (%)
Net interest income	**2,799**	2,941	-4.8
of which: net income from long-term equity investments[1]	**63**	73	-13.7
Net fee and commission income	**1,955**	1,864	4.9
Gains and losses on trading activities	**285**	506	-43.7
Gains and losses on investments	**150**	10	>100.0
Other gains and losses on valuation of financial instruments	**-120**	289	>100.0
Net income from insurance business	**490**	907	-46.0
Loss allowances	**-21**	-786	-97.3
Administrative expenses	**-4,059**	-3,959	2.5
Staff expenses	-1,843	-1,808	1.9
Other administrative expenses[2]	-2,216	-2,151	3.0
Other net operating income	**-109**	38	>100.0
Profit before taxes	**1,370**	1,810	-24.3
Income taxes	**-452**	-712	-36.5
Net profit	**918**	1,098	-16.4

1 Total of current income and expense from income from other shareholdings, current income and expense from investments in subsidiaries, current income and expense from investments in associates, income/loss from using the equity method, and income from profit-pooling, profit-transfer, and partial profit-transfer agreements; see consolidated financial statements, notes to the consolidated financial statements, note 34.
2 General and administrative expenses plus depreciation/amortization expense on property, plant and equipment, investment property, and on other assets; 2017 amount restated; see note 02 in the notes to the consolidated financial statements.

Operating income in the DZ BANK Group amounted to €5,450 million (2017: €6,555 million). This figure comprises net interest income, net fee and commission income, gains and losses on trading activities, gains and losses on investments, other gains and losses on valuation of financial instruments, net income from insurance business, and other net operating income.

Net interest income (including net income from long-term equity investments) in the DZ BANK Group declined by 4.8 percent year on year to €2,799 million (2017: €2,941 million).

Net interest income at DZ BANK (excluding net income from long-term equity investments) went down by €63 million. It decreased by €67 million at BSH and by €53 million at DZ PRIVATBANK. At DZ HYP, net interest income was down by €23 million, although the equivalent figure at DVB increased by €9 million. At VR LEASING and TeamBank, net interest income rose by €10 million and €23 million respectively.

Net income from long-term equity investments in the DZ BANK Group fell by €10 million to €63 million (2017: €73 million).

Net fee and commission income in the DZ BANK Group increased by 4.9 percent to €1,955 million (2017: €1,864 million).

It rose by €12 million at DZ BANK and by €56 million at DZ PRIVATBANK. At BSH, net fee and commission income improved by €8 million, whereas this item declined year on year at TeamBank (down by €14 million), DVB (down by €9 million), and VR LEASING (down by €8 million).

The DZ BANK Group's **gains and losses on trading activities** in 2018 came to a net gain of €285 million compared with a net gain of €506 million for 2017. This was largely attributable to the gains and losses on trading activities at DZ BANK amounting to a net gain of €258 million (2017: net gain of €485 million).

The net gains under **gains and losses on investments** went up by €140 million to €150 million (2017: €10 million).

The main reasons for the year-on-year change in gains and losses on investments were the factors described in the details for the operating segments DZ BANK, DVB, and UMH.

Other gains and losses on valuation of financial instruments in the DZ BANK Group amounted to a net loss of €120 million in 2018 (2017: net gain of €289 million).

Of the figure reported for the DZ BANK Group for 2018, a loss of €20 million (2017: gain of €291 million) was accounted for by DZ HYP and a loss of €105 million (2017: loss of €23 million) by DVB.

The DZ BANK Group's **net income from insurance business** comprises premiums earned, gains and losses on investments held by insurance companies and other insurance company gains and losses, insurance benefit payments, and insurance business operating expenses. In 2018, this figure decreased by 46.0 percent to €490 million (2017: €907 million).

This year-on-year change was attributable to a significant fall in gains and losses on investments held by insurance companies and other insurance company gains and losses.

The **loss allowances** determined in 2018 for the first time in accordance with IFRS 9 amounted to a net addition of €21 million (2017: net addition of €786 million).

Further disclosures on the nature and extent of risks arising from financial instruments and insurance contracts can be found in note 83 of the notes to the consolidated financial statements.

Administrative expenses in the DZ BANK Group rose year on year by €100 million, or 2.5 percent, to €4,059 million (2017: €3,959 million). Of this increase, €50 million was attributable to the first-time consolidation of VR Payment GmbH, Frankfurt am Main (until January 3, 2019: CardProcess GmbH, Karlsruhe). Staff expenses went up by €35 million or 1.9 percent to €1,843 million (2017: €1,808 million) and other administrative expenses by €65 million or 3.0 percent to €2,216 million (2017: €2,151 million).

The DZ BANK Group's **other net operating income** amounted to a net expense of €109 million (2017: net income of €38 million).

The main reasons for the year-on-year change in other net operating income were the factors described in the details for the operating segments DZ PRIVATBANK, DZ BANK, DVB, and UMH.

Profit before taxes in the reporting year amounted to €1,370 million compared with a figure of €1,810 million in 2017.

The DZ BANK Group's **cost/income ratio** (i.e. the ratio of administrative expenses to operating income) for 2018 was 74.5 percent (2017: 60.4 percent).

The **regulatory return on risk-adjusted capital (RORAC)** was 8.2 percent (2017: 11.3 percent).

The DZ BANK Group's **income taxes** amounted to €452 million in the reporting year (2017: €712 million). This figure included deferred tax income of €272 million (2017: deferred tax expense of €267 million) and a current tax expense of €724 million (2017: €445 million).

The DZ BANK Group generated a **net profit** of €918 million in 2018 compared with a net profit of €1,098 million in 2017.

The following provides an explanation of the above information and the details below (section 3.2) concerning the financial performance of the DZ BANK Group with reference to the corresponding presentation in the outlook for 2018 (chapter V of the 2017 group management report).

In 2018, the DZ BANK Group generated profit before taxes that was slightly below the budgeted figure. While the change in loss allowances was lower than expected, significant items on the other side of the equation were the net gains under gains and losses on trading activities, which were well below budget because of the widening of spreads in the interest-bearing securities portfolios, and other gains and losses on valuation of financial instruments, which fell short of projections. The latter budget shortfall was largely attributable to changes in credit spreads for bonds from the peripheral countries of the eurozone. In addition, it was not possible to attain the budgeted figure for net income from insurance business. The reason was a lower net gain under gains and losses on investments held by insurance companies and other insurance company gains and losses compared with budget as a consequence of the widening of spreads in the interest-bearing securities portfolios. Another factor was that other net operating income did not reach the budgeted figure, mainly because of the impairment losses recognized at DZ PRIVATBANK in respect of goodwill and customer relationships. However, the net gains under gains and losses on investments exceeded the budget by almost the same amount as this budget shortfall, primarily because of the sale of securities by DZ BANK.

3.2 Financial performance in detail

Figure 3 shows the details of the financial performance of the DZ BANK Group's operating segments in 2018 compared with 2017.

FIG. 3 – SEGMENT INFORMATION

2018

€ million	DZ BANK	BSH	DVB
Net interest income	1,081	766	177
Net fee and commission income	362	-40	84
Gains and losses on trading activities	258	-	-3
Gains and losses on investments	142	13	-18
Other gains and losses on valuation of financial instruments	36	8	-105
Premiums earned	-	-	-
Gains and losses on investments held by insurance companies and other insurance company gains and losses	-	-	-
Insurance benefit payments	-	-	-
Insurance business operating expenses	-	-	-
Loss allowances	140	-11	-80
Administrative expenses	-1,466	-480	-200
Other net operating income	-31	39	15
Profit/loss before taxes	**522**	**295**	**-130**
Cost/income ratio (%)	79.3	61.1	>100.0
Regulatory RORAC (%)	8.0	26.8	-33.8
Average own funds/solvency requirement	4,772	1,098	352
Total assets/total equity and liabilities as at Dec. 31, 2018	271,189	71,667	20,566

2017

€ million	DZ BANK	BSH	DVB
Net interest income	1,276	833	168
Net fee and commission income	350	-48	93
Gains and losses on trading activities	485	-	-26
Gains and losses on investments	49	18	-64
Other gains and losses on valuation of financial instruments	21	1	-23
Premiums earned	-	-	-
Gains and losses on investments held by insurance companies and other insurance company gains and losses	-	-	-
Insurance benefit payments	-	-	-
Insurance business operating expenses	-	-	-
Loss allowances	22	-20	-728
Administrative expenses[1]	-1,563	-470	-175
Other net operating income	112	20	-19
Profit/loss before taxes	**752**	**334**	**-774**
Cost/income ratio (%)	68.2	57.0	>100.0
Regulatory RORAC (%)	9.7	32.5	>100.0
Average own funds/solvency requirement	4,598	1,027	506
Total assets/total equity and liabilities as at Dec. 31, 2017	265,843	68,337	23,414

1 Amount restated in the DZ BANK operating segment and in the DZ BANK Group (see note 2).

DZ HYP	DZ PRIVAT-BANK	R+V	TeamBank	UMH	VR LEASING	Other/ Consolidation	Total
522	64	-	449	25	153	-438	**2,799**
2	182	-	-13	1,416	7	-45	**1,955**
1	10	-	-	-	-	19	**285**
-10	-	-	-	-23	22	24	**150**
-20	-	-	-	-51	-	12	**-120**
-	-	15,997	-	-	-	-	**15,997**
-	-	1,342	-	-	-	-69	**1,273**
-	-	-14,208	-	-	-	-	**-14,208**
-	-	-2,721	-	-	-	149	**-2,572**
12	-	-	-70	-	-13	1	**-21**
-299	-219	-	-222	-895	-142	-136	**-4,059**
24	-188	3	1	30	-26	24	**-109**
232	**-151**	**413**	**145**	**502**	**1**	**-459**	**1,370**
57.6	>100.0	-	50.8	64.1	91.0	-	**74.5**
16.0	-44.8	5.5	31.8	>100.0	0.2	-	**8.2**
1,460	336	7,564	458	345	325	-	**16,711**
85,882	18,322	107,351	8,536	2,559	4,768	-72,107	**518,733**

DZ HYP	DZ PRIVAT-BANK	R+V	TeamBank	UMH	VR LEASING	Other/ Consolidation	Total
545	117	-	426	29	143	-596	**2,941**
-	126	-	1	1,415	15	-88	**1,864**
11	10	-	-	-	-	26	**506**
3	-	-	-	8	10	-14	**10**
291	7	-	-	13	-	-21	**289**
-	-	15,181	-	-	-	-	**15,181**
-	-	3,531	-	-	-	-57	**3,474**
-	-	-15,312	-	-	-	-	**-15,312**
-	-	-2,595	-	-	-	159	**-2,436**
18	-	-	-70	-	-10	2	**-786**
-233	-217	-	-214	-858	-136	-93	**-3,959**
2	-23	-10	5	3	-39	-13	**38**
637	**20**	**795**	**148**	**610**	**-17**	**-695**	**1,810**
27.3	91.6	-	49.5	58.4	>100.0	-	**60.4**
43.4	6.8	11.4	34.6	>100.0	-7.6	-	**11.3**
1,487	301	6,970	430	350	330	-	**15,999**
85,855	16,802	103,419	8,009	2,445	4,749	-73,279	**505,594**

3.2.1 DZ BANK

Net interest income (excluding net income from long-term equity investments), which is primarily attributable to the lending business portfolios (Corporate Banking business line and a separately managed real estate lending portfolio) and the portfolios from the money and capital markets business, declined by 9.8 percent to €583 million (2017: €646 million). Net interest income also includes the interest expense and income relating to issued subordinated bonds and those purchased by group entities. The amounts of the individual items and the effects on the change in net interest income are described below.

In the lending business, net interest income fell by 1.1 percent to €466 million (2017: €471 million). Within this figure, net interest income in Corporate Banking declined marginally, by 1.1 percent, to €430 million (2017: €435 million). Net interest income from the separately managed real estate lending portfolio remained at the prior-year level of €36 million (2017: €36 million).

At DZ BANK, the Corporate Banking business line comprises the five regional corporate customer divisions that focus on corporate banking in Germany (Northern and Eastern Germany, Western Germany, Central Germany (from January 1, 2019: Central Corporate Banking), Baden-Württemberg, and Bavaria), the Investment Promotion division, and the Structured Finance division covering business with German corporate customers and foreign customers with links to Germany.

In accordance with the cooperative principle of decentralization, the distribution of responsibilities in the Volksbanken Raiffeisenbanken cooperative financial network, and the focus on the needs of companies, customer relationship management for corporate customers is provided by the local cooperative bank in conjunction with DZ BANK, or directly by DZ BANK.

The cooperative financial network has been pivotal in supporting the sustained economic upturn experienced by Germany's large and medium-sized companies that began some years ago. This is confirmed by its position in the corporate finance market.

Over the past ten years, the cooperative financial network's volume of lending has grown at a much faster rate than that of the market as a whole. As a result, the group's share of the corporate finance market in Germany has now increased to approximately 22 percent.

The macroeconomic conditions in Germany are generally positive for the corporate banking business operated jointly by DZ BANK and the cooperative banks, even though the pace of growth in the German economy slackened over the year under review. The country's large and medium-sized companies remain in robust financial health.

At the same time, however, the competitive environment in corporate banking is becoming increasingly challenging and there is still a great deal of pressure on credit margins. The game changers of our age, digitalization and the accompanying shift in customer behavior, are further intensifying this competition and significantly increasing the need for innovation and optimization in the Corporate Banking business line.

Moreover, the vast majority of large and medium-sized companies continue to be able to meet their capital investment requirements from their own cash flows or reserves thanks to their sound capital and liquidity position.

According to a survey carried out by DZ BANK in the autumn of 2018, German large and medium-sized companies' significant propensity to invest has eased off slightly compared with the spring of 2018, even though capacity utilization has remained at a high level. One of the key reasons for this is likely to be the shortage of skilled employees, which is an ever-growing concern for these firms. Geopolitical factors, particularly the worldwide trade disputes and the uncertainties linked with the approach of Brexit, are acting as a further brake on the inclination of businesses to invest.

Partly as a result of the stable German economy and companies' robust financial health, large and medium-sized companies have increasingly ventured into international business over the last few years. More than half of large and medium-sized companies operate internationally through exports, imports, joint ventures, foreign production facilities, or partnerships. DZ BANK has recognized this trend and, in the reporting year, entered into a cooperation agreement with Indonesia's third-largest bank, PT Bank Central Asia Tbk. The aim of this agreement is to provide support for each other's corporate customers, i.e.

direct and cooperative financial network customers in Germany that are targeting the Indonesian market as well as PT Bank Central Asia's Indonesian customers that are looking to enter the German market.

Net interest income from the money and capital markets business went down by 31.0 percent to €169 million (2017: €245 million), mainly in connection with a contraction in the portfolio of long-term securities in the year under review. Securities were sold to reduce the duration of the portfolio.

The adverse impact of subordinated capital (balance of subordinated own issues and subordinated securities purchased by group entities) on net interest income declined by 25.7 percent in 2018 to €52 million (2017: €70 million) as a consequence of a contraction in the liability portfolios.

Net fee and commission income rose by 3.4 percent to €362 million (2017: €350 million).

The principal sources of income were service fees in the Corporate Banking business line (encompassing, in particular, lending business including guarantees and international business), in the Capital Markets business line (mainly comprising securities issuance and brokerage business, agents' fees, transactions on futures and options exchanges, financial services, and the provision of information), and in the Transaction Banking business line (mainly consisting of payments processing including credit card processing, safe custody,-and gains/losses from the currency service business).

As part of service procurement arrangements, DZ BANK has transferred processing services in the lending business to Schwäbisch Hall Kreditservice, in the payments processing business to Equensworldline, and in capital markets business/transaction banking to Deutsche WertpapierService Bank. The expenses arising in connection with obtaining services from the above external processing companies amounted to a total of €167 million (2017: €164 million) and are reported under net fee and commission income for the individual Corporate Banking (€12 million) and Transaction Banking (€155 million) business lines.

The Corporate Banking business line saw a slight overall rise in net fee and commission income of 2.9 percent to €105 million (2017: €102 million). In the five regional corporate customer divisions, net fee and commission income went down by 22.9 percent to €27 million (2017: €35 million). By contrast, net fee and commission income in the Structured Finance division rose by 10.5 percent to €84 million (2017: €76 million). Net fee and commission income in corporate finance increased to €5 million (2017: €2 million).

In the Capital Markets business line, the contribution to net fee and commission income rose by 6.2 percent to €154 million (2017: €145 million). In this regard, net fee and commission income from securities issuance activities went up by 46.4 percent to €41 million (2017: €28 million) on the back of additional client portfolios in the bond issuance business.

In addition, net fee and commission income in the Transaction Banking business line amounted to €120 million, which equated to a year-on-year increase of €8 million or 7.1 percent. This increase was primarily attributable to higher income from the securities safe custody business and payments processing.

Net fee and commission income from other financial services fell by 88.9 percent in the reporting year to a net expense of €17 million (2017: net expense of €9 million).

€4 million of this decline was accounted for by first-time fee and commission expenses for rating information in connection with services for cooperative banks and €1 million by higher commission expenses related to own issues.

Gains and losses on trading activities amounted to a gain of €258 million in 2018 (2017: gain of €485 million).

Income from trading on behalf of customers matched the high level achieved in the prior year. The deterioration of gains and losses on trading activities was attributable to market-price-related measurement losses, specifically spread-induced measurement losses in interest-rate and fixed-income trading.

The liabilities recognized at fair value gave rise to a positive effect on earnings of €28 million in 2018 (2017: loss of €45 million).

Further factors influencing the gains and losses on trading activities in 2018 included interest-rate-related changes in the fair value of cross-currency basis swaps used for the hedging of financial instruments denominated in foreign currency amounting to a loss of €23 million (2017: loss of €49 million).

In the year under review, DZ BANK's balance of unrealized and realized gains and losses relating to asset-backed securities (ABSs) amounted to a loss of €4 million (2017: gain of €21 million).

Key influences on capital markets during the reporting year were the continuation of the ECB's program of quantitative easing up to the end of the year, as mentioned earlier, and its decision to leave the main refinancing rate unchanged at 0.00 percent and the deposit facility for banks at minus 0.40 percent beyond the end of 2018.

Furthermore, during the course of 2018, the Fed raised its target range for the federal funds rate in four stages (in March, June, September, and December 2018), in each case by 25 basis points, with the target range at the end of the year then standing at 2.25 percent to 2.50 percent.

The weakening of economic growth that was discernible in Germany and the eurozone from the start of 2018, but especially in the second half of the year, took hold against a backdrop of far-reaching geopolitical changes. The principal factor weighing on economic trends, other than the Brexit negotiations and the increasingly entrenched positions in the debt dispute between Rome and Brussels as the year progressed, was the trade disputes between the US and China, leading to an escalation in the reciprocal imposition of customs tariff barriers. These trade disputes in particular had a detrimental impact on the German economy, which is heavily dependent on exports.

In this environment, the DAX averaged out at 12,270 points in the year under review, which was virtually unchanged on the equivalent figure of 12,435 points for 2017. However, market prices were far more volatile in 2018 than in the previous year. The regulatory environment also impacted on the markets and market players, which again had to cope with the demanding requirements imposed by banking regulators in the year under review.

The products and services of DZ BANK's customer-oriented capital markets business are geared to the needs of cooperative banks, specialized service providers within the cooperative sector, and their retail and corporate customers.

In addition, DZ BANK has business relationships with direct corporate customers and institutional customers in Germany and abroad. The portfolio comprises competitively priced investment and risk management products involving the asset classes of interest rates, equities, loans, and foreign exchange. These products are complemented by a broad range of advisory and research services, structuring expertise, and platforms. In respect of all customer groups, the proportion of business conducted through electronic systems is rising significantly and increasingly replacing traditional telephone trading.

Against the current backdrop of low interest rates, German retail investors' top priorities are safety and understandable investment solutions. By focusing on these customer needs, and thanks to the successful sales performance of the cooperative banks, the cooperative banking group was able to achieve investment certificate sales of more than €4.5 billion in the year under review, repeating the record sales level achieved in 2017. DZ BANK's performance – as measured by data from the Deutscher Derivate Verband (DDV) [German Derivatives Association] – has once again been impressive, demonstrating its market strength with a market share of 17.9 percent as at the end of December 2018, based on the market volume invested in structured securities (97.8 percent of which is accounted for by investment products). The comprehensive range of high-quality services also earned DZ BANK the Best Issuer of 2018/2019 award from an independent panel of experts in this year's Investment Certificates Awards, the second time that DZ BANK has received this accolade following its success in the 2017/18 awards.

DZ BANK continued to focus on steadily and effectively digitalizing and optimizing securities processes in retail securities business. DZ BANK also has an advanced quality management system for customer service and product development based on the new ISO 9001:2015 standard. The system has been audited and certified by DQS GmbH Deutsche Gesellschaft zur Zertifizierung von Managementsystemen.

In order to stabilize their financial performance over the long term, the cooperative banks acquired investments with residual maturities of more than five years as part of their own-account investing activities. They stepped up their investments in corporate bonds and simply structured credit products in the form of credit-linked notes. Demand for structured bullet maturity bonds and share bonds was also brisk. The cooperative banks also aimed for broad diversification in their securities portfolios, particularly with regard to investments in equities and real estate. To this end, the main focus of demand was on fund products from the Union Investment Group, whose inflows again increased year on year.

The ECB's monetary policy of negative interest rates and the accompanying distortion of market prices and risk premiums also influenced DZ BANK's capital markets business with institutional customers. Income sources ranged across the entire fixed-income product segment but were primarily focused on bond trading in the secondary market. In the case of interest-rate structures and credit-linked notes, DZ BANK has been supporting its institutional customers for many years by offering a broad range of products, and in 2018 even managed to slightly exceed the high trading volumes seen in previous years.

A growing prevalence of trading business conducted on electronic platforms was observable in the year under review, resulting in a sharp rise in trading volumes with asset managers and banks both in Germany and abroad. Insurance companies and pension funds were increasingly directing their investing activities toward alternative asset classes, such as real estate and infrastructure. In the case of banks and asset managers, interest focused on flow products as well as spread products such as corporate bonds and bonds from emerging markets. Another key area of product activity in 2018 comprised the deals between DZ BANK and institutional customers relating to multi-tranche bonds from international and supranational issuers.

DZ BANK's capital markets business with large and medium-sized companies as well as major corporations is underpinned by a broad spectrum of products, with a particular focus on currency and interest-rate hedging in order to manage currency and interest-rate risk. The year under review saw encouraging growth in the currency business. This range is complemented by basic products in the core deposit-taking business and securities business for liquidity management.

The ongoing, ECB-driven policy of low interest rates, combined with limited demand for credit given that the majority of large and medium-sized companies have ample liquidity, meant that these companies' interest-rate hedging activities were concentrated on maturities of more than ten years.

An increase in active money market business was also evident.

New bond issuance business was significantly influenced in the reporting year by the ECB's measures in connection with its bond-buying program, as previously described. As a result of the ECB's plans to scale back its asset-buying program, there was a notable increase in risk premiums for bond issuers and, as a consequence, a reduced level of bond issuing activity compared with 2017. Banks obtained part of their traditional funding through unsecured bonds in the secured Pfandbrief market and/or in the international covered bond market. DZ BANK was able to benefit from this trend and expand its market share in the primary market for covered bonds. Overall, against the backdrop of a contracting new issues market, DZ BANK was able to significantly lift both its relative market share and also the absolute volume of its supported bond issues in some market segments.

The net gain under **gains and losses on investments** rose by €93 million to €142 million (2017: €49 million), largely as a result of gains from the disposal of securities in the liquidity pool in an amount of €172 million, some of which were offset by losses of €39 million arising from the termination of hedges measured at fair value through OCI as part of portfolio fair value hedge accounting.

Loss allowances, which were determined in 2018 for the first time in accordance with IFRS 9, amounted to a net reversal of €140 million (2017: net reversal of €22 million). This was mainly due to borrowers' rating improvements and successful restructuring and recovery measures.

Administrative expenses at DZ BANK amounted to €1,466 million, a decrease of €97 million, or 6.2 percent, on the comparable figure in 2017 of €1,563 million.

Other administrative expenses fell by €74 million in 2018 to €818 million (2017: €892 million). It should be noted, however, that the prior-year figure was adversely affected by merger-related expenses of €91 million related to the migration of data. On the other hand, there was a notable increase in the year under review of €12 million in the expenses incurred for the bank levy (2018: €36 million; 2017: €24 million).

The €23 million drop in staff expenses to €648 million (2017: €671 million) was due, among other things, to lower variable remuneration in the reporting year.

In 2018, **other net operating income** amounting to a net expense of €31 million (2017: net income of €112 million) included expenses of €80 million from the addition to the provisions for restructuring as part of the 'Verbund First 4.0' strategic program. A net income amount of €57 million (2017: net income of €51 million) arose from the reversal of provisions and accruals.

Other net operating income in 2017 had included, in particular, gains of €126 million on the disposal of DZ BANK's long-term equity investment in Concardis GmbH, Eschborn.

Profit before taxes for the year under review amounted to €522 million. The decrease of €230 million compared with the figure of €752 million reported for 2017 was mainly a consequence of the changes described above.

The **cost/income ratio** for DZ BANK in 2018 was 79.3 percent (2017: 68.2 percent).

Regulatory RORAC was 8.0 percent (2017: 9.7 percent).

3.2.2 BSH

In the BSH subgroup, **net interest income** declined by 8.0 percent to €766 million (2017: €833 million).

In the year under review, net interest income again suffered a detrimental impact from the low level of interest rates in capital markets. In addition, gains and losses on investments in joint ventures accounted for using the equity method went down by €22 million in the year under review to a net gain of €3 million (2017: net gain of €25 million). The main reason for this change was an impairment loss of €18 million recognized in 2018 on the carrying amount, calculated in accordance with the IFRS equity method, of Bausparkasse Schwäbisch Hall's Chinese long-term equity investment.

Interest income from investments in the reporting year remained below the 2017 level as a result of a lower average return coupled with a contraction in the volume of investments.

The simultaneous growth in the portfolios of loans issued under advance or interim financing arrangements reflected buoyant customer demand. This portfolio expansion enabled Schwäbisch Hall to reinforce its non-collective income base, more than compensating for the fall in income from home savings loans.

The volume of home savings deposits grew by a further €3.3 billion year on year to reach €61.6 billion as at December 31, 2018. The rise in interest expense associated with this portfolio growth was offset almost entirely by the higher proportion of low-interest-rate tariffs. The considerable volume of home savings deposits bears testimony to the particular merits of home savings, which enable the customer to enjoy steady capital growth independently of any capital market volatility, especially against the backdrop of inflation, which has recently begun to rise again.

Net fee and commission income amounted to a net expense of €40 million in 2018 (2017: net expense of €48 million).

This improvement was due to the fall in fees and commissions not directly attributable to the conclusion of a home savings contract.

In the home savings business, Bausparkasse Schwäbisch Hall signed approximately 554 thousand new home savings contracts (2017: 558 thousand), generating another impressive level of new home savings business with a volume of €29.7 billion and exceeding the corresponding prior-year figure of €28.0 billion by 6.3 percent.

In the home finance business, the realized volume of new business amounted to €15.2 billion, an increase of 3.8 percent on the corresponding prior-year figure of €14.6 billion. This figure includes home savings loan contracts and bridging loans from Bausparkasse Schwäbisch Hall and other referrals totaling €1.92 billion (2017: €1.86 billion).

The substantial growth in home savings and home finance reflects a marked preference among German citizens for personal pension arrangements based on home ownership. At a time of persistently low interest rates, more than half of the populace (and therefore twice as many as before the financial crisis in 2008) believes that home ownership is the best type of asset investment.

Not least because of the stable economic conditions currently prevailing in Germany, the heightened demand for additional homes was sustained in the year under review, although residential construction activity is failing to keep up with the substantial need for living space generated by a rising trend toward urbanization despite the very high level of capacity utilization in the construction industry, especially in urban centers.

Building society operations are receiving a further boost from the considerable modernization requirements in the existing housing stock, especially in relation to climate targets, which have recently once again become a hot topic of political debate. In this context, it is significant that just 22 percent of the entire housing stock consists of updated properties. This modernization deficit is not only affecting the quality of living accommodation but also damaging the environment because residential buildings account for two-thirds of energy consumption in Germany. An increase in the modernization rate alone from the current level of 1 percent to 2 percent would mean an energy-efficient upgrade for 70 percent of the housing stock.

Age-appropriate housing is another key area for future growth, and there is likely to be a substantial increase in the renovation of current housing stock, with demand for properties with barrier-free or improved access estimated to be approximately 3 million units by 2020.

By cross-selling supplementary products, Bausparkasse Schwäbisch Hall field sales staff also sold cooperative bank pension products, Union Investment Group investment funds, and R+V insurance policies.

Administrative expenses went up by €10 million to €480 million (2017: €470 million). At €221 million, staff expenses remained unchanged on the equivalent 2017 figure. Other administrative expenses rose by €10 million to €259 million (2017: €249 million), primarily as a consequence of higher IT costs in strategic projects and measures to enhance the home savings and home finance core businesses.

The main reason behind the rise in **other net operating income** of €19 million to €39 million (2017: €20 million) was the lower addition to provisions in 2018.

Profit before taxes declined by €39 million in the reporting year to €295 million (2017: €334 million), mainly as a consequence of the changes described above.

The **cost/income ratio** in 2018 was 61.1 percent (2017: 57.0 percent).

Regulatory RORAC was 26.8 percent (2017: 32.5 percent).

3.2.3 DVB

Net interest income in the DVB subgroup went up by 5.4 percent to €177 million (2017: €168 million).

Net interest income excluding net income from long-term equity investments declined by €12 million to €168 million (2017: €180 million). The prior year had been affected by special accelerated depreciation allowances on assets subject to operating leases.
One of the notable features in 2018 was a further contraction in the portfolio volume compared with the previous year as a result of a continuation in the trend toward early redemption of loans. This reduced net interest income in the year under review because the resulting available funds were invested with Deutsche Bundesbank, which pays negative interest rates.

Net income from long-term equity investments improved by €21 million to net income of €9 million (2017: net expense of €12 million). In 2017, net income from long-term equity investments in respect of three equity-accounted entities had come to a total net expense of €15 million.

The international transport industry experienced overcapacity in existing fleets within some segments of the international maritime shipping market and offshore business, leading to falling freight rates and considerable pressure on shipping prices. Even though shipyards continued to offer attractive prices in these tough market conditions, ordering activity in the first half of 2018 was sluggish. This indicated the need for a realignment of supply and demand. Further orders for new vessels could jeopardize the recovery.

In 2018, the DVB subgroup generated new business of €3.7 billion (2017: €3.2 billion) in its core transport finance business and in investment management, based on a total of 144 deals (2017: 122 deals). DVB Bank maintains international branches in Amsterdam, London, Oslo, and Singapore.

At €84 million, **net fee and commission income** was down by €9 million year on year (2017: €93 million).

The fee and commission income generated by ongoing lending and by new business in transport finance declined by €5 million to €15 million and by €4 million to €32 million respectively. In contrast, fee and commission income from asset management increased by €1 million to €16 million, whereas the equivalent figure from consulting went down by €1 million to €21 million.

The improvement in **gains and losses on trading activities** of €23 million to a net loss of €3 million (2017: net loss of €26 million) was largely due to the change in the US dollar/euro exchange rate.

Gains and losses on investments amounting to a net loss of €18 million (2017: net loss of €64 million) included a gain of €7 million from the sale of a long-term equity investment and a gain of €5 million from the disposal of an aircraft by an equity-accounted long-term equity investment. Significant items offsetting these gains included impairment losses of €30 million on the carrying amounts of entities accounted for using the equity method. The figure for the prior year notably included impairment losses recognized in respect of five equity-accounted entities.

Other gains and losses on valuation of financial instruments deteriorated by €82 million to a net loss of €105 million (2017: net loss of €23 million) as a result of market conditions. In this regard, IFRS-related measurement effects, particularly from hedge accounting, and interest-rate-related measurements of cross-currency swaps led to a negative impact on earnings.

Loss allowances were calculated in accordance with IFRS 9 in the reporting year and decreased by €648 million to €80 million (2017: €728 million) due to the lower loss allowance requirement in 2018.

Administrative expenses amounted to €200 million (2017: €175 million). Within this figure, staff expenses rose by €20 million to €111 million (2017: €91 million). In contrast to the year under review, the 2017 figure had not been adversely impacted by the recognition of a provision for variable remuneration. Other administrative expenses rose by €5 million to €89 million (2017: €84 million), largely owing to higher consultancy expenses.

Other net operating income amounted to €15 million (2017: net expense of €19 million); the prior-year figure notably included expenses of €21 million incurred in connection with the refinement of the DVB business model.

In 2018, the **loss before taxes** improved by €644 million to a loss of €130 million (2017: loss of €774 million), primarily because of the above-mentioned reduction in loss allowances.

The **cost/income ratio** in 2018 was greater than 100.0 percent (2017: greater than 100.0 percent).

Regulatory RORAC was minus 33.8 percent (2017: greater than 100.0 percent).

3.2.4 DZ HYP

The merger of DG HYP and WL BANK to form DZ HYP was completed on July 27, 2018 when the necessary entries were made in the commercial register. DZ HYP is included in the consolidated financial statements for the year ended December 31, 2018 as a separate operating segment entity. Instead of the income statement line items of the two operating segment entities DG HYP and WL BANK, which were previously reported separately, the corresponding DZ HYP line items are presented for the prior year.

Net interest income at DZ HYP decreased by 4.2 percent to €522 million (2017: €545 million).

This decrease in net interest income is largely explained by the fact that the prior-year figure was boosted by significantly higher early redemption payments (2018: €63.7 million; 2017: €79.4 million). Effects from subsequent measurement in connection with the purchase price allocation (PPA) for the merger of the two former central institutions also had a negative impact of €19 million on net interest income in the reporting year (2017: positive impact of €11 million).

In 2018, the German commercial real estate market was bolstered by the stable economic conditions in the country. Against the backdrop of a sustained economic recovery in Germany (albeit weaker over the course of the year), the low interest rates continued to facilitate real estate financing and at the same time make this asset class relatively attractive to investors compared with other types of investment.

The transaction volume (excluding commercial investments in housing) amounted to €60.3 billion, which once again equated to a year-on-year increase of 6.2 percent (2017: €56.8 billion), although some of this increase was due to one-off items. The volume of transactions in the market for commercial investments in housing rose to €18.7 billion (up by 19.1 percent compared with the prior-year figure of €15.7 billion). Including the commercial investments in housing, the volume of transactions in 2018 totaled €79 billion (2017: €72.5 billion).

The high prices of real estate assets in prime locations encouraged German investors to invest in properties at sites outside the major cities. The transaction volume for commercial real estate (including housing investment) outside the prime locations amounted to €33 billion in the year under review. This means that around 42 percent of the total investment in 2018 was made outside the prime locations.

A sustained high level of demand from investors both in Germany and abroad, combined with an ongoing shortage of attractive properties, especially in prime locations, led to a further rise in prices in commercial real estate markets and, in particular, in the market for commercial investments in housing.

In the public-sector market, higher tax receipts in the first half of 2018 put local authorities in clear positive territory and led to a budget surplus of almost €800 million for these authorities.

The existing regional network of cooperative banks and the very close cooperation between the bank's two predecessor institutions and the local cooperative banks over many years provide DZ HYP with a huge advantage that will enable it to successfully implement its enhanced corporate strategy.

The local presence ensures not only that DZ HYP has access to the regional market and the necessary proximity to customers, but also that it can benefit from valuable detailed local market knowledge. At the same time, the real estate finance know-how of DZ HYP is also the ideal complement to the local cooperative banks' extensive knowledge. Supported by its six regional centers in major German cities and a further seven regional offices, DZ HYP is a reliable partner for the cooperative banks throughout the country. Its decentralized market presence also creates an advantage in terms of the allocation of risk because greater differentiation between credit portfolios based on region, sector, and customer group is possible.

In the year under review, DZ HYP expanded its real estate finance business year on year while maintaining a prudent risk policy. It generated a new business volume of €10,970 million (2017: €10,129 million) across its Commercial Real Estate Investors, Housing Sector, and Retail Customers/Private Investors divisions. Including financing in the Public Sector division, the bank generated new business of €11,864 million (2017: €10,894 million) from its four divisions in 2018.

In the commercial real estate finance business, DZ HYP lifted the volume of new business in 2018 to €7,725 million (2017: €7,105 million). Based on effective mutual support and greater information-sharing with the local cooperative banks in connection with commercial real estate finance, jointly generated new lending business was further expanded, the volume in 2018 amounting to €3,451 million (2017: €3,559 million).

In the business with the German housing sector, the commitment volume in 2018 amounted to €1,013 million, slightly exceeding the excellent prior-year level despite fierce competition (2017: €975 million). A significant area of focus in this business was the provision of long-term finance for new construction and renovation investment projects.

In the retail customers/private investor business, DZ HYP continued to expand the number of its partner banks within the cooperative financial network. This created the foundation for the successful new business figures generated by DZ HYP in 2018 from its consumer home finance activities. Based on these developments, the bank achieved encouraging year-on-year growth in the volume of new commitments in this division to €2,232 million (2017: €2,049 million).

Within the DZ BANK Group, DZ HYP also operates as the center of excellence for business involving public-sector customers. This primarily consists of business with local authorities in Germany, and with their legally dependent enterprises. These relationships are managed nationwide with the close involvement of the local cooperative banks. In the year under review, DZ HYP generated new local authority loan business of €894 million (2017: €765 million). Of this amount, €639 million (2017: €561 million) was attributable to business brokered through the local cooperative banks and €255 million to direct business (2017: €204 million). Some 84 percent of all deals were generated through the brokering activities of the local cooperative banks. This included €108 million (2017:

€53 million) relating to short-term local authority loans during the year.

Other gains and losses on valuation of financial instruments in 2018 amounted to a net loss of €20 million (2017: net gain of €291 million). This change was largely attributable to a widening of credit spreads during the year under review.

Administrative expenses went up by €66 million to €299 million (2017: €233 million). Within this figure, staff expenses rose by €8 million to €98 million (2017: €90 million). Other administrative expenses rose by €58 million to €201 million (2017: €143 million). Notable reasons for these increases were higher consultancy and IT expenses. The consultancy expenses of €98 million (2017: €56 million) included an amount of €61.4 million (2017: €20.3 million) relating to the following two projects: the 'Real estate business reorganization' project, which included the necessary consulting and other services in connection with the merger between the former DG HYP and the former WL BANK; and the 'Commercial real estate finance portfolio integration' project, which involved expenses in connection with the transfer of the commercial real estate portfolio from the former WGZ BANK to the former DG HYP.

Other net operating income increased by €22 million to €24 million (2017: €2 million), mainly as a result of the reversal of provisions.

Profit before taxes declined in the year under review by €405 million to €232 million (2017: €637 million). The primary reason behind this decrease was the negative change in other gains and losses on valuation of financial instruments as a consequence of the factors described above.

The **cost/income ratio** in 2018 was 57.6 percent (2017: 27.3 percent).

Regulatory RORAC was 16.0 percent (2017: 43.4 percent).

3.2.5 DZ PRIVATBANK

Net interest income at DZ PRIVATBANK contracted by 45.3 percent year on year to €64 million (2017: €117 million).

The decrease in net interest income was due to the fact that the figure for the reporting year contained the sales commission on interest-bearing transactions for the first time (2018: expense of €55.1 million; 2017: expense of €57.1 million). This commission had been included in net fee and commission income in the prior year. Net interest income in 2018 was also squeezed by the persistently low level of interest rates, the ongoing implementation of a risk-conscious investment strategy, and the expiry of securities exposures bearing higher rates of return.

DZ PRIVATBANK acts as the competence center for foreign-currency lending and investing in the interest-earning business. In 2018, the average volume of guaranteed LuxCredit loans was €4.4 billion (2017: €4.7 billion).

Net fee and commission income rose by 44.4 percent to €182 million (2017: €126 million). The increase in net fee and commission income was largely due to the fact that, as referred to above, sales commission on interest-bearing transactions was recognized for the first time under net interest income in 2018 (2018: expense of €55.1 million; 2017: expense of €57.1 million). Fee and commission income from the fund services business also went up, although the equivalent income from private banking went down.

As at December 31, 2018, the value of funds under management amounted to €101.6 billion (December 31, 2017: €108.8 billion). The number of fund-related mandates as at December 31, 2018 was 565 (December 31, 2017: 579).

At the end of the year under review, the volume of assets under management relating to high-net-worth clients amounted to €16.7 billion (December 31, 2017: €17.3 billion). The assets under management comprise the volume of securities, derivatives, and deposits of customers in the private banking business. The decentralized collaboration with the cooperative banks in Germany is coordinated through the branches of DZ PRIVATBANK in Berlin, Düsseldorf, Frankfurt, Hamburg, Hannover, Leipzig, Munich, Nuremberg, Oldenburg, and Stuttgart.

Other gains and losses on valuation of financial instruments declined by €7 million to a net gain of €0 million (2017: net gain of €7 million) as a result of market conditions.

Administrative expenses for the reporting year amounted to €219 million (2017: €217 million). Within this figure, staff expenses rose by €2 million to €128 million (2017: €126 million). General and administrative expenses fell slightly year on year to €80 million (2017: €82 million) despite an increase of €1.8 million in bank levy expenses. By contrast, the depreciation and amortization expense went up by €2 million to €11 million (2017: €9 million).

Other net operating income amounted to a net expense of €188 million (2017: net expense of €23 million) and in 2018 mainly consisted of impairment losses of €128 million on the goodwill recognized in connection with the merger of DZ PRIVATBANK S.A. and WGZ BANK Luxembourg S.A. completed in 2011 and impairment losses of €41 million in respect of customer relationships. These impairment losses were based on the enterprise valuation of DZ PRIVATBANK in November 2018, which took into account a range of factors, including information from the latest multi-year planning. Other net operating income also included expenses of €7 million relating to measures in connection with the restructuring of the private banking business.

In 2018, DZ PRIVATBANK generated a **loss before taxes** of €151 million. The decline of €171 million compared with the profit before taxes of €20 million in 2017 was attributable to the factors described above.

The **cost/income ratio** for DZ PRIVATBANK in 2018 was greater than 100.0 percent (2017: 91.6 percent).

Regulatory RORAC was minus 44.8 percent (2017: 6.8 percent).

3.2.6 R+V

Premiums earned (net) climbed by €816 million to €15,997 million (2017: €15,181 million), reflecting the tight integration of the R+V subgroup into the cooperative financial network. This exceeded the level of premiums earned in 2017 by 5.4 percent. Gross premiums written increased by 5.2 percent to €16,133 million in the year under review (2017: €15,338 million), also surpassing the excellent level of premiums written in 2017.

Premium income in the life insurance and health insurance business grew year on year by a total of 3.2 percent to €7,868 million.

In the life insurance business, premiums rose markedly, by 2.9 percent, to €7,273 million. This growth was predominantly attributable to higher one-off premiums, particularly in the Neue Garantien and bAV (occupational pensions) product lines, whereas premiums from products in the classic and unit-linked businesses declined.

In the health insurance business, net premiums earned rose by 6.3 percent to €595 million. The year-on-year growth in the full health insurance and other supplementary insurance lines was particularly encouraging. On the other hand, the occupational health insurance and private long-term care insurance lines contracted.

In the non-life insurance business, premium income grew by 4.8 percent to €5,788 million, with most of this growth being generated from vehicle insurance and corporate liability insurance business.

Premium income from the inward reinsurance business rose by 15.1 percent to €2,341 million. The business in Europe performed well on the whole, with particularly strong growth in the United Kingdom. Business was also encouraging in Asia, whereas other regions registered a decrease in premiums.

Gains and losses on investments held by insurance companies and other insurance company gains and losses declined by 62.0 percent to a net gain of €1,342 million (2017: net gain of €3,531 million).

At the end of the year under review, the level of long-term interest rates was slightly below the corresponding level at the end of the previous year. At the same time, the significant widening of spreads on interest-bearing securities had an adverse impact on this item during the year under review. Equities markets relevant to R+V did worse during the course of 2018 than they had in the prior year. In 2018, movements in exchange rates between the euro and various currencies were noticeably more favorable overall than in the previous year.

Overall, these trends in the reporting year essentially resulted in a €1,695 million deterioration in unrealized gains and losses to a net loss of €1,297 million (2017: net gain of €398 million), a €1,195 million deterioration in the contribution to earnings from the derecognition of investments to a loss of €21 million (2017: gain of €1,174 million), and a fall of €121 million in current income and expense to income of €2,346 million (2017: income of 2,467 million). On the other hand, foreign exchange gains and losses improved significantly, by €838 million, to a net gain of €181 million (2017: net loss of €657 million) and the balance of depreciation, amortization, impairment losses, and reversals of impairment losses improved by €91 million to a net expense of €50 million (2017: net expense of €141 million).

Owing to the inclusion of provisions for premium refunds (particularly in the life insurance and health insurance business) and claims by policyholders in the fund-linked life insurance business, the change in the level of gains and losses on investments held by insurance companies also affected the 'insurance benefit payments' line item presented below.

Net insurance benefit payments decreased by 7.2 percent from €15,312 million in 2017 to €14,208 million in 2018.

At the companies offering personal insurance, the changes in insurance benefit payments were in line with the change in premium income and in gains and losses on investments held by insurance companies and other insurance company gains and losses. An amount of €305 million (2017: €827 million) was added to the supplementary change-in-discount-rate reserve. The 'corridor method' for calculating the supplementary change-in-discount-rate reserve was introduced in accordance with the German Regulation for Amending the Regulation on the Principles Underlying the Calculation of the Premium Reserve (DeckRV), which came into force on October 23, 2018. This method changed the procedure for determining the reference discount rate in order to restrict excessive changes under the previous rules. The corridor method was applied retrospectively for the whole of 2018 for those R+V Group companies offering personal insurance that were affected.

The non-life insurance business had to absorb expenses arising from storms Friederike and Burglind of around €90 million and from storms Wilma and Yvonne of around €50 million during the reporting year. Overall, the level of natural peril losses was within the anticipated claims budget.

In the inward reinsurance business, the net claims ratio was considerably lower than in the previous year. Notable natural disaster events included the Camp Fire in California, Typhoons Jebi and Trami in Japan, and Hurricane Michael in Florida, which together gave rise to a total expense of €149 million.

Insurance business operating expenses went up by 4.9 percent to €2,721 million (2017: €2,595 million) in the course of ordinary business activities in all divisions, with a particularly sharp rise in the non-life and inward reinsurance segments.

As a result of the factors described above, **profit before taxes** for the reporting year fell by €382 million to €413 million (2017: €795 million).

Regulatory RORAC was 5.5 percent (2017: 11.4 percent).

3.2.7 TeamBank

Net interest income at TeamBank amounted to €449 million, a rise of 5.4 percent compared with the figure of €426 million in 2017. This increase was the consequence of growth in the portfolio of existing contracts in the easyCredit business with a portfolio interest margin that remained virtually unchanged year on year.

In the year under review, TeamBank benefited from significant consumer propensity to buy goods and services and take on finance, fueled by the stability of the German economy along with low interest rates and rising real wages.

During the year under review, TeamBank continued to face the challenges posed by advancing digitalization and the associated far-reaching structural transformation in the consumer finance market, changes that are accompanied by fierce competition. A large number of new providers, primarily fintechs, tech giants, and web portals, have identified consumer finance as an attractive area of business and are stepping up their efforts to position themselves in this market.

TeamBank, as the liquidity management expert in the Volksbanken Raiffeisenbanken cooperative financial network, focused at an early stage on aligning its business activities with market requirements in respect of the new technological challenges and on systematically ensuring that all changes are conceived from the customer perspective.

The integration of all customer touchpoints – mobile, online, and offline – in a digital ecosystem for liquidity management gives customers easy and innovative access to liquidity and services wherever and whenever they want. In these activities, a business policy committed to the cooperative values of fairness and transparency, which has been put into practice now for many years, remains an inalienable guiding principle for TeamBank.

Having introduced the seamless cross-media payment process 'ratenkauf by easyCredit', which is an important element of this ecosystem, TeamBank is so far the only provider, both in e-commerce and at the point of sale, to offer a simple and uniformly designed installment purchase function.

Moreover, an app called 'fymio', an innovative, proactive personal finance management facility, gives customers a projection of their future liquidity based on intelligent analysis of the transactions across all of their accounts.

Another milestone in creating a fully digitalized customer process was TeamBank's launch in February 2018 of a pilot program that enables loans of up to €15,000 to be sold based on account transaction data. Customers benefit from having to record much less information themselves, which also saves them time.

In 2018, TeamBank continued to strengthen the market presence of its product variants, which have been successfully established as part of its customer business.

In addition to Finanzreserve with a credit card, customers have also been able to benefit from easyCredit-Finanzreserve without a card since October 2016, providing them free of charge with a cash reserve incorporating a simple drawdown function. As at December 31, 2018, around 181,000 customers had either signed up for the easyCredit-Finanzreserve or were already using this fair and flexible means of borrowing. As a result, some 12.2 percent of new business was already being generated through easyCredit-Finanzreserve.

The proven advisory concept known as easyCredit-Liquiditätsberater – a financial compass created individually for each customer that provides both the customer and the advisor with the transparency necessary for the credit decision – is helping the cooperative idea to gain more prominence. Approximately 110,000 members of cooperative banks benefited from advice in 2018, of whom around 16,000 were new to the cooperative financial network.

The business model of a fair, innovative consumer finance provider constructed on this basis enabled TeamBank to increase loans and advances to customers by a substantial 5.3 percent to €8,390 million as at December 31, 2018 (December 31, 2017: €7,966 million). The number of customers rose again, by 44,000, to reach 877,000.

TeamBank now works in collaboration with 782 of Germany's 876 cooperative banks and with 117 partner banks in Austria. This underscores the success of the systematic focus on customer needs and the associated continuous refinement of the bank, to which TeamBank attaches huge importance as one of its unique selling propositions, especially at a time of increasingly fierce competition.

Net fee and commission income declined by €14 million to a net expense of €13 million (2017: income of €1 million). This change was primarily due to the lower level of fee and commission income from loan protection insurance agreements and higher commission payments to partner banks.

Loss allowances, which were determined in accordance with IFRS 9 in 2018, amounted to €70 million, the same level as in 2017.

As forecast, **administrative expenses** rose by €8 million to €222 million (2017: €214 million), including an increase in staff expenses of €5 million to €89 million (2017: €84 million) owing to a rise in employee numbers and an increase in other administrative expenses of €3 million to €133 million (2017: €130 million). The rise in other administrative expenses was predominantly due to higher IT and marketing expenses.

Other net operating income went down by €4 million to €1 million (2017: €5 million).

Profit before taxes for the year under review amounted to €145 million. The small decrease of €3 million compared with the figure of €148 million reported for 2017 was a consequence of the factors described above.

At TeamBank, the **cost/income ratio** in 2018 was 50.8 percent (2017: 49.5 percent).

Regulatory RORAC was 31.8 percent (2017: 34.6 percent).

3.2.8 UMH

Net fee and commission income at UMH rose marginally, by 0.1 percent, to €1,416 million (2017: €1,415 million).

The change in net fee and commission income was predominantly due to the factors described below. Because of the rise in the average assets under management of the Union Investment Group, which climbed by €20.2 billion to €330.7 billion (2017: €310.5 billion), the volume-related contribution to net fee and commission income rose significantly compared with the prior year. It accounted for 89.0 percent of the net fee and commission income.

The assets under management of the Union Investment Group comprise the assets and securities portfolios measured at their current market value, also referred to as free assets or asset management, for which Union Investment offers investment recommendations (advisory) or bears responsibility for portfolio management (insourcing). The assets are managed both for third parties and in the name of the group. Changes in the managed assets occur as a result of factors such as net inflows, changes in securities prices, and exchange-rate effects.

In 2018, income from performance-related management fees was significantly lower than in the prior year. Income from real estate fund transaction fees saw a year-on-year decrease.

In the year under review, global capital markets were significantly more volatile than in the previous year as forecasts regarding global economic growth were scaled back as the year progressed and efforts around the world to introduce protectionist measures gained momentum. The latter included escalating international trade disputes, notably between the US and China, involving the growing imposition of customs tariff barriers and the UK's contractual agreement with the EU in November 2018 to leave the EU, although this agreement failed to attract parliamentary consent in the UK in a vote held on January 15, 2019. Furthermore, the formation of a populist government in Italy and its plans for significant expenditure programs led to considerable uncertainty in capital markets. To add to this, the ECB's decision to end its net bond-buying in full by the end of 2018 reduced the economic stimulus provided by its monetary policy.

In these challenging conditions, Union Investment once again managed to generate a significant level of net inflows from its retail business amounting to a total of €7.5 billion (2017: €9.9 billion).

The long-standing sales partnership with the local cooperative banks has played an exceptionally important role in this regard, the success of which is due to the close working relationship between the local cooperative banks and their customers on the basis of trust.

In a challenging environment with persistently low interest rates, Union Investment's investment solutions have proven to be products of choice for customers looking to supplement interest-related investments with material and intangible assets and exploit associated opportunities with the aim of generating adequate returns on the basis of broadly diversified, long-term investments.

In the year under review, there was a further rise in the popularity among customers of the Union Investment Group's six product variants offered in the innovative PrivatFonds series of products. The six different multi-asset solutions combine an asset structure in line with customer preference with a graduated risk profile tailored to the needs of each individual customer. Following net inflows of €3.0 billion in the year under review, the PrivatFonds portfolio had grown by 4.8 percent as at December 31, 2018 to €21.9 billion (December 31, 2017: €20.9 billion).

Traditional fund-based saving offers an attractive investment aimed at long-term capital accumulation. The number of fund-linked savings plan contracts had risen to 2.3 million by the end of the year under review, with an increase in the 12-month savings volume to €4.3 billion (December 31, 2017: €3.5 billion).

In addition, customers invested a total of €1.2 billion in 2018 in the fund-based Riester pension products (UniProfiRente and UniProfiRente Select) offered by the Union Investment Group. The total assets in the portfolio of Riester pension products swelled to €16.7 billion as at December 31, 2018 (December 31, 2017: €16.5 billion).

Business involving fund-based saving in regular installments continued to enjoy dynamic growth overall. This is demonstrated by the number of fund-linked savings plans managed by Union Investment in its retail business at the end of 2018, which totaled 4.9 million (December 31, 2017: 4.4 million). These plans included contracts under employee-funded capital formation schemes as well as the traditional savings plans and Riester pension contracts referred to above.

The open-ended real estate funds offered by the Union Investment Group are tried and tested as an intrinsic-value-based component of the investment mix. The three open-ended real estate mutual funds and the UniImmo:Wohnen ZBI fund launched in July 2017 generated net new business totaling €1.7 billion in 2018.

In its institutional business, the Union Investment Group generated net inflows amounting to €7.8 billion (2017: €15.2 billion). A total of 64 new institutional clients were gained in the reporting year.

The persistently low level of interest rates also demanded a special effort to manage the risk and returns in the institutional business. As in other areas, the diversification of the institutional client portfolio is therefore now well advanced. This is reflected in the structure of the investment accounts, which feature a greater number of asset classes and a broader allocation by country.

In 2018, demand was focused primarily on concentrated equity strategies, structured credit, and, in general, sustainable investment. As the pressure from institutional investors to generate returns is increasing, short-term investments were switched to products with higher returns.

Sustainability is becoming an indispensable investment strategy component for an ever greater number of institutional customers, although such investors are also increasingly focusing on economic criteria and not just, as in the past, solely on ethical, social, and environmental aspects. As a result of the constantly growing interest in sustainably managed funds, Union Investment's portfolio of such funds grew from €33.5 billion as at December 31, 2017 to €41.4 billion as at December 31, 2018.

The Union Investment Group's outstanding reputation as a professional risk and portfolio manager was particularly reflected in the popularity of capital preservation strategies, the invested volume of which amounted to €25.7 billion at the end of 2018.

The negative change of €31 million in **gains and losses on investments** to a net loss of €23 million (2017: net gain of €8 million) was largely attributable to lower realized gains than in 2017 on the sale of funds in Union Investment's own-account investing activities. The prior-year figure also included the reversal of an impairment loss in respect of the equity carrying amount for BEA Union Investment Management Limited, Hong Kong.

The €64 million decline in **other gains and losses on valuation of financial instruments** to a net loss of €51 million (2017: net gain of €13 million) can be explained by a negative contribution from the valuation of own-account investments and, above all, by higher losses related to the valuation of guarantee commitments compared to the previous year.

The rise in **administrative expenses** by €37 million to €895 million in 2018 (2017: €858 million) was for the most part attributable to an increase in other administrative expenses of €26 million to €489 million (2017: €463 million). The latter was caused primarily by higher expenses for external research services that Union Investment has been recognizing in its own books since the year under review. Staff expenses went up by €11 million to €406 million (2017: €395 million), mainly caused by average pay rises and appointments to new positions.

Other net operating income improved by €27 million to €30 million (2017: €3 million). The remeasurement of provisions gave rise to higher income in the reporting year.

Profit before taxes went down by €108 million to €502 million overall (2017: €610 million), primarily because of the changes described above.

The **cost/income ratio** in 2018 was 64.1 percent (2017: 58.4 percent).

Regulatory RORAC was greater than 100.0 percent (2017: greater than 100.0 percent).

3.2.9 VR LEASING

Net interest income at VR LEASING amounted to €153 million, which was an increase of 7.0 percent on the equivalent figure in 2017 of €143 million.

The growth in net interest income (excluding net income from long-term equity investments) largely resulted from an increase in the core business of

€11 million, which in turn was mainly attributable to a sharp rise in the volumes of the digital products 'VR Smart flexibel' (until July 2018: 'VR Leasing flexibel') and 'VR Smart express' (until July 2018: 'VR Leasing express'). This offset a slight drop of €3 million in net interest income from non-core business, which is being scaled back in accordance with the strategy. This non-core business includes real estate leasing, centralized settlement, IT leasing, hire purchase and leasing business with a value of more than €750,000, together with VR LEASING's factoring and international business. Contracts of sale had already been signed by the end of 2018 for the following businesses: real estate leasing (VR-IMMOBILIEN-LEASING GmbH), centralized settlement, and IT leasing (BFL Leasing GmbH). Siemens Finance & Leasing GmbH, Munich, is available to act as a partner for the cooperative banks in the case of individual transactions with an asset value of more than €750,000.

Net income from long-term equity investments rose slightly, by €2 million, compared with the equivalent prior-year figure. The contributory factors were an increase of €1 million in the net income from long-term equity investments relating to the unconsolidated property companies and also an increase of €1 million relating to the joint venture VB-Leasing International Holding GmbH, Vienna, (VBLI). The international activities of VR LEASING came to an end with the sale of VBLI (including the associated local companies) in September 2018.

In the year under review, the priority at VR LEASING was to continue the work to transform itself into a digital provider of finance for the self-employed and small businesses. In this regard, VR LEASING has been using the brand name VR Smart Finanz since July 2018 to present its core business of leasing, hire purchase, and lending up to an asset value of €750,000 in the marketplace. VR Smart Finanz serves as a decentralized partner for very simple solutions for small and medium-sized enterprises (SMEs), supporting the cooperative banks with automated financing solutions for leasing, hire purchase, and lending up to €750,000, digital services, and forward-looking intelligent data analysis in connection with day-to-day finance activities in omnichannel sales. This brand focuses on the self-employed and small businesses as well as on the lower end of the SME segment. Its strengths lie in reliable, digitally supported financing decisions made within just a few minutes.

This is made possible by the online tool VR LeasyOnline. The tool facilitates integrated, automated decision-making, enabling cooperative banks to come to a decision in real time on applications for finance up to an amount of €250,000 (up to €60,000 in the case of the 'VR Smart flexibel' business lending product and up to a total lending volume of €250,000 in the case of 'VR Smart express' asset finance). These solutions support the digital and digital/face-to-face sales channels. They help the cooperative banks provide their customers with a digital ecosystem of solutions and make use of the income potential offered by small-business and self-employed customers.

The growing importance of digitally supported financing solutions was underlined by the year-on-year rise of 17.6 percent (2017: 41.5 percent) in the volume of online business (leasing, hire purchase, and lending) transacted with the cooperative banks in the year under review. The proportion of total new business (leasing, hire purchase, and lending) accounted for by contracts concluded online declined slightly from 83.1 percent in 2017 to 81.8 percent in the reporting year.

Nevertheless, rapid market changes in the era of digitalization require solutions and processes to be refined and updated on an ongoing basis in order to keep up with the ever-shorter innovation cycles. That is why VR Smart Finanz's innovative online order channel is gaining significance: Small-business customers of the participating cooperative banks can now use an entirely online process via the website of their local cooperative bank at any time not only to apply for a business loan up to €60,000 but also to enter into the related agreement. The online order channel, which has been piloted since September 2017, continued to be rolled out in the year under review.

The digital services under the VR Smart Finanz brand have been enhanced to provide further components of a cooperative ecosystem. For example, December 2018 saw the market launch of the accounting software VR Smart Guide. This amalgamated the previous solutions SmartBuchhalter from VR Smart Finanz and VR FinanzGuide from DZ BANK into an even more powerful joint solution. VR Smart Guide provides digital support for small businesses and the self-employed, focusing on bookkeeping and financial planning. Further development work was also carried out on the Bonitätsmanager (credit status manager) application, which had been launched as a pilot project in 2017. The online application enables business people to check their own credit status and obtain information on how to optimize this status. The application was made available to businesses throughout Germany in 2018.

Net fee and commission income declined by €8 million to €7 million (2017: €15 million). The main reason for this change was the level of trailer fees to be paid to the cooperative banks, which climbed by €10 million to €25 million in line with the volume of business.

Gains and losses on investments amounted to a net gain of €22 million (2017: net gain of €10 million). The main item under gains and losses on investments in 2018 was the impact of the deconsolidation of VR-LEASING AG's equity-accounted 50 percent long-term equity investment in VBLI.

Administrative expenses rose by €6 million to €142 million (2017: €136 million). Within this total, staff expenses fell by €10 million to €77 million (2017: €87 million), mainly due to the reduction in the number of full-time equivalents. However, other administrative expenses increased by €16 million to €65 million (2017: €49 million), in particular because of higher consulting expenses in connection with VR LEASING's transformation into a digital provider of finance for the self-employed and small businesses.

In 2018, **other net operating income** amounting to a net expense of €26 million (2017: net expense of €39 million) included restructuring expenses of €17 million (2017: €52 million) in connection with the transformation into a digital provider of finance for the self-employed and small businesses.

VR LEASING generated a **profit before taxes** of €1 million in the year under review (2017: loss before taxes of €17 million), largely as a consequence of the factors described above.

The **cost/income ratio** in 2018 was 91.0 percent (2017: greater than 100.0 percent).

Regulatory RORAC was 0.2 percent (2017: minus 7.6 percent).

3.2.10 Other/Consolidation

The consolidation-related adjustments shown under Other/Consolidation to reconcile operating segment profit/loss before taxes to consolidated profit/loss before taxes are attributable to the elimination of intragroup transactions and to the fact that investments in joint ventures and associates were accounted for using the equity method.

The adjustments to net interest income were primarily the result of the elimination of intragroup dividend payments and profit distributions in connection with intragroup liabilities to dormant partners and were also attributable to the early redemption of issued bonds and commercial paper that had been acquired by entities in the DZ BANK Group other than the issuer.

The figure under Other/Consolidation for net fee and commission income largely relates to the fee and commission business of TeamBank and BSH with R+V.

The remaining adjustments are mostly also attributable to the consolidation of income and expenses.

4 Net assets

As at December 31, 2018, the DZ BANK Group's **total assets** had increased by €13.1 billion, or 2.6 percent, to €518.7 billion (December 31, 2017: €505.6 billion). This increase was largely attributable to a higher level of total assets at DZ BANK (up by €5.3 billion), R+V (up by €3.9 billion), and BSH (up by €3.3 billion).

The **return on assets**, which was calculated by dividing the net profit by the total assets at December 31, 2018, was 0.2 percent.

The **volume of business** amounted to €904,918 million (December 31, 2017: €871,114 million). This figure comprised the total assets, the assets under management at UMH as at December 31, 2018 amounting to €323,370 million (December 31, 2017: €323,919 million), the financial guarantee contracts and loan commitments amounting to €61,871 million (December 31, 2017: €40,505 million), and the volume of trust activities amounting to €944 million (December 31, 2017: €1,096 million).

The DZ BANK Group's **loans and advances to banks** rose to €91.6 billion, an increase of €2.2 billion or 2.5 percent. The corresponding prior-year figure has been restated (see note 02 in the notes to the consolidated financial statements). Loans and advances to banks in Germany went up by €1.2 billion to

€85.0 billion and loans and advances to foreign banks by €1.0 billion to €6.6 billion.

The DZ BANK Group's **loans and advances to customers** amounted to €174.4 billion, which was unchanged on the prior-year level.

Within this figure, loans and advances to customers in Germany rose by €5.9 billion to €145.9 billion, whereas loans and advances to customers outside Germany went down by €5.9 million to €28.5 billion.

As at December 31, 2018, **financial assets held for trading** amounted to €37.9 billion, a decline of €0.8 billion, or 2.0 percent, on the figure as at December 31, 2017. This change was mainly due to a fall in derivatives (positive fair values) (down by €1.5 billion), receivables (down by €0.7 billion), and shares and other variable-yield securities (down by €0.4 billion), although some of these decreases were offset by an increase in bonds and other fixed-income securities (up by €1.8 billion).

FIG. 4 – TOTAL ASSETS

Investments were down by €9.2 billion, or 16.0 percent, to €48.3 billion. The principal reasons were a decline of €8.9 billion in the portfolio of bonds and other fixed-income securities and a decline of €0.2 billion in the portfolio of shares and other variable-yield securities.

Investments held by insurance companies rose by €4.4 billion (4.6 percent) to €100.8 billion (December 31, 2017: €96.4 billion), above all due to a €4.0 billion increase in fixed-income securities to €48.9 billion and a €0.5 billion increase in registered bonds to €9.6 billion.

In the DZ BANK Group, **non-current assets and disposal groups classified as held for sale** amounted to €7.1 billion as at December 31, 2018, a rise of €7.0 billion compared with the figure as at December 31, 2017. This year-on-year change was largely attributable to two items. First, it consisted of an amount of €6.4 billion relating to credit portfolios at DVB in the aviation finance and land transport finance businesses and the wholly owned fully consolidated subsidiary LogPay Financial Services GmbH, Eschborn; these assets are to be sold by the end of 2019. Secondly, it consisted of an amount of €0.7 billion relating to two subsidiaries of VR LEASING classified as held for sale (BFL Leasing GmbH and VR-IMMOBILIEN-LEASING GmbH).

The DZ BANK Group's **deposits from banks** as at December 31, 2018 amounted to €142.5 billion, which was €6.4 billion, or 4.7 percent, higher than the figure reported as at December 31, 2017. Deposits from domestic banks were up by €4.1 billion to €128.8 billion, while deposits from foreign banks increased by €2.3 billion to €13.7 billion.

Deposits from customers grew by €6.2 billion, or 4.9 percent, to €132.5 billion (December 31, 2017: €126.3 billion). Deposits from domestic customers increased by €5.0 billion to €117.0 billion (December 31, 2017: €112.0 billion). Deposits from foreign customers rose by €1.2 billion to €15.5 billion (December 31, 2017: €14.3 billion).

At the end of the reporting year, the carrying amount of **debt certificates issued including bonds** in the DZ BANK Group was €63.9 billion (December 31, 2017: €67.3 billion). The contraction of €3.4 billion was largely due to a decline of €3.8 billion in the portfolio of other debt certificates issued to €12.9 billion, although, at the same time, the portfolio of bonds issued grew by €0.4 billion to €51.0 billion.

Financial liabilities held for trading went up by €0.7 billion, or 1.6 percent, to €45.0 billion (December 31, 2017: €44.3 billion). Increases in bonds issued (up by €1.5 billion) and in short positions (up by €0.5 billion) more than offset the fall in derivatives (negative fair values) (down by €0.7 billion) and in liabilities (down by €0.6 billion).

Insurance liabilities increased by €3.9 billion, or 4.4 percent, to €93.2 billion (December 31, 2017: €89.3 billion). This was largely attributable to rises of €3.0 billion in the benefit reserve and €1.0 billion in the provision for claims outstanding.

As at December 31, 2018, the **equity** reported by the DZ BANK Group was unchanged at €23.5 billion

(December 31, 2017: €23.5 billion). While retained earnings increased (up by €0.9 billion), there was a decline in both the reserve from other comprehensive income (down by €0.8 billion) and non-controlling interests (down by €0.1 billion).

The **capital and solvency situation** of the DZ BANK financial conglomerate, the DZ BANK Group, and the R+V Versicherung AG insurance group is described in this group management report in chapter VI (Combined opportunity and risk report), section 7.3 (Regulatory capital adequacy).

5 Financial position

Liquidity management for the entities in the DZ BANK Group is carried out by the Group Treasury division at DZ BANK and on a decentralized basis by the individual subsidiaries. The individual entities are provided with funding by DZ BANK (group funding) or the entities exchange cash among themselves via DZ BANK (group clearing). Liquidity is managed within DZ BANK centrally by head office treasury in Frankfurt and by the associated treasury units in its international branches, although Frankfurt has primary responsibility.

In the context of liquidity management, the DZ BANK Group distinguishes between operational liquidity (liquidity in the maturity band of up to one year) and structural liquidity (liquidity in the maturity band of more than one year). Dedicated steering committees have been established for both types of liquidity.

The DZ BANK Group has a highly diversified funding base for **operational liquidity**. A considerable portion is accounted for by money market activities resulting from the cash-pooling function with the local cooperative banks. This enables local cooperative banks with available liquidity to invest it with DZ BANK, while local cooperative banks requiring liquidity can obtain it from DZ BANK. Traditionally, this results in a liquidity surplus, which provides the main basis for short-term funding in the unsecured money markets. Corporate customers and institutional clients are another important source of funding for operational liquidity requirements. The DZ BANK Group therefore has a comfortable level of liquidity at its disposal. Funding on the interbank market is not strategically important to the DZ BANK Group.

The DZ BANK Group issues money market products based on debt certificates through its main branches in Frankfurt, New York, Hong Kong, London, and Luxembourg. DZ BANK has initiated a standardized groupwide multi-issuer euro commercial paper program, which DZ BANK and DZ PRIVATBANK S.A. can draw on.

Money market funding also includes collateralized money market activities, which form the basis for broadly diversified funding on money markets. To this end, key repo and securities lending activities, together with the collateral management process, are managed centrally in DZ BANK's Group Treasury division. Group Treasury also has at its disposal a portfolio of investment-grade liquid securities. These securities can be used as collateral in monetary policy funding transactions with central banks, in bilateral repos, or in the tri-party repo market.

Structural liquidity activities are used to manage and satisfy the long-term funding requirements (more than one year) of DZ BANK and, in coordination with the group entities, those of the DZ BANK Group.

Both for the DZ BANK Group and each individual group entity, structural liquidity is measured daily on the basis of total cash flows.

DZ BANK secures its long-term funding for structural liquidity by using structured and non-structured capital market products that are mainly utilized for the local cooperative banks' own-account and customer-account securities business and marketed to institutional clients. Long-term funding that is not covered is secured through systematic integration between the entities in the DZ BANK Group. Options for obtaining covered liquidity through Pfandbriefe or DZ BANK BRIEFE are used on a decentralized basis, in other words based on the different cover assets at DZ BANK, DZ HYP, and DVB.

Long-term funding requirements in foreign currencies are covered through the basis swap market, ensuring matching maturities.

The Group Treasury division at DZ BANK carries out groupwide **liquidity planning** annually. This involves determining the funding requirements of the DZ BANK Group for the next financial year on the basis of the coordinated business plans of the individual companies. Liquidity planning is updated throughout the year.

Monthly **structural analyses** of the various resources available on the liabilities side of DZ BANK's balance sheet are also conducted. The purpose of these analyses is to provide senior management with information that can then be used as the basis for actively managing the liability profile.

To complement the description of the funding structure, further information on **liquidity risk** can be found in this group management report in chapter VI (Combined opportunity and risk report), section 6.2 (Economic liquidity adequacy). The year-on-year changes in cash flows from operating activities, investing activities, and financing activities are shown in the **statement of cash flows** in the consolidated financial statements. Contractual cash inflows and cash outflows are set out in the **maturity analysis** in note 84 of the notes to the consolidated financial statements.